PRIVATE PENSION EXPANSION IN THE EU: OBSTACLES AND OPPORTUNITIES

By Pınar Çebi and Margo Thorning,
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INTRODUCTION

Policymakers around the world are concerned about their country's pension systems and are constantly trying to reform the current systems to meet the needs of increasingly aging populations, tightening budgets and increased movement of workers across international boundaries. Many countries are either moving away from state sponsored, pay-as-you-go (PAYG) pension models or complementing the existing system with additional tiers. The success of these reforms in meeting these goals is still an important question. This report investigates the current retirement systems across countries and shows the worldwide trends in pension reform.

THE REASONS FOR REFORM

There are a number of reasons for the adoption of new pension systems but the most important of these is, no doubt, the demographic challenges faced by most countries. The following table shows estimates of the percentage of the population over sixty years old and the ratio of population aged 20 to 59 to the population over 60 years old for the next 40 years for selected countries.

As can be seen from the Table 1, the problem of aging population is grave; especially for the European Countries. The decrease in mortality and fertility rates and rising life spans are the biggest contributors to aging population. These numbers are very important for

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pension systems. The old PAYG systems began to look risky both for future retirees and governments due to the decrease in the ratio of working age population to the population over 60 years old. For example, in the original 15 European Union

TABLE I

Demographic Projections for Individual Countries						
	Percentage of the Population Over 60 years old			Population aged 20 to 50/ Population over 60 years old		
	2010	2030	2040	2010	2030	2040
Argentina	14.1	17.9	21.3	3.8	3	2.4
Australia	19.3	28.1	30	2.9	1.7	1.6
Belgium	23.9	32.6	33.4	2.3	1.4	1.3
Brazil	9	15.9	19.4	6.3	3.5	2.7
Canada	20.3	31.4	32.4	2.8	1.5	1.4
Chile	12.6	20.9	23.4	4.4	2.5	2.2
China	11.9	21.7	24.8	5	2.4	2
Denmark	23	29.3	30.2	2.3	1.6	1.5
France	22.5	30	31.5	2.4	1.6	1.5
Germany	25.1	36.3	37.6	2.3	1.2	1.1
India	8.6	13.5	16.5	6.3	4.1	3.3
Indonesia	8.4	14.5	18.6	6.7	3.8	2.9
Italy	26.1	35.6	39.2	2.1	1.3	1.1
Japan	29.8	34.9	37.6	1.7	1.3	1.1
Mexico	8.1	14.5	19	6.7	3.9	2.8
Netherlands	22.3	32.5	33.4	2.5	1.4	1.3
Poland	18.2	25.2	27.7	3.2	2.1	1.8
Singapore	14.5	30.5	31.2	4.1	1.5	1.5
Sweden	25.9	31.8	32.2	2	1.5	1.4
United Kingdom	23.3	30.1	30.8	2.3	1.6	1.5
United States	18.8	27.7	28	2.9	1.7	1.7
EU 15	23.2	31.4	33.5	2.4	1.5	1.4
EU 10 (New Members)	20.8	27.7	30.5	2.8	1.8	1.6

Source: Robert Palacios and Montserrat Pallares-Miralles, "International Patterns of Pension Provision" (World Bank, April 2000).

countries, this ratio is expected to decrease from 2.4 in 2010 to 1.5 in 2030 and to 1.4 in 2040. These numbers indicate a large tax burden for future retirees if there is no action on the government side to correct the system. It is also a big burden for governments in the form of staggering fiscal costs. According to projections by the Center for Strategic and International Studies (CSIS), if current trends continue, public retirement spending could grow to 23 percent of GDP in the typical developed country.[1] So there will be a definite solvency problem with existing PAYG systems in many countries.

The second biggest concern about the pension system is inadequate saving by workers. For example, in the United States many households remain unaware of the need for further retirement saving. Although financial experts believe that retirees will need at least 70 to 80 percent of their pre-retirement income in order to maintain their current living standards, many households expect to get by on much less. According to the 2002 Retirement Confidence Survey conducted by the Employee Benefit Research Institute and the American Saving Education Council, 17 percent of workers who participated in the study expect that they will need less than half of their pre-retirement income. In fact, only 32 percent of those surveyed have tried to calculate how much money they will need to save. Another survey carried out for the German Institute for Pension Provision showed that a high proportion of the population is under the illusion that they need not worry about their retirement: 50 percent of those questioned said that they had made adequate provision for retirement.[2]

The third annual Global Financial Well-Being Study conducted by Principal Financial Group in 2004 shows the flip side of the story: "The study's participants are so pessimistic that only a minority (22%) is very confident that they will have enough money to pay for basic expenses – food, shelter, and clothing – during retirement. Moreover, the percentage of respondents who foresee a worsening standard of living in retirement has actually increased between 2003 and 2004 in eight out of 12 countries surveyed."[3, 4]

The existing PAYG system exacerbates this situation. According to Harvard University Professor Martin Feldstein, PAYG systems discourage personal saving. This conclusion

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[1] Richard Jackson, "The Global Retirement Crisis: The Threat to World Stability and What to Do About It," (Washington, D.C.: Center for Strategic and International Studies, April 2002).
[2] Daniel Bogler, "Germany's Big Pensions Idea", in Financial Times, July 24, 2002.
[3] 12 countries are Brazil, Chile, China, France, Germany, Great Britain, Hong Kong, India, Italy, Japan, Mexico and the United States.
[4] The Principal Global Financial Well-Being Study, 2004, News Release, Paragraph 1. (http://www.principal.com/about/news/gwbs061704.htm)

is further supported by the CSIS study which found other negative impacts of the system: PAYG retirement systems penalize work and offer participants a poor deal on their contributions.[5] In the United States, the typical single male retiring in 1960 earned a return of 11 percent on his Social Security payroll taxes. By 1980 this number had fallen to 4.2 percent, today it is around 1.6 percent.[6]

THE WORLDWIDE TREND IN PENSION REFORMS:

Governments, alarmed by current demographic trends, are taking actions to fix their retirement systems. For starters, many countries are using a pension reform approach which might include a combination of an unfunded mandatory tier, a funded mandatory tier, and a voluntary private tier. When considering alternative reform choices, governments have the option of choosing private or public management of the funded systems. The pros of private systems compared to public systems are:

- Existing evidence indicates that privately managed pension systems contribute to the development of capital markets, lower the cost of capital, lower security price volatility, and lead to higher traded volumes. According to Augusto Iglesias, fully funded pension systems may imply a decrease in the cost of funds for firms because of the type of financial savings, as opposed to other types of wealth such as real estate, gold, land and others. Focusing on reforms in Chile, Argentina, and Peru, Eduardo Walker and Fernando Lefort found evidence that pension fund investment in stocks is associated with reduced responsiveness to external shocks in all countries.[7] They also found the evidence of increased liquidity and decreased transaction costs.
- Privately managed pension systems increase investment, thus reinforcing economic growth and productivity. Furthermore, the generation of financial resources through pension reforms, could play a key role in the further

[5] Richard Jackson, "The Global Retirement Crisis: The Threat to World Stability and What to Do About It," Center for Strategic and International Studies, April 2002. p.5

[6] Richard Jackson, "The Global Retirement Crisis: The Threat to World Stability and What to Do About It," Center for Strategic and International Studies, April 2002. p.24

[7] Eduardo Walker and Fernando Lefort, "Pension Reform and Capital Markets: Are There Any Hard Links?", December 2001

development of less developed countries. This might be crucial for the ten new EU countries.

- Returns under private pensions are higher than under PAYG systems. According to calculations done by Iglesias and Palacios using IMF IFS statistics for a set of countries, while the difference between real annual private pension fund returns and the real income per capita growth on average is around 4%, the number is around –8.4% for the difference between real annual compounded publicly managed pension fund returns and real income per capita growth in selected countries.[8] This illustrates the low replacement rate of publicly managed systems.
- Political risk under privately managed pensions is lower compared to traditional social security systems.

A major consideration in establishing private systems is the high administration costs. However, as shown by William G. Shipman of the Cato Institute, it is possible to keep the administrative costs in a market-based system low because of constantly improving technologies such as the internet[9]. In addition, as the pension system expands, these costs may be reduced due to economies of scale. There are also concerns about the negative effects of the new system on income inequality, especially between low- and high-income earners.

WHERE DO THE COUNTRIES STAND?

Chile was the first country to replace its public pension system with a mandatory individually fully funded scheme. Later on, the Chilean experience provided a blueprint for other countries. According to Jose Pinera, the growth rate of the Chilean economy doubled from its historical level to 7 percent a year. Since 1981, pension assets in Chile have grown to be around 50 percent of GDP[10]. Given these facts, it is no surprise that privatization of pensions began to be perceived as an important ingredient of macroeconomic strength. As a result, in 1990's the Chilean reform had a domino effect both in Latin America and Eastern Europe in the form of full or partial pension

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[8] Augusto Iglesias and Robert J. Palacios, " Managing Public Pension Reserves: Part I Evidence from the International Experience" World Bank, January 2000.
[9] William G. Shipman, "Retirement Finance Reform Issues Facing the European Union" CATO Institute, January 2003.
[10] Jose Pinera, 2001, "Liberating Workers: The World Pension Revolution" Cato Institute, pg.2.

privatization. Many of these reforms are not perfect but they are the right steps towards a more certain future.

While Latin American and Eastern European politicians are undertaking bold reforms in their countries, their counterparts in the developed world are moving more slowly. Their actions are far from enough. A recent study[11] by CSIS presents an assessment of the capacity of twelve developed countries to meet the aging challenge using an aging vulnerability index. The novelty of this study is its ability to provide comparisons across countries. The index is prepared by using four main indicators in order to show the vulnerability of chosen developed countries. These indicators are:

- Public-burden indicators (public spending burden in each country).
- Fiscal-room indicators (how well each country can accommodate the growth in old-age benefits via higher taxes, cuts in other spending, or public borrowing).
- Benefit dependence indicators (how dependent the elderly are on public benefits).
- Elder affluence indicators (the relative affluence of the old versus the young).

The results are presented by Table II:

Table II

Aging Vulnerability Index 2003 Edition (Rankings from Least to Most Vulnerable)	Low Vulnerability	1	Australia
		2	United Kingdom
		3	United States
	Medium Vulnerability	4	Canada
		5	Sweden
		6	Japan
		7	Germany
		8	Netherlands
		9	Belgium
	High Vulnerability	10	France
		11	Italy
		12	Spain

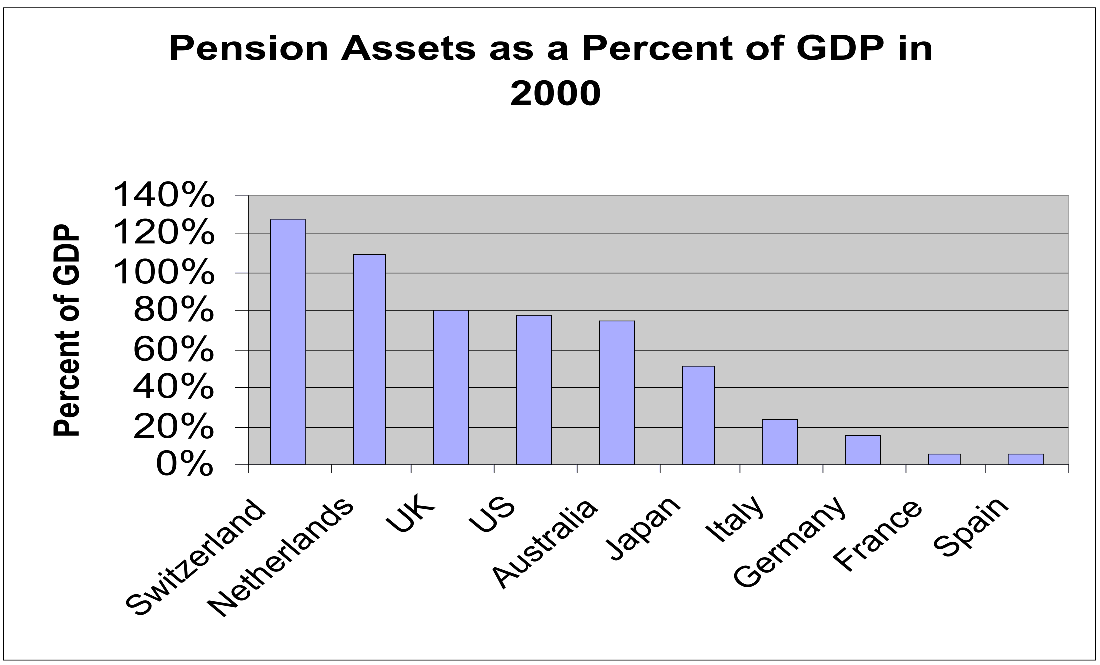
Source: Richard Jackson and Neil Howe, "The 2003 Aging Vulnerability Index", CSIS and Watson Wyatt Worldwide, March 2003, pg.iii.

This index sorts countries into three groups: Low, medium and high vulnerability. When we compare the vulnerability index with private pension ownership across the countries,

[11] Richard Jackson and Neil Howe, "The 2003 Aging Vulnerability Index", CSIS and Watson Wyatt Worldwide, March 2003.

it looks as if there is a close relationship. Figure I shows pension assets as a percentage of GDP in 2000 for some developed countries. In the vulnerability index Australia, U.K., and U.S.A. share the first three places, mainly thanks to their well developed private retirement systems. Within this group, pension assets as a percentage of GDP range from 75% to 81%. Although this group is not problem free, they are in much better shape than other countries in the group. In the case of Australia, the implementation of the Superannuation Guarantee with mandatory private pension coverage promises excellent results. The reformed private pension system is projected to raise national saving by 3.6 percent of GDP by the year 2020[12]. The United Kingdom has also undertaken structural

Figure I



Source: International Pension Fund Indicators 2001 (UBS Asset Management, 2002)

reform in its public pension system. According to Jose Pinera[13], two thirds of British workers contributed to private funds. In the United States, the popularity of private

[12] Hazel Bateman and John Piggott, "Australia's Mandatory Retirement Saving Policy: A View from the New Millenium".
[13] Jose Pinera, 2001, "Liberating Workers: The World Pension Revolution" Cato Institute.

pension assets takes the form of defined contribution plans due to their easier portability and lower costs.[14]

The story is different for other countries. Political resistance against reforms or slow action in the rest of the developed countries increases their vulnerability against the "old-age time bomb". Although Germany has taken the first steps towards private retirement accounts, the results so far have not been been good, mainly because of the complicated bureaucracy and high regulations. As a result of these barriers eligible workers have failed to sign up for the new pensions. According to figure 1, total private pension assets in Germany amounted to just 15 percent of GDP in 2000, far less than many other European countries. However, three countries, France, Italy and Spain, are doing far worse than Germany and they are included in the high vulnerability group. Their weaknesses come from a combination of unfavorable demographics, very generous benefit formulas, early retirement, and heavy dependence on PAYG systems. For example, in the case of France, replacement rates in the pension system range from 60 percent for high wage workers to almost 100 percent for low wage workers[15]. The current system can not support these lavish returns. The French government, however, has been slow to take action. The situation is no better in Italy and Spain. Although the European Commission adopted the "open method of coordination" in order to speed up the progress of pension reform, the process seems to be insufficient given the measures undertaken by most of the European countries. In addition, there is still one important instrument missing for the European economic integration: a pension system that allows for full labor mobility across professions and states.

GOALS FOR PENSION REFORM AND EXPANSION IN THE EU

Europe is far from its goal of a harmonized economy. One basic ingredient of this target is a reformed pension system which is feasible for all European countries. According to

[14] Alicia H. Munnell, Annika Sunden and Catherine Taylor, "What Determines 401(k) Participation and Contributions," Center for Retirement Research, Boston College, December 2000, WP #2000-12

[15] Robert Holzman, Landis MacKellar and Michal Rutkowski. 2003 "Accelerating the European Pension Reform Agenda: Need, Progress, and Conceptual Underpinnings" in Pension Reform in Europe: Process and Progress (eds Robert Holzman, Mitchell Orenstein and Michal Rutkowski), pg 29.

Robert Holzmann[16] of the World Bank, the new and improved pension system in Europe should include the following characteristics:

- Unrestricted mobility between professions, sectors, and regions.
- Consistency with the European concept of solidarity.
- Enough space for countries to use their own national preferences for target levels of benefits or contributions.
- Feasibility of transmission from current national system to the proposed future system.

The recently approved directive of the European Parliament on the activities of institutions for occupational retirement provision is especially designed to deal with the issues mentioned above.

Besides these important points mentioned by Holzmann, there are some other points that should be taken into consideration, given the demographics and the current pension system:

- The new system should increase the average retirement age by offering suitable incentives to remain at work. For example, the current lavish replacement rates that are mentioned in previous sections encourage most European workers to retire earlier, increasing the burden on both the current and future workers.
- In most of the countries, introduced reforms are more complex and impose more rules on the system, thus preventing the spread of private funds among the population. An ideal pension system should have fairly simple and stable rules which can be used universally given labor migration between the countries.
- Given the importance of retirement savings and the lack of public knowledge about the issue, governments should try to improve the financial literacy of their constituents. It is well known that the workplace is the primary medium for reaching most workers. Employers should be encouraged to offer personal finance courses in the workplace by granting incentives such as a tax deduction for the cost of such education.

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[16] Robert Holzman, "Toward a Reformed and Coordinated Pension System in Europe: Rationale and Potential Structure". Social Protection Discussion Paper No. 0407. (Washington, D.C: World Bank, March 2004).

- Employer-sponsored retirement plans play a key role in retirement security. Plan sponsorship among small and medium sized employers should be encouraged by allowing for a tax credit to offset the costs of setting up new plans and both employers and employees should be educated about the benefits of such plans.

Actions should be taken quickly since there will be greater political obstacles in the future given that a bigger portion of the political power will belong to the population over sixty years of age.

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