

# ETUI Policy Brief

## European Economic and Employment Policy

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### Public and private pensions: Lessons from the crisis

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#### Policy implications

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The population of Europe is ageing and, as a result, pension systems are exposed to major difficulties. This requires measures to increase employment rates, to prolong working lives, promote qualified migration, and to curb, to some extent, income replacement rates. Private pension systems are, just like the public ones, dependent on adequate economic growth rates, as well as being equally sensitive to demographic change; what is more, unlike public systems, they are highly risk-susceptible in relation to financial markets. It is far from clear that there are economically sound reasons for giving them public support or even tax relief, especially in countries with a strong and fully developed public system. In those countries where private

schemes are already widespread careful monitoring is required. The social partners must have a substantial say in the design of whatever arrangements are used. We are going to have to pay more for the older members of our societies (or to put it more correctly, for our own old age) but the much lower-risk approach is to secure old-age pensions via public systems.

#### Introduction

The population of Europe is ageing and, as a result, pension systems are exposed to major difficulties. For these systems to remain sustainable requires real GDP growth rates of above 2.5% as well as urgent reforms designed to adjust to demographic change. This means, in the main, measures to increase employment rates, to prolong working lives and to curb, to some extent, income replacement rates. Because the main focus of discussion is public systems, large numbers of people, especially the young, believe that it is much safer to invest in private pensions: you save your own money and when you are old you can reap your investments plus interest.

This view completely disregards the risks inherent in private pension systems. These systems are, just like the public ones, dependent on adequate growth rates, as well as being equally sensitive to demographic change; what is more, unlike public systems, they are highly risk-susceptible in relation to financial markets. The financial crisis has revealed these risks all too clearly but the crisis is easily and quickly forgotten.

Nevertheless, the risks still exist - they are not an occasional phenomenon but are inherent in funded systems, and more so in private systems which have less safety nets than public ones. Moreover, contrary to popular opinion, private systems are not cheaper than public ones if they are to provide the same benefits. The prevailing ill-informed and uncritical opinions surrounding private pensions need to be challenged. Otherwise, not only are people in for massive disappointments but they also run the risk of experiencing poverty in their old age.

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Table 1: Percentage contribution of components of the obligatory pension system to weighted average pension wealth

	Public redistributive tier	Public	Insurance tier	
			Private DB	Private DC
Belgium	4.4	95.5		
Denmark	40.1			59.7
Germany	1.5	98.5		
Finland	2.9	97.1		
France	4.7	95.3		
Greece		100.0		
Ireland	100.0			
Italy		100.0		
Luxembourg	16.0	84.1		
Netherlands	41.2		58.8	
Austria		100.0		
Poland	1.5	48.2		50.3
Portugal	1.8	98.2		
Sweden	4.5	52.6		42.9
Slovakia	0.3	44.9		54.8
Spain	1.2	98.8		
Czech Republic	17.1	82.9		
Hungary		65.9		34.1
United Kingdom	87.1	12.9		

Source: OECD 2009b, Pensions at a Glance. p 133.

## Private pensions and the financial crisis

Pension systems in Europe are predominantly publicly organised. Table 1 (which excludes purely voluntary schemes) shows that there are some countries with obligatory or quasi-obligatory strong private defined-contribution (DC) schemes, while the Netherlands has an obligatory private defined-benefit (DB) scheme. In general, however, private pensions in Europe serve essentially to complement public ones. This is clear from Table 2 which shows that public expenditure on pensions by far exceeds private expenditure in this area.<sup>1</sup>

Nevertheless, in the OECD taken as a whole, private pension systems have reached tremendous proportions in absolute terms. In 2007 US-\$ 28 trillion were accumulated in private pension systems in the OECD area. The OECD-weighted average ratio of private pension assets to the area's GDP reached 111% in 2007. There are large differences between OECD countries. While the ratio is 149% of GDP in the Netherlands and 124% in the United States, it is only 7% in France and less than 4% in Italy. This definition comprises a wide scope of different systems: from both mandatory and voluntary employment-based systems (either defining contributions or defining benefits) to individual retirement arrangements. All have in common the principle of asset accumulation or book reserve financing but they entail very different risks.

In the 1990s private pension assets grew mainly in the United States, a development largely induced by the introduction of

Table 2: Public and private pension expenditures in selected OECD countries, 2006 as a percentage of GDP

Country	Public expenditure	Private expenditure
Austria	12.1	0.2
Belgium	8.1	1.3
Czech Republic	7.2	0.3
Denmark	4.8	4.2
Finland	1.1	9.2
Germany	11.7	0.1
Hungary	8.1	0.1
Italy	12.0	0.3
Netherlands	5.4	3.6
Norway	4.4	1.4
Poland	10.4	0.0
Portugal	7.5	1.0
Spain	7.8	0.6
Sweden	7.7	1.1
Switzerland	6.7	5.5
United Kingdom	7.5	3.1

Source: OECD 2009a, Private Pension Outlook, p 142.

<sup>1</sup> For each country other values can be found and the OECD calculations are subject to much discussion. Nevertheless, it was decided to use them here as they provide the possibility of international comparison.

publicly supported private pension plans (401(k)). Since 2000 Europe has been following a similar trend. Stock prices rocketed and this was correlated with a massive expansion of private pension plans. At the same time assets were shifted from low-risk bonds to high-risk stocks and shares.

Financial assets held by investors in the OECD are heavily pension-oriented. As much as 60% of the total volume of assets held by institutional investors worldwide has as its main purpose the financing of retirement benefits (OECD 2009a, 39).

**Table 3: Total private pension assets, 2007  
As a percentage of GDP**

Country	2007
Austria	18.8
Belgium	14.4
Czech Republic	4.7
Denmark	140.6
Finland	78.1
France	6.9
Germany	17.9
Greece	0.0
Hungary	10.9
Ireland	93.6
Italy	3.6
Netherlands	149.1
Norway	54.5
Poland	12.2
Portugal	26.0
Slovak Republic	4.2
Spain	12.1
Sweden	57.4
Switzerland	151.9
United Kingdom	96.4
United States	124.0
Total OECD	111.0

Source: OECD Global Pension Statistics and OECD estimates. OECD 2009a, 44.

This development entailed a huge crash potential and the financial crisis threw back pension funds by five years. By October 2008 the total assets of all pension funds in the OECD had declined by about US-\$ 3.3 trillion, or nearly 20%, relative to December 2007. Including other private pension assets, such as those held under personal plans in the United States and in other countries, brings the loss to about USD 5 trillion (OECD 2009, 15 – OECD published this Private Pension Outlook in February 2009, therefore there are no more recent numbers on the aggregate effect of the crisis on pension funds worldwide). Even funds having a well-balanced portfolio lost on average 17% (Whitehouse 2008, 1).

Financial crises are self-reinforcing. When firms have difficulty in meeting their pension obligations there is, on the one hand, a reaction on the financial markets: reduced profits mean worse debtor-ratings and, as a consequence, higher credit costs. On the other hand, problems also arise in the real economy where additional or unplanned payments for pension obligations mean less money available for wages and for important investments in equipment and research. This reduces firms' chances in the future, thereby generally enlarging the financial gap in pension obligations.

There are many examples of how firms tried to exit this vicious circle that is rather reminiscent of compulsive gambling practices. For example, the Chicago Transit Authority realized that there was too little money in their pension plans – they were underfunded by 62%. They therefore issued \$ 1.9 billion in bonds, promising 6.8% percent return, expecting that they would be able to invest the sales incomes at 8.75% interest. In actual fact, the proceeds of the bond sale earned a 2% return and, before the year ended, the pension fund was paying out more to bondholders than it was earning on its new influx of money. Instead of closing its funding gap, the CTA was falling further behind (Evans 2009).

Nevertheless, lobbying for private pensions continues as there is so much money in this market. The question that has to be asked is therefore: do private pensions just need a little bit of regulating to prevent another crisis or do private systems have systematic disadvantages compared to public ones? Below, this question is analyzed for different variables.

## The sustainability of private and public schemes

### Growth

Each pension system, regardless of its concrete implementation, needs economic growth. Growth has slowed down in western Europe but long-term projections issued by the European Commission nevertheless show that, if productivity grows moderately and labour participation increases, public pension systems are sustainable. The EU 2009 Ageing Report shows that, if pension reforms (which have been introduced in most European countries) produce the intended results, no further policy change is required to achieve sustainability – provided that productivity growth remains at least at 1.1% p.a. on average and employment rates increase to 70% by 2060.

Under realistic assumptions concerning growth and productivity, public pension expenditure in the EU as a whole will grow from today's 10.2% of GDP to 12.6%. Different countries have different developments, depending on the state of reforms and other parameters, but, generally speaking, in no country is the situation running out of control.

It is not always realized that, ultimately, the retired population consumes goods and services which are produced by the working population, regardless of the actual source of income for retirees.

Table 4: Projected public pension expenditure in % of GDP

	2007	2010	2020	2030	2040	2050	2060
EU27	10.2	10.2	10.5	11.4	12.1	12.4	12.6
Belgium	10.0	10.3	11.8	13.9	14.6	14.7	14.7
Czech Republic	7.8	7.1	6.9	7.1	8.4	10.2	11.0
Denmark	9.1	9.4	10.6	10.6	10.4	9.6	9.2
Germany	10.4	10.2	10.5	11.5	12.1	12.3	12.8
France	13.0	13.5	13.6	14.2	14.4	14.2	14.0
Italy	14.0	14.0	14.1	14.8	15.6	14.7	13.6
Hungary	10.9	11.3	11.0	11.0	12.2	13.2	13.8
Netherlands	6.6	6.5	7.8	9.3	10.3	10.3	10.5
Austria	12.8	12.7	13.0	13.8	13.9	14.0	13.6
Poland	11.6	10.8	9.7	9.4	9.2	9.1	8.8
Sweden	9.5	9.6	9.4	9.5	9.4	9.0	9.4
United Kingdom	6.6	6.7	6.9	7.6	8.0	8.1	9.3

Source: European Commission: The 2009 Ageing Report, Table 47.

This means that real growth is needed for private systems too. In other words, to convert affordable savings into comfortable retirements depends on investments delivering strong and stable returns over the long run, which requires economic growth.

Public systems are, in general, more growth-supporting than private ones, insofar as they act counter-cyclically. In times of financial crisis public systems act as safety nets keeping up domestic consumption. In private systems there is both the risk of incomes and consumption dropping at the same time as the financial markets and of firms getting into difficulties because during a crisis they cannot afford to pay their contributions. In defined contribution systems these risks are mainly a burden upon firms, while in defined benefit systems these are risks carried by the individual.

### Demography

One of the big misunderstandings regarding private systems is the assumption that they are demography-resistant. This is incorrect. When looking at a single savings plan, there is the problem that longer life-expectancy will automatically lead to lower monthly benefits. This problem is multiplied when the whole population of retirees is considered. At the present time most private systems are still building up their assets. In other words, large volumes of contributions are coming in while significantly fewer benefits are being paid out. This situation will change when the systems mature. For example, in the year 2030 many baby-boomers will be retired, while there will be fewer working people. Pension plans have to be liquidated but, as there are more sellers than buyers, asset prices can be expected to go down and thus the value of the outstanding saved assets will deteriorate.

There are no reforms or measures really able to assuage this problem. The demographic burden will have to be paid for

and the trick is going to be to distribute this burden evenly. Some countries (Sweden, for example) try to solve the problem by a so-called balance mechanism, according to which the benefits paid out cannot exceed the contributions coming in. Such a mechanism may be fiscally sustainable, but it does not meet the requirement of fair distribution as the burden is placed solely on retirees. Thus, in long-term projections, public contributions to these systems by definition do not increase. The working population will not have to pay more, but retirees will receive ever less. It is very questionable whether this will be a sustainable development in the long run.

The solution will consist in finding ways of increasing the number of working years and raising labour market participation. Qualified migration is also an important element of sustainability of pension systems.

### The risks of the financial markets

Private pension systems face more manifold and more complex risks than public systems. In addition to macroeconomic risks (which are relevant for public systems too), there are also market risks, strategic and management risks and implementational risks.

The experience of Enron or of the employees of the Maxwell empire shows the scope of management and implementation risks. To depend on private pension plans from a single employer means risking mismanagement and even fraudulent practices.

But even if everything is above board there are huge market risks. These appear in different forms depending on whether the system is defined contribution or defined benefit. Collective, defined benefit systems in which social partners have their voice are usually less risk-prone for retirees than individual plans.

The volatility of financial markets has increased tremendously in the last two decades. Investing in financial markets is thus something of a lottery. While there is a chance of winning, participants do not usually receive as much as they expected. While this aspect is of course more inherent in defined contribution systems, defined benefit systems also entail risks for retirees (i.e. when firms get into financial troubles).

Pension funds and other private pension plan institutions have promised high returns. But in recent years (and not only due to the financial crisis) these expectations have been shown to be completely unrealistic. For example the biggest US pension fund Calpers (California Public Employees' Retirement System) published 7.75% as its annual expected returns for the last eight years. In reality it reached 3.32%. Similarly, the Teacher Retirement System of Texas published expected returns of 8% and realised only 2.6% (Evans 2009).

The goal of high returns increases the volatility of investments and supports short-term shareholder interests more than investing in low-risk long-term sustainable assets. Nobody can know for sure what will be the value of saved assets at the time of retirement. What is certain is that those currently within five to ten years of retirement will find it hard to recover the losses suffered as a result of the financial crisis. Moreover, if average returns in the long run are only about 2.5 to 3 percent the question arises: why not rely on much less risky public pay-as-you-go systems? These average returns are equal to the long-term projected growth rates in public systems.

In defined contribution systems there is the risk of the exact date of entrance upon retirement leading to massive differences in retirement incomes. The Center for Retirement Research at Boston calculated that a person retiring in October 2000 with an inflation-adjusted annuity would have had a replacement rate almost twice as high as someone retiring in October 2008 (Munell 2009, 5).

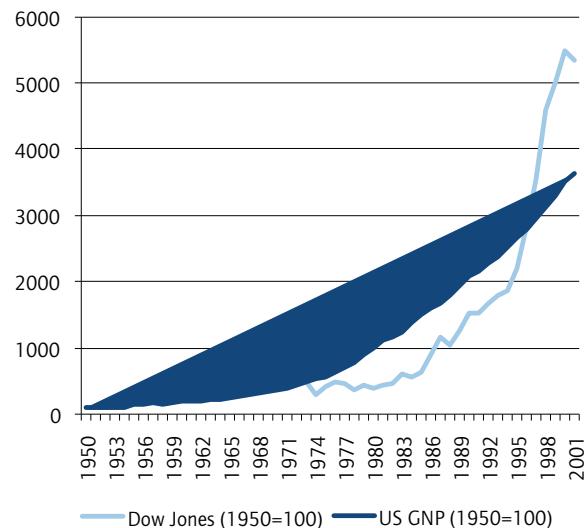
### Costs

Retirement systems always cost a lot of money. How much they cost does not depend on the system itself but on social conventions about how high old-age income should be, whether it should cover only a minimal level of subsistence or whether it should support a given living standard, and which risks should be covered, in other words, are we insuring against old age alone or are risks like disability or survivor pensions covered as well?

If what happens is merely that exactly the same scheme and level of provision is transferred from the public to the private sector, then in both cases someone is paying and someone is receiving the benefit. It is hard to see why an accounting convention about what social spending goes through public accounts should make a real difference to economic outcomes (Pearson; Martin 2005, 10).

In addition to these overall costs of retirement, it can easily be shown that private systems generate much higher costs on top. Administration is cheaper the greater the number

Graph 1: On average in the long-run financial markets do not have higher returns than the real economy, but they are a lot more volatile



Source: Own calculations based on official Dow Jones Statistics ([www.djindexes.com](http://www.djindexes.com)) and OECD GNP statistics ([stats.oecd.org](http://stats.oecd.org)).

of risks that are managed, which means that public systems have lower administration costs. Regulation, risk management and marketing costs are incurred only in private systems. Nor should the information costs incurred by individuals be forgotten. It is almost impossible to inform oneself of the best form of investment. Financial experts alone are in a position to calculate costs and benefits (and, as the financial crisis showed, even being a financial expert does not always help).

### Conclusion

Private pension systems will undoubtedly always remain in existence. But it is far from clear that there are economically sound reasons for giving them public support or even tax relief, especially in countries with a strong and fully developed public system. In those countries where private schemes are already widespread careful monitoring is required. The social partners must have a substantial say in the design of whatever arrangements are used. Particularly important aspects are the presence of solidarity elements and clear rules on low-risk investment (for example differentiated stock ratios depending on age).

It is true that we are going to have to pay more for the older members of our societies (or to put it more correctly, for our own old age) but the much lower-risk approach is to secure old-age pensions via public systems. These are less vulnerable to financial market risks and, at the same time, they encompass the population as a whole, including those who are less well off, those with shorter or atypical employment careers, as well as those who could afford to pay high contributions into high-risk private pension gambling plans.

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