THE ANATOMY OF THE
PENSIONS "CRISIS"

and

THREE FALLACIES ON PENSIONS

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Comments and suggestions are welcome.

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An individual's standard of living is sustained by a flow of goods and services, including the services of capital investments such as houses. There are two ways to secure that flow after retirement (see Barr, 1993a, 1993b).

The first is to actually store the goods and services themselves, like a squirrel hiding its nuts. The young could put aside goods and, where possible, invest in the capital goods that will directly yield needed services, and then consume them in old age. This is a very inefficient strategy, indeed for many goods and most services it is impossible. Apart from the excessive costs of storage (especially of perishable goods) over time many commodities become outdated and even useless, and many services, such as medical and care services, cannot be stored at all.

So the second approach predominates. Living standards are secured in retirement by acquiring monetary claims that can be used to purchase part of the contemporaneous flow of goods and services produced by the current workforce. The pensions problem is to ensure that retired people have a sufficient number of monetary claims to buy the goods and services they need, and to secure the agreement (tacit or implicit) of the workforce to "give up" the goods and services they have produced.

Under any circumstances, ensuring that all the elderly have sufficient monetary claims to sustain a minimal decent standard of living is a major issue of economic policy. A large inter-generational transfer inevitably poses complex social and economic issues. And the authorities have a direct interest in ensuring adequate provision. For whether the transfer is made by the public sector or via private sector financial institutions, if pensioners do not have enough to live on the state will need to provide some form of back-up social security.

The problem of how the inter-generational transfer is to be made becomes significantly more difficult when the population is ageing, i.e. when the proportion of the population that has retired is rising due to falling birth rates and increased longevity. It is the ageing of the population in many countries over the next several decades which lies behind today's pensions "crisis". As will be demonstrated below, that "crisis" is a general phenomenon, independent of how pensions are financed. But it has typically been portrayed as a crisis of state pension systems, as is the case in Table 1.

**Table 1. Demographic effects on the share of state pensions in GDP,
and the financing burden, 1984-2040.**

	1984	2000	2020	2040
Germany				
Pensions as %GDP	13.7	16.4	21.6	31.1
Burden (1980 = 100)		106	124	154
Japan				
Pensions as %GDP	6.0	9.4	14.0	15.7
Burden (1980 = 100)		115	142	154
Netherlands				
Pensions as %GDP	12.1	13.4	19.6	28.5
Burden (1980 = 100)		100	114	139
United Kingdom				
Pensions as %GDP	7.7	7.5	8.6	11.2
Burden (1980 = 100)		93	101	111
United States				
Pensions as %GDP	8.1	8.2	11.3	14.6
Burden (1980 = 100)		96	117	131

Notes: Burden is defined as the real value of pensions per head of population in the age group 15-64. The German figures are for west Germany.
Source: OECD *Ageing Populations: The Social Policy Implications*. Paris, 1988.

In Table 1 the first line for each country expresses the proportion of GDP which will be absorbed by state pensions should they be paid at the rates currently planned, in other words, should states not default on their commitments. In all the countries shown, a sharp increase is projected between 1984 and 2040. Thereafter the proportion should decline as the population assumes a balance associated with the lower birth rate. The second line for each country is an index of real value of state pensions per head of the *working-age* population. In Germany, for example, the burden on a member of the working-age population is expected to increase by 54% between 1980 and 2040. A similar increases in burden will occur in Japan. There will be a very large increase in the Netherlands and a large increase in the United States. The only country which does not suffer such a large increase is the United Kingdom. This is because over the past two decades the British government has reduced the rate of increase in the real value of state pensions (in effect the state has defaulted on the real value of pensions which were expected by present state pensioners when they made their plans for retirement 30 or 40 years ago). Nonetheless, even in the UK, the ageing of the population results in a 10% increase in the burden on the working population.

The issues raised by difficulties confronting state pension systems are not confined to the public sector, they are quite general. These difficulties can be highlighted by means of a simple model. In this model pensioners will be treated as the only dependent group in the population, leaving out of consideration the young and the sick. Some attention will be given to the proportion of the population of working age who are not in the workforce (those performing unpaid work in the household, the unemployed and so on). But predominantly pensioners will be the only dependent group taken into account. It will also be assumed that all savings and taxes are directed toward providing for the flow of goods and services to pensioners. Other uses of savings and taxes will be ignored, though clearly there could be a redirection of savings and taxes toward meeting the needs of pensioners

Consider the following relationship:

$$PN = (S + T)YW \qquad (1)$$

where *P* is the average pension per head per year and *N* is the number of pensioners. So *PN* is the total amount of the pensions paid every year. Those pensions are a flow of purchasing power which will be used to buy the goods and services which have been produced by the working population. On the right hand side *W* is the working population, *Y* is value of output per head, or productivity, of the working population. Hence *WY* is the total value of the flow of goods and services. *S* is the average savings rate and *T* is the average tax rate. These savings and taxes are the means of extracting from the working population the goods and services which the pensioners require - the proportion of the output of the working population which they themselves do not consume. So, on the left-hand side is the amount of goods and services going to pensioners and on the right-hand side the amount of goods and services being produced and released by the working population. This inter-generational transfer is the central relationship in any pensions calculation.

Re-arrangement of equation (1) yields:

$$N/W = RY/P \qquad (2)$$

the ratio of the pensioner population to the workforce is equal to the ratio of income not consumed to the average pension, $(R = S + T)$.

Equations (3) and (4) express same core relationship in terms of growth rates:

$$n - w = r + y - p \qquad (3)$$

$$r = sa + t(1 - a) \qquad (4)$$

where lower case letters indicate rates of change. So *n* is the rate of growth of the pensioner population, *w* is the rate of growth of the workforce, *y* is rate of growth of productivity, *p* the

rate of increase in the real value of the average pension, and r is a weighted average of the rates of growth of taxes, t, and of the savings rate, s, as defined in equation (4), $a = S/(S + T)$.

The source of the pensions "crisis" is that n is greater that w, the pensioner population is growing more rapidly then the workforce. So the left hand side of (3) is positive and the right hand side must be positive too. This can be achieved by an increased value of r, increasing savings or taxes, or by a higher rate of productivity growth y, or by a lower value (even a negative value) for p, that is a decline in the growth rate of the real value of the average pension. An increase in r could also be achieved by a change in a, i.e. a change in the balance between savings and taxation. Since savings ratios are typically significantly lower than tax ratios this would suggest an increase in taxation as a means of reducing the consumption of the workforce.

A further factor which should be taken into account is the possibility of increasing w, the rate of growth of the workforce. This could be done both by reducing the unemployment rate, and by increasing the participation rate of all those of working age. Or it might be done by raising the age of retirement, so increasing the proportion of the population deemed to be of working age. This will have the effect of both raising w and lowering n. This may be particularly important in the transition economies of central and eastern Europe where retirement ages are comparatively low. More hypothetically w could be raised by lowering the age at which young people enter the workforce. Of course some of these increases are once and for all, and so would not result in a permanent rebalancing of equation (3).

A solution to the "crisis" therefore rests on determining which of the values of w, r, y or p are to be changed. Given the increase in the value of n, an appropriate combination of them *must*, of necessity, be changed, either by policy or by default. Much of the attention in considerations of the pensions "crisis" has been focused on the relationship between the manner in which pensions are financed and equation (3). It should, therefore, be noted that the same issues will arise however pensions are financed. The debate over financing should be conducted in the light of impact of different financial arrangements on w, r, y or p.

Financing pensions

The increase in the ratio of the pensioner population to the workforce has initiated a debate over the manner in which pensions are financed. In its most stark form this has been a debate between, on the one hand, pay-as-you-go pensions (PAYG) and, on the other hand, fully-funded pensions (FF).

A PAYG pension scheme is a public sector scheme in which taxes are raised in order to fund the transfer of purchasing power to pensioners. The right to receive a pension is essentially a political right, the terms of which are guaranteed by the state - though this is not so say that the state might not subsequently alter the terms on which pensions are offered. The transfer of goods and services from the workforce to the pensioners is very transparent.

An FF pension scheme may be run by the public sector, though typically these are private

sector schemes. Under an FF scheme an individual saves in his or her lifetime and thus acquires a stock of financial assets which may be used in the future to buy the goods and services required, either by cashing in the assets or by buying an annuity from an insurance company. The right to receive a pension is a financial right, owned by the individual - though the value of that right will depend on a wide variety of economic circumstances, such as the state of the markets for financial assets, interest rates and the rate of inflation.

An important preliminary point to make which is fundamental to the entire debate on the pensions is that in overall macro-economic terms there is no difference between these two schemes as regard the overall transfer, i.e. in their impact on r. For given values of n, w, y and p, the value of r must be the same whatever the financing scheme. In a PAYG scheme current taxes are being used to pay current pensions. In an FF scheme it is current savings which are being used to pay current pensions. Savings today are funding the pensions of today. Accordingly, the "burden" on the workforce, defined as the goods and services that are "extracted" from the income of workforce is exactly the same whether the nation's pension scheme is FF or PAYG.

A further similarity is that just as the workforce may resist increases in taxation, so they may also resist the attempt to reduce their consumption via an FF scheme. Suppose that instead of PAYG pension schemes Germany and the United States funded pensions by means of FF schemes. The increased "burden" associated with the ageing of the population would be created by the large aggregate of financial claims accumulated by the growing number of retired persons. These claims would then need to be met by increased saving. The pensioners would use their monetary claims to extract the resources from the workforce. If the workforce was unwilling to effect this reduction in their real consumption by increasing their savings, then prices would be bid up. The acceleration in the rate of inflation would continue until either the real value of pensions were reduced to a level which the workforce was willing to accept, or the workforce increased their savings rate in order to sustain the real value of their own accumulating stock of financial claims. If the workforce refuses to reduce their consumption, either by refusing to pay higher taxes, or by refusing to save more, then pensions must be cut (p must be lowered). In the case of an FF scheme the process is less transparent that under a PAYG scheme. But, in macro-economic terms, the outcome is exactly the same.

The comparison between PAYG and FF pensions should therefore be made in terms of characteristics other than their overall macro-economic impact. Some of the major advantages and disadvantages of PAYG schemes are set out in Table 2.

Table 2. Advantages and disadvantages of pay-as-you-go (PAYG) pensions

Advantages:

simplicity and transparency
low administration costs
progressive redistribution
wide coverage
do not inhibit the mobility of labour
low risk

Disadvantages:

budgetary burden
no "choice"
over-commitment to a specific level of pensions
resistance to tax funding

The simplicity and transparency of PAYG pensions is self evident. Money raised by taxation is transferred to pensioners. This simple procedure has extremely low administration costs compared to FF pensions. Major public PAYG schemes typically have administration costs of around 3% to 4%, whereas privately managed FF pensions typically have administration costs of around 20%. PAYG pensions also tend to be relatively egalitarian. Whereas FF schemes tend *at best* to reproduce in retirement the distribution of income of the workforce, PAYG schemes tend to have a less highly skewed distribution. One of the major problems of FF pensions is that poor people do not have the wherewithal to save, and, therefore, tend to have no pension at all, in which case the state must make some sort of social security provision out of taxation. PAYG schemes also have a very wide coverage, usually the whole population is covered. Nor is there any inhibition to the flexibility of the labour market, because PAYG pensions are not associated with tenure of a particular job. There is relatively low risk with PAYG schemes, though there does exists the possibility that a government may default on its commitments.

The major disadvantage of a PAYG scheme is the perceived budgetary burden, and the resistance to raising necessary funds via taxation. An associated problem is that there is may be an over-commitment to a specific level of pensions. If the rate of growth of the economy is lower than expected (y is lower than was expected at the time the pension scheme was established) then it may be necessary to reduce p, the rate of growth of pensions. This can create severe political difficulties. A further problem with public sector PAYG schemes is that pensioners may lack choices as to the particular pensions package that suits their needs

The major advantages and disadvantages associated with FF schemes are set out in Table 3.

Table 3. The advantages and disadvantages of fully-funded (FF) pensions

Advantages:

higher returns from professional equity investment
the saver has independence and choice
increases savings and growth
promotes the development of financial markets, and effective corporate
    governance
automatically adjusts the level of pension to available returns

Disadvantages:

regressive impact on the distribution of income
high administration costs
limited coverage
uncertain return (high risk)
need for a social security safety net
in some cases limit mobility of labour (occupational pensions)

FF schemes, particularly private sector FF schemes are said to enjoy the advantage of high returns from professional equity investment. This has been a particularly popular argument given the rate of growth of stock market prices over recent years. What this suggests is that for FF pension holders p will be higher than might have been expected. From equation (3) other variables will need to adjust, i.e. r or y must increase. Or it may be the case that some pensioners enjoy higher pensions whilst others do not and that the average value of p is unchanged. With private FF schemes the saver has independence and choice. Savers may the feeling of "owning" their own pension fund (even though this does not guarantee a higher pension than under other arrangements). It is also claimed that FF schemes increase savings and growth for the whole economy and promote the development of financial markets. Perhaps the greatest advantage of FF schemes is that there is an automatic adjustment of the level of pensions to the available resources. If available resources are lower than expected then either equity returns are also lower than expected or the real value of financial claims are reduced by inflation. Both processes operate "automatically". Pensioners may be disappointed in the real value of their pensions. But they do not perceive any deliberate political decision in the reduction of their pensions by inflation or by the failure to attain a suitable return in the financial markets.

The major disadvantages of FF schemes pensions are their regressive impact on the distribution of pensioner income and their high administration costs. Also FF schemes typically do not cover the whole population. The return on FF schemes is uncertain in that it depends on the performance of the stock market and on the level of interest rates on retirement (which determine the return on any purchased annuity). There is a need for a social security safety net to cover those whose pension provision is below a minimum value and for those who have no pension at all. In the case of funded occupational pensions

schemes there is a limitation on the flexibility of the labour market.

Savings and growth, and the promotion of the development of financial markets and of effective corporate governance.

Given the rather weighty disadvantages of FF schemes, it is important to consider the advantages claimed for them, particularly in so far as this particular method of financing pensions is believed to have an impact on the real performance of the economy, i.e. on *y* in equation (3).

A fundamental determinant of the real value of pensions is macro-economic performance. If FF pensions do result in higher rates of savings and growth, as compared with PAYG schemes, then the overall impact is likely to be beneficial, certainly to the "average" pensioner. What matters for the overall level of pensions in the future is whether the economy that grows rapidly or not, not whether there is some particular segment of society that benefits.

There has been a good deal of controversy over the question of the impact of different pension arrangements on real investment rates and hence on the scale of future income flows. This controversy is unresolved. Feldstein (1974) argued that PAYG schemes could reduce aggregate savings and investment. However his work was shown to suffer from serious statistical flaws (Leimer and Lesnoy, 1982), and not clear-cut conclusion can be drawn.

It is sometimes argued that because FF schemes are more likely to be invested in foreign assets and will increase the future growth of national income. However, this argument is incorrect. Net foreign investment is equal to the balance of net domestic savings (public and private). If *r* is of given value relative to domestic investment, then the value of net foreign investment will be the same whether the pensions are PAYG or FF.

Nor is it clear that the development of the financial infrastructure associated with FF schemes results in an improved allocation of savings, or better improved flows of funding to industry (Rosa, 1982; World Bank, 1994; Singh, 1995). Virtually all new funds required for corporate investment are derived from retained profits rather than from the investment of new savings. For example, in 1998 American companies financed *over* 100% of their investment by retained profits, and no new net funds were raised from the financial markets. The figure was *over* 100% because of the prevalence of share buy-back schemes. Similar results may be found for the UK economy.

The relationship between structures of corporate governance, the development of stock markets and economic performance is also very controversial. It is not possible on the basis of the available evidence to argue definitively for the superiority of stock-market based governance structures over bank-based governance structures (Mayer, 1990), or for the efficiency of the take-over mechanisms which liquid stock-markets promote (Hughes and Singh, 1987; Jensen, 1988; Warshawsky, 1987; Singh, 1992). Nor is it possible to argue that development of international financial markets, in which institutional investors, including pension funds, have played a major role, have resulted in an unambiguous improvement in

economic performance (Eatwell, 1997).

So whilst it may be possible to argue that the existence of FF pension schemes promotes the development of financial markets, there is no clear relationship between the growth of financial markets and aggregate savings, growth or economic efficiency.

The pensions "crisis".

Given the uncertainties surrounding the impact of different funding schemes on the performance of the economy, the debate comes down to the question of the relative efficiency of PAYG and FF schemes as means of inter-generational transfer, given the performance of the real economy.

The pensions "crisis" has typically been associated with public PAYG pension schemes, and a typical reaction has been to propose a switch to some version of FF schemes. An influential OECD study argued:

> "It is clear that if present [public] pension payments are left untouched, the pension schemes in some countries would impose major burdens on their societies in the next century, either through requiring higher taxation or other spending cuts, or by rapidly increasing public debt burdens resulting from high primary deficits, compounded by explosive debt dynamics" (Leibfritz, Roseveare, Fore and Wurzel, 1995, para.50).

But this argument applies just as much to FF schemes, *so long as the level of pension provision is unchanged.* Whilst in many ways FF pensions are significantly less efficient than PAYG pension schemes, they have the considerable political virtue of reducing the real value of pensions *automatically* to the available resources, i.e. without overt political decision. In the face of the pensions "crisis" they are a device for cutting the rate of growth of average per capita pensions.

But equation (3) suggests that other measures might be taken which would limit the need to cut pensions. Assuming that n is given, the left-hand side of (3) could be reduced by measures to increase the rate of growth of the working population, to extend the length of working life, to encourage a higher rate of labour force participation, perhaps by enabling more women to enter the labour force, or to import labour from areas which have labour surpluses. It is also important to pursue policies which secure the lowest possible rate of unemployment.

With respect to the right-hand side of (3) a variety of measures could be implemented to increase r by the introduction of attractive schemes which encourage savings, or perhaps by linking taxes directly to future pension benefits. Steps can also be taken to increase productivity, y, by increasing the rate of investment or by improving the quality of the labour force by investing in education and training. Without such measures the only remaining possibility is a cut in p.

Whatever system of the provision of pensions is used, there will remain the necessity of transferring a given amount of real resources from the working population to pensioners. If

FF pensions schemes are in place, or are to be adopted, steps should be taken to reduce their high administration costs, inequity, and high risk. There will also need to be some sort of safety net for the elderly poor. The switch to FF pensions must not be a covert device for cutting the pensions of the poor. If PAYG are used then steps should be taken to increase public awareness of the relationship between taxation and pensions provision, and to introduce a variety of schemes which will provide greater choice.

Whatever scheme, or combination of schemes, is used, the characteristics of the scheme should be evaluated with respect to the parameters defined in equation (3).

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Three fallacies on pensions

John Eatwell

It seems that no-one can sort out the pensions mess. State-pensioners are condemned to ever greater penury in old age and reliance on means tested benefits, occupational pensions are schemes closing and even defaulting on their obligations, private pensions providers are reducing substantially the levels of pensions they pay out. And this in at a time when the "demographic timebomb" has not yet exploded.

Of course the falling FTSE has caught out all those who thought (against all historical evidence) that the market would rise forever. Pensions "holidays" were a disgrace. But far more important in the long term is the policy muddle – a series of pensions initiatives by governments over the past decade that have done nothing to make pensions more secure.

Policy is in a muddle because it is permeated by 3 great fallacies:

1. That moving from Pay as You Go (PAYG) state pensions, paid out of taxation, into funded pensions paid out of accumulated savings will solve the "pensions crisis" of an aging population. It will not.

2. That pensions problems can be solved if we all save more. They cannot.

3. That the switch from PAYG to private funded pensions will avoid the necessity of raising taxes to pay for an aging population. It will not.

All three fallacies stem from widespread confusion between action that individuals can take on pensions, and the action which society as a whole can take. As so often in economics, the whole is quite different from the sum of the parts.

An individual's standard of living is sustained by a flow of goods and services – food, clothing, transport, medical care, etc. and the services of capital investments such as houses. There are two ways to secure that flow after retirement.

The *first* is to actually store the goods and services themselves, like a squirrel hiding its nuts. The young could put aside goods and, where possible, invest in the capital goods that will directly yield needed services, and then consume them in old age. This is a very inefficient strategy, indeed for many goods and most services it is impossible. Apart from the excessive costs of storage (especially of perishable goods) over time many commodities become outdated and even useless, and services, whether entertainment or medical care, cannot be stored at all.

So the *second* approach predominates. Living standards are secured in retirement by acquiring monetary claims that can be used to purchase part of the contemporaneous flow of goods and services produced by the current workforce. The pensions problem is to ensure that retired people have a sufficient number of monetary claims to buy the goods and services they need,

and to secure the agreement (explicit or implicit) of the workforce to "give up" a share of the goods and services they have produced.

The problem of this inter-generational transfer becomes significantly more difficult when the population is ageing, i.e. when the proportion of the population that has retired is rising due to falling birth rates and increased longevity. If the ratio of the retired to the working population is rising then the income that the working population must give up must also rise.

The goods and services for the pensioners are "released" by the working population in two forms - savings or taxes. They are transferred to the pensioners either via the state, or via the monetary claims the pensioners have built up. The direct transfer via the state (the PAYG pension) is clear. Less obvious is the fact that if pensioners monetary claims exceed the amount that the working population is willing to save, then either inflation will erode the value of pensions to equal savings, or the government will be forced to raise taxes to force "savings" on the working population.

The substance of the first two fallacies should now be clear. The pensions problem has nothing to do with how pensions are financed (by taxes or via accumulated funds) and everything to do with how the working population either chooses or is prevented from consuming all the goods and services it produces.

The difference between the individual and society as a whole should also be clear. The individual by saving more accumulates monetary claims that command a greater *share* of the goods and services that the working population gives up. In other words, personal savings change the distribution of goods and services between pensioners, but the total value of pensions is fixed by the amount of goods and services given up by the working population.

Everyone saving more today is a total waste. It will do nothing to increase future pensions as a whole. Indeed, it could result in slower growth today, and lower income for all in the future. This would not be the case, of course, if the greater savings were invested in greater productive capacity. But exhaustive studies have identified no impact of increased personal savings on the rate of investment. So all those arguments about the need for society to save more are quite simply, poppycock.

Note that this is not the same as saying that at the future date, when the pensions are needed, increased saving by the working population would not help provide pensioner incomes. But that is a totally different matter.

But surely it must be true that the switch to private pensions relieves the government of the pensions burden, and ensures that taxes won't have to cover the needs of pensioners? This view underlies Chart 2.6 of the Government's recent *Pre-Budget Statement.* It is false.

Suppose that all pensions derive from pension funds – the state provides nothing. The growing number of pensioners wish to use the monetary claims they have accumulated to "extract" a greater volume of goods and services from the working population. But the working population refuses to reduce its level of consumption. The only way that the working population's consumption can be cut is for the state to raise taxes. In other words, *taxes must be raised to provide for pensions whether those pensions are provided by the state or through*

private funds. The Treasury's statement (para. 2.68) that "the changing demographic structure of the UK's population is expected to have only a limited impact on the public finances over the coming decades" is economically illiterate.

The only advantage to the government of a switch to private pensions is that it can disavow responsibility for the failure of privately accumulated funds to provide for pensioners needs. It can't disavow responsibility for cutting the state pension. But even here that Government is in error. Ultimately, political pressure will force it to step in to protect a decent minimum pension. That responsibility cannot be privatised.

Once the fallacies implicit in current debate are recognised the way will be clear to construct a sensible pensions policy.