REPORT ON WILTON PARK CONFERENCE S06/26
in association with HSBC Insurance

EUROPEAN PENSIONS POLICIES

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Summary

This conference reviewed progress on reform of both state and private pension systems in the UK and other major European countries. Participants from a wide variety of countries reflected on their national experiences of pensions reform, and touched upon developments in North America and the Far East.

Pensions in the wider context

1. Pensions reform is one of the consequences of ageing societies, and needs to be seen in a wider context. Higher public expenditure will be incurred for some decades to come, not only by state pension systems, but by health and long-term care services. The big rises in spending are due to begin after 2010, and decisions about them are therefore likely to be postponed beyond the term of present governments. Worries about long-term fiscal sustainability, due to the growth of future pension liabilities, are dealt with in the small print, while the headlines are focussed on the current year's budget. Health spending is due to rise, both because of advances in medical technology, and because longer lives are not necessarily healthier lives; the thesis of 'compression of morbidity', suggesting that terminal illness periods are postponed towards the end of life rather than lengthened, is open to question.

2. Ageing is due to one expected development – the move of the baby boom generation into the retirement age bracket – and to two unexpected phenomena – the rise in longevity and the fall in fertility. The dependency of the older generation on younger generations is therefore rising. Life expectancy in most countries has risen faster than predicted, except in Russia and in African countries plagued by HIV/AIDS. Pension schemes, particularly funded ones, have thus suffered an increase in their liabilities, as members have lived on to continue drawing pensions for longer than expected. The trend towards later retirement, and away from early retirement, has contributed to the rise in longevity by keeping brains and bodies active where they might otherwise have atrophied. The increase in longevity has in its turn encouraged people to work for longer, often on a part-time basis, by holding out the prospect of more years of life in retirement.

3. Until recently, it was assumed that a successful career would be crowned by earlier rather than later retirement, as a reward for success. Corporate pension schemes were structured so as be able to make early leavers offers they could not refuse. It was then found that early retirement was increasing the deficits of pension schemes by cutting contributions and increasing benefits compared with the case where all served their full term. Both public and private pension schemes have cut back on early retirement provisions, so that employees at least retire on time. Later retirement raises new issues. Can pensions be raised for each year of extra work in an actuarially neutral manner? Does productivity decline with age, or remain constant? The answer will clearly be different for sportspeople and for senior managers. Is there a way of making the gradient from full-time work to none at all a gradual one, with pensions rising inversely as labour input falls? Is there a way of making retirement ages flexible to suit personal choices of lifestyle? Those with low life expectancy may wish to retire earlier than those who expect to live longer.

4. These demographic trends may depress rates of economic growth, as the population of working age in the total population declines relatively or even absolutely. The wealth available to be shared among pensioners may thus fall because of the slowing of output growth on the part of the labour force, as well as the rising number of retired claimants. Policies should aim to maintain the rate of economic growth, so as to fund the welfare of ageing populations. If the population of working age falls, more use can be made of its labour by higher participation, lower unemployment, and longer hours. National patterns differ enormously, with high participation in the US, the UK and Scandinavia, and low participation in the southern European countries. The Lisbon targets for employment do not look as if they will be achieved by 2010. The total employment rate will fall short of the 70 per cent target, although employment of women will reach its 60 per cent target. The employment rate of older people will also fall below the 50 per cent target. Lower labour inputs can be offset by higher capital inputs designed to increase labour productivity, but this has been difficult to increase, even to measure.

5. Ageing is a global phenomenon. Even if it is becoming apparent earlier in Europe than elsewhere, the numbers, if not yet the proportions of older people, are even more striking in the Less Developed Countries (LDCs). By 2050, 35 per cent of the population of Europe will be over 60, making 200 million people. In LDCs, only 20 per cent of the population will be over 60, but they will total 1,300 million in number. Ageing will hit particularly hard in China, where the one-child policy will leave the country short of labour, and massive immigration of skilled people will be needed. Migration may not in itself be the answer to shrinking labour forces, which can be counteracted by changes in domestic policy, but in a global market for skills it is bound to increase. Only in the short run can younger migrants play a part as contributors to pension schemes; in the longer run they become recipients.

Pension reform in Europe

6. The reform of pension systems generally uses a mixture of solutions. These comprise higher taxation, later retirement, more saving, and lower benefits. Higher taxation may have disincentive effects on economic growth, and will be politically unpopular if the younger generation feels that it is being forced to transfer income to the older generation. Later retirement has the merit of increasing tax revenue and reducing pension expenditure. It is not universally welcomed by either employers or employees. If retirement age is linked to life expectancy, as often suggested, then it should perhaps not rise as fast for lower income or disabled groups with lower expectations of longevity. More saving can best be achieved by the reform of existing private sector pension schemes, or by the creation of new ones, which are designed to shift some of the burden away from state schemes. Lower benefits by over-generous state schemes can be mitigated by better private sector pensions, but where such benefits are already low, there is pressure to increase as well as to supplement them.

7. There is such a wide variety of arrangements among European countries, that it is hard to imagine a Europe-wide pensions regime. The respective roles of the state, companies and individuals differ greatly. Today's schemes have arisen out of complicated histories, starting with key figures such as Bismarck and Lloyd George. The role of the state has come to be far wider than that of providing basic pensions. The use of tax relief and regulation by governments has by turns stimulated and discouraged private pension schemes. Tax systems should also avoid penalizing work after retirement by withdrawal of pension benefits. The UK model of funded schemes, once admired by other countries, has suffered a 'hero to zero' decline. Other European countries have tried to learn from the UK's mistakes, and have observed how these are being corrected. There has been a universal shift from defined benefit to defined contribution schemes, to transfer

some of the risk from companies to their employees. State pensions have also been more closely linked to contributions.

State pension changes

8. State pension schemes show a wide variety of characteristics and objectives. Some are linked to prices, some to earnings. Some are means-tested, some offer universal benefits. Some aim at a safety net, to alleviate extreme poverty, others aim to replace a set percentage of previous income. They may be based on years of contributions, on age above or below normal retirement age, or on length of residence. In all cases, there are close links between pensions and social security systems. Social security for the disabled can become a substitute for an early pension, and family circumstances may determine pension entitlements. The withdrawal of pension benefits, like that of other social security benefits, can adversely affect the willingness of pensioners to continue working after state pension age.

9. France has increased contribution rates and periods, and reduced benefits in the state scheme. The full pension is to depend on 40 years of contributions, rising over time to 45, so that less skilled workers joining the labour force earlier will be able to leave it earlier than more skilled people starting work at a later age. The aim is that the state pension should be at least 30 per cent of earnings, rising eventually to 50 per cent. The second and third pillars – corporate and individual pensions – are to be developed.

10. In Germany the state pension accounts for 66 per cent of pension income – higher in former East Germany, where private schemes are more recent. But only 50 per cent of men and 10 per cent of women get the full state pension. There is to be a minimum income guarantee, making the pension more related to earnings and less to contributions. The state pension age is to be raised to 67 in 2029. The aim is to reduce the replacement rate from 70 per cent in 2001 to 54

per cent by 2050. Germany, like the UK, is moving from a benefit-based to a contribution-based system.

11. Italy has been forced to reform a system so generous that it would have cost 35 per cent of GDP by 2040, according to the OECD. In the early 1990s, pensions were indexed to prices not earnings, and the state pension age was raised to 60 for women and 65 for men. The contribution period has been extended, and the system of defined benefits has been switched to one of notional defined contributions. Replacement rates are to fall from 79 per cent of former income now to 64 per cent in 2050. The best that the reforms are expected to do is to keep the pensions deficit at around 15 per cent of GDP, rather than allowing it to rise. Italy still has the highest notional future pension liabilities of four times GDP.

12. The UK state system differs from others in that it costs only 5 per cent of GDP, and even this low figure is due to rise only moderately. Women fare badly, with only 30 per cent entitled to a full pension, compared with 85 per cent of men. The number of contribution years for women to get a full pension is to be reduced from 39 to 30, but this is still a high hurdle to jump. Women save less than men, and are motivated more by short-term needs rather than by retirement. The state pension has been seen as a way of alleviating poverty, and to this end a new means-tested pension credit has been introduced to supplement the basic pension. Recent research suggests that means-testing does not act as a disincentive to work or to saving, but this has been disputed. Means-testing is taken for granted in the tax system, but it is controversial in the welfare system, to the point where over £4bn in benefits remains unclaimed. The suggestion of a universal pension benefit has been turned down as too expensive, but the government has undertaken to restore the link of pensions to earnings by 2012 – too late for many pensioners who will be dead by then.

New private pension schemes

13. The variation among countries is even higher in the private than in the state sphere. In the Netherlands and Sweden 90 per cent of employees are in occupational pension schemes, in Germany 60 per cent (plus another 15 per cent in the new Riester schemes), in the UK 50 per cent, in France only 10 per cent, and in Italy 8 per cent, with another 2 per cent in individual schemes. One brake on development has been the double payment problem, where employees have to contribute to both the state pension and a new funded private scheme.

14. In France the main reform was the *Loi Fillon* in 2003. The two main new schemes are the *plan d'épargne de retraite collective* (PERCO), a defined contribution scheme for company employees, and the *plan d'épargne de retraite populaire* (PERP), a scheme for groups of individuals managed by insurance companies. The response to these schemes has been disappointingly low. The tax system is even more favourable to saving through life insurance, which is exempt from inheritance tax, and accounts for €1,000 billion, one-third of total private saving.

15. In Germany there has been a switch from defined benefit to defined contribution schemes, with the contribution rate limited to a maximum of 22 per cent. The new Riester plans hope to attract 4 per cent of wages by 2008, but the take-up so far has been only 15 per cent of those eligible. In Italy, severance pay of 6 per cent of salary has been subsumed into new pension schemes. There are 463 funds with nearly 3 million members and €43 billion – still only 12 per cent of the possible total.

16. The US has failed to carry out fundamental reform of its pension system, apart from the gradual raising of the state pension age from 65 to 67. It has seen

an expansion of personal at the expense of corporate pension accounts. In 1980 92 per cent of such plans were corporate based, but by 2000 87 per cent of those eligible has switched to 401(k) personal pension plans. Canada has introduced pensions which offer choice of retirement age between 60 and 70; the pension is reduced for each year of retirement below 65, and increased for each year above. The UK has recently introduced a similar system, but little use has so far been made of it.

17. The UK has illustrated some of the problems which face other countries in their corporate pension schemes. Deficits have arisen in many schemes, owing to the increase in tax rates on pension funds in 1997, and the collapse in the equity market in the early 2000s. Companies have pension liabilities totalling £500 billion, and in some case deficits amount to half the company's market capitalization. The result has been a massive switch from defined benefit to defined contribution schemes. As many as 57 per cent of defined benefit schemes have been closed to new members. There are still 6.4 million active members of company pension schemes, but the contributions paid into defined contribution schemes are only 10 per cent, compared with 18 per cent into defined benefit schemes. Even if state pensions are increased, company pensions are thus likely to be lower than otherwise. The state has not accepted full responsibility for advising members that corporate pension schemes were safe, but it has set up a Pension Protection Fund, financed on a collective basis, to provide at least partial compensation for members of failed schemes.

18. The British Government published details of its new National Pension Savings Scheme (NPSS) in a White Paper at the time of the conference. It was commented on by James Purnell, MP, Minister of State for Pension Reform, in a lively debate. The NPSS was recommended by the Turner Commission on pensions. The government has adopted the Turner approach, rather than letting private financial institutions run the scheme. It is aimed at nearly 10 million middle and lower income people not now covered by any private pension

scheme. It would involve a 3 per cent contribution by employers, 4 per cent by employees, and 1 per cent tax relief from the government on the employee contributions. The government wants to keep the charges down to 0.3-0.5 per cent, and there is evidence from the example of the Swedish savings scheme that such a low level is feasible. The pensions industry claims that it would cost more, and points to overruns on other government computer projects. As a sop to the industry, there could be branded products in the mix on offer, but the evidence from Sweden is that most people would go into a default scheme. There are nevertheless 757 savings funds in Sweden, but they are 'vendor-blind', so as to prevent financial institutions spending on marketing to savers. The project is to be handled by a private sector delivery authority, due to begin operations by 2012.

19. The NPSS has been criticized on the wider grounds that contributions would be wasted, because in their absence pensioners would benefit from a combination of earnings related state pensions and means-tested pension credits. Another charge is that company schemes would level down their provisions to contribution rates matching those of the NPSS. The government has sought to forestall this danger by ring-fencing the NPSS in order to prevent existing corporate defined contribution schemes being merged into it. Auto-enrolment is an important feature of schemes such as the NPSS. Asian pension funds show that deduction of contributions at source by employers results in high levels of saving. Individualized accounts within collective systems also help members to feel that they are responsible for their own future pensions.

Concluding remarks

20. The ageing society, like global warming, is a long-run global issue. The two issues are similar in that early decisions are needed to forestall the worse outcomes arising from postponement. There is a marked change from the worries of earlier decades about the effects of uncontrolled world population

growth. It is now the structure rather than the size of population which represents the big issue. While global warming is likely to be a continuous trend – even if it paradoxically brings cooling to some areas - the ageing society's effects will probably peak in the next 10 to 20 years, as the baby boom bulge fades out when its members move from retirement to death. In both cases, the experience of different countries, even within regions such as Europe, will diverge widely. Just as some countries will get colder while most get hotter, most societies will continue to age as fertility remains low, while some may rediscover stable demography if fertility rises or longevity levels off. Reforming pensions, like all economic policies, depends on forecasting many distant and unknowable variables, extending well outside the range of the normal economic uncertainties about growth, productivity, saving and investment, to cover chosen lifestyles, desire to have children, and the search for everlasting life.

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