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Comments on OECD Pensions Outlook 2012

Retirement age of 70? Individual Defined Contribution Schemes For All? – Is this the Pension Future the OECD Wants?

TUAC Secretariat
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1. The long awaited "Pensions Outlook 2012", the new flagship publication of the OECD on pensions, was released on 11 June 2012. The OECD press release[1] and the media coverage that followed are unequivocal about the main policy message: "Raising the retirement age and expanding private pension coverage are essential". The OECD recommends increasing the retirement age beyond current levels, which range from 65 to 69 across OECD economies. It is not clear whether the OECD is recommending the age of 70, or even higher.

PAYG under attack

2. "Pension Outlook 2012" focuses on the expansion of pre-funded private pension schemes – as opposed to tax-financed and to pay-as-you-go (PAYG) schemes – so as to fill the growing "pension gap" appearing across OECD economies. Four out of six chapters of the report are devoted to pre-funded schemes. Little is said about PAYG schemes. The current financial crisis, we are told, has hit PAYG systems "firstly" (p17) – despite the fact that PAYG systems are by definition immune against turmoil in the financial markets. And while OECD concedes that pre-funded systems "were also severely hit", it nevertheless calls for "an expanded role for funded, private pensions" in the future. (p17&20)

3. "Funded, private pensions is of prime policy importance" the OECD states "because PAYG pension systems are not expected to fill in that gap". The OECD takes the stance that PAYG benefits need to be lowered, and that PAYG systems as a whole cannot be reformed to face tomorrow's demographic challenge: "PAYG pensions to new entrants to the labour force are not expected to reach 60% for workers on average earnings. In all these countries, *therefore*, funded pensions are needed to ensure retirement income adequacy" (p124). The OECD call for "a mix of providers – public and private – and of financing mechanisms: pay-as-you-go and pre-funding" (p96) can be understood as an implicit call for shifting the pension package in Europe, where PAYG and taxation currently account for over 90% of old age income in all but 7 EU countries[2].

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[1] http://www.oecd.org/document/35/0,3746,en_21571361_44315115_50555875_1_1_1_1,00.html

[2] Pre-funding account for 15% of old age income in Germany and is substantial source of income (ie. above 20%) in Finland, Netherlands, UK, Denmark, Ireland, Sweden.

4. As Joseph Stiglitz puts it, claiming that the "pension problem" is unfixable within PAYG systems "is an irresponsible way to get radical change. It is even more irresponsible to believe that privatization is an opportunity for a free lunch. Some may benefit from privatization – especially the managers of private investment funds – but more will lose. There is a real risk that there will be many more losers than winners – the losers being the poor elderly and average retirees and taxpayers."[3]

Biased toward un-protected defined contribution schemes

5. By "private pensions" the OECD in effect means defined contribution (DC) schemes, which provide no form of protection for workers – it is workers who take all the investment risk, and often the longevity risk as well. Defined benefit (DB) and hybrid schemes – which protect workers' right to retirement and account for well over half of world pension assets – are ignored throughout the report.

6. Further evidence of the OECD's bias towards DC schemes lies in the report's account of the recent "pension-reform reversals" in Hungary and Poland. Based on these two individual cases of "re-nationalisation" of private DC schemes – which by any standards are exceptional, if not radical – the OECD is confident enough to establish a rule according to which "reversing systemic pension reforms, which sought to encourage more private provision for retirement" is something that needs to be avoided (p94).

7. The OECD does, however, acknowledge the limitations of DC schemes: their low coverage of the working population and, importantly, the fact that the "growing role of DC private pensions raises concerns over workers' exposure to investment risk" (p17). An entire chapter is in fact spent on "the role of guarantees" on investment returns in DC schemes. But its conclusions do not give grounds for optimism: guarantees "can be very expensive", those that apply to basic default options of individual DC schemes are "controversial" and overall "some serious implementation challenges" remain (p152 & p176-177). Public guarantees would in any case generate "a substantial burden for the government". At best, we are told that the "nominal value" of contributions could be guaranteed to "protect plan members from worst-case scenarios" (p18). The OECD also sees value in developing "substantial government subsidies" in the form of matching contributions to DC schemes to make DC schemes more attractive (p125). Using public money to help finance private pensions seems to be the OECD's new policy line.

8. Perhaps more disturbingly, the report fails to factor in the severe deterioration of OECD labour markets since the 2008 financial crisis and, before that, the rise of casual employment and career disruptions. When measuring the replacement rates of DC schemes in Eastern Europe (p81-83), the OECD takes as standard scenario a full-employment career from the age of 20 until the age of retirement, with no single disruption or period of unemployment and a constant annual net investment return (after the various fees taken by asset managers) of no less than 3.5%. This surely looks unrealistic with the unemployment rate currently at close to 10% in Europe and with the most recent GDP growth projections by the OECD being at +2% for 2012-2017, +2.2% for 2018-2030 and +1.9% for 2031-2050[4]. It is little wonder, therefore, that DC schemes appear in such a favourable light.

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[3] Stiglitz, J. (2005), Securing Social Security for the Future, The Economists' Voice, Volume 2, Issue 1. http://webpub.allegheny.edu/employee/s/smartin/441_SS_Stiglitz.pdf

[4] OECD Economic Outlook Series, Vol. 2012/1, n°91, May 2012 – table 4.1.
http://dx.doi.org/10.1787/888932610843

9. It is in fact acknowledged that “labour-market risk (either regarding employment prospects or real-wage growth career paths) as well financial-market risk (uncertainty about returns on investment and inflation) has the largest impact on retirement income from DC pension plans” (p164-165). When these factors are taken on board, “there is close to a 60% probability that replacement rates may fall short of expectations if uncertainty is not taken into account”.

The OECD should respect diversity of systems, and the societal choices that underpin them

10. Pension systems are diverse across OECD economies and they are so for a reason: they are deeply rooted in societal choices by citizens and their democratic representative institutions. Many OECD economies rely on PAYG systems to finance over 90% of workers’ right to decent, adequate and predictable pensions. However, pre-funded schemes account for a substantial source of retirement income for several countries. The OECD often claims that “no one size fits all”. It is essential that the Organisation adheres to this principle and accept the diversity of pension systems across the OECD economies.

11. Raising the retirement age is an easy solution to maintain sustainability from a pure accounting perspective. But in times of depressed labour markets, raising the retirement age without also giving workers the choice about when and how to retire, simply transfers the costs from pensions to unemployment. The emphasis on increasing the retirement age as a sole and unique solution to old age poverty is misplaced and misguided.

12. The way forward for pension sustainability lies not in transferring ever more market and longevity risks on to the shoulders of workers – as called for by the OECD through the expansion of DC schemes – but in restoring wage-based economic growth and breaking with the policies of the past of debt-financed consumer spending and labour de-regulation that have squeezed labour incomes.