Book Review

Pension strategies in Europe and the United States

**Robert Fenge, Georges de Menil and
Pierre Pestieau (eds.)**

*The MIT Press, Cambridge, MA, 2008, hardback, x+299pp., £22.95/US\$35.00,
ISBN: 978-0262062725*

Pensions (2009) **14**, 75–78. doi:10.1057/pm.2008.39

This book is a collection of nine essays on public (state) pension provision, very largely written from a European perspective, and based on a conference held in autumn 2004 in Munich. An introduction by the editors covers the overarching theme of the demographic challenge arising from the ageing population and declining support ratio in Europe (set to halve by 2050). Aggravating factors in many countries are the unsustainable financing of pay-as-you-go (PAYG) pensions and – at least until recently – early retirement. It is becoming ever harder to discern a viable way to fund a state pension system without formidable costs imposing a treble burden on the working population, that is, funding their own pension provision and at the same time supporting current pensioners via the tax system, while the prospect of retirement recedes into the distance.

The first three chapters of the book deal with the choice of the statutory retirement age and the effective, earlier, retirement age, which currently averages 59 in France, Germany and Italy. Eytan Sheshinski argues from a mathematical analysis that delayed retirement credits should be more than actuarially fair to offer the necessary incentive to work longer. In the United Kingdom, a worker reaching state pension age may choose to indefinitely defer their pension in return for an effective annual increment of

10.4 per cent; this represents a 40 per cent improvement on the incentive rate on offer before 6 April 2005 (when the maximum deferral period of 5 years was also removed). The United Kingdom is also raising the state pension age, first of all for women from 60 to 65 over 10 years from 2010 and then for both sexes to 68 over the period 2024–2046.

France has adopted a different strategy. In 1981 President Mitterand actually lowered the state pension age in France from 65 to 60. In 1993, instead of restoring the minimum age the French government chose to extend the length of working life in the private sector required to qualify for a full pension. A further reform in 2003 extended this to the public sector and also added another two years to the working life. Antoine Bozio examines the extent to which workers have been able and willing to comply, and finds that every additional year of required work history generated about six months of effective additional work. The unpopularity of working longer is illustrated by the doubling (to 4 per cent) of the probability of retiring early on a disability pension in France.

Juan C. Conesa and Carlos Garriga demonstrate that in the United States, at least (where taxes are lower and the demographic crisis not so acute as in Europe generally), a solution is

possible. The optimal response to the crisis, they argue, consists of the elimination of compulsory retirement; lower rates of income tax for the young, with the rate following a bell curve and a temporary increase of government debt during a period of around 15 years of increased dependency ratio. While the first of these conditions has received some recognition, the second is novel and warrants wider consideration; the third may be unmentionable at the moment (October 2008).

Theodore Bergstrom and John Hartman examine the democratic conflict in funding PAYG pensions between the preference of young voters for reduced pension benefits and older voters' desire to raise social security taxes. They find that in the United States, where benefits paid out are projected not to exceed social security tax revenues until about 2018, the median voter – currently in their late 40s – will continue to prefer higher taxes at least until the surplus in the social security trust fund is depleted around 2040. The primary reason is that US workers begin to be net beneficiaries from the future costs and benefits of social security while in their early 40s. A second factor is a general belief that if benefits are maintained at current levels they are less likely to be cut later on, whereas cuts made today are unlikely to be restored. (A counterweight to the latter belief is a commitment from the present UK government to restore the earnings link to the UK basic state pension, broken in 1980 and replaced by price-indexing.)

Continuing the theme of individual choice, in another paper heavily permeated by mathematics Gabrielle Demange compares first pillar (basic state pension) systems using stylised versions of the British and French systems. The former pays flat rate and the latter earnings-related pensions. If the underlying economies are dynamically efficient, she suggests the general preference will be for the British model; the rich would vote for it because it requires lower taxes and the poor because it is the most redistributive. This also draws attention to the importance of supplementary private pensions, which outside the United Kingdom and the Netherlands has

historically been very much a minor theme in European pension provision.

In Chapter 6 Woojen Chung, Richard Disney, Carl Emmerson and Matthew Wakefield look at public policy and retirement incentives in the United Kingdom. Here, contracting-out (opting-out) of the supplementary state earnings-related pension system has substantially reduced state pension liabilities. Incentives to contract-out in the form of national insurance contributions rebates, particularly in the early years of personal pensions (post-1988) incited selection against the state and take-up was substantial. This lessened as rebates were made more neutral, although saving rates among remaining optants increased. Stakeholder pension schemes were introduced in 2001 to address certain unattractive features of the personal pension regime, notably perceived high charges; bringing no new incentive, however, these did not add significantly to national savings. The onus to save in the United Kingdom is largely upon the individual: there is still no requirement for any employer to contribute at all to a private pension scheme on behalf of employees (although this might change from 2012).

Luisa Fuster, Ayse Imrohoroglu and Selahattin Imrohoroglu consider the annuitisation of savings. Although a well-off minority in the United Kingdom with diverse financial assets is vociferously opposed on principle to mandatory annuitisation, the authors show that this benefits most households. In their model, based on US data, when combined with a personal savings account into which 5 per cent of social security taxes are paid, the preference over the current PAYG system is nearly universal. The longevity insurance is the attraction; although in theory the PAYG state pension also covers this risk, it is felt to be vulnerable and its value is also negated somewhat in the authors' model by their assumption that children will always support their parents.

The Netherlands, the only other European country with a substantial second pillar (that is funded) pension system is the subject of Chapter 8 by economists Lans Bovenberg and Thijs Knaap. They quantify the vulnerability of both the

PAYG state pension and funded pensions to the consequences of an ageing population. The Dutch pensions economy is arguably the most similar to the UK's, the main differences being that if an employer offers a pension scheme, membership by all employees is obligatory, and that most funded pension schemes are still Final Salary arrangements. After an experiment with voluntarism since 1988, the United Kingdom is moving back towards auto-enrolment (although it will still be possible to opt out), but a pronounced trend away from DB to the DC model already dominant in the United States is now irreversible.

Options examined by Boverberg and Knaap to address the projected shortfall in funding are less radical, and entail raising (employee) contributions, with or without a reduction in indexation. The first option alone would require a very sharp increase to 25 per cent, and even when stabilised, a long-term contribution rate of around 16 per cent. The negative impact on net wages, particularly for those born around 1980, renders this option alone infeasible. The second option combines an immediate increase in the contribution rate to 16 per cent with conditional indexation; this has a less deleterious effect on the wider economy, but produces lower pensions for the first 20 years and thus may also be politically impractical.

An alternative – still assuming a 16 per cent contribution rate – is to switch to a career average basis instead of final salary (with a transitional cohort, those already in the final salary system, for whom the average wage until the base year is set at their wage at the start of the transition). Inter-generational fairness can be improved by adding conditional indexation to this model. Wider options briefly reviewed include adjusting the income tax rate to subsidise pensions and increasing labour-force participation, although not an increase to retirement ages. However, Boverberg and Knaap recognise that ultimately the inter-generational risk-sharing implicit in DB schemes can only be eliminated by a wholesale switch to DC.

Citizens of European countries which continue to operate relatively generous PAYG state pension

schemes are becoming increasingly (and justifiably) sceptical that their pension promise will be delivered. Perhaps only a small minority of the current workforce are in a position to do much about this on their own, especially in a depressed global economy; but for those who are, the final chapter in which Christian Gollier considers optimal portfolio management for individual pension plans is relevant. Gollier qualifies the conventional wisdom that younger households should be less risk-averse, by reference to individual factors such as the riskiness of the household's human capital, the intensity of potential liquidity constraints it faces (for example, the risk of unemployment), the degree of flexibility of their labour supply and the quality of their knowledge of the functioning of financial markets.

This book analyses different possible strategies for addressing a looming crisis in developed countries. The editors conclude their introduction by examining how two European countries have actually grasped the nettle, that is, the imperative to extend working lives and increase personal savings. Successive German governments since 2001 have introduced a new voluntary (but subsidised) vehicle for retirement savings and new initiatives to improve labour-market flexibility for older workers. The statutory retirement age has also been set to gradually increase from 65 to 67 over the period 2012–2035. Take-up of the new 'Riester' savings accounts has been limited (less than 20 per cent of those eligible, in the first 5 years), partly for the same reason that bedevils saving in the United Kingdom: the perception that in a system which guarantees welfare benefits to the poorest, it does not pay to save.

The United Kingdom, where the state pension is far less generous, has also shied away from the introduction of mandatory saving for retirement. Even with the planned introduction of auto-enrolment in 2012, a major policy initiative, it will still be possible for individuals to opt out. However, none of those who do opt out will any longer receive a contracting-out rebate; instead they will pay full national insurance contributions. They will also forego a contribution from their employer: for the first time in the United

Kingdom, it will be mandatory for an employer to contribute to a private pension scheme (unless the employee opts out). Minimum total contributions are to be 8 per cent of qualifying earnings, broadly speaking double the level going into the German 'Riester' accounts.

At the same time, wage indexation of the UK state basic pension is to be restored following its replacement by price indexation in 1980. The purchasing power will thereby increase, although as a percentage of average earnings the UK basic state pension will remain lower than in practically all other European countries. This is only slightly mollified by a reduction to 30 in the number of working years required to qualify for a full, flat rate basic pension. As the earnings-related part of

the UK state pension is also to become flat rate, the pressure upon the individual to save for their retirement will increase. The final part of the UK's reforms is a gradual increase to the age of state pension entitlement, ultimately to 68 in 2046.

UK citizens can only pray this package of reforms will not prove to be too little, too late. The challenge remains a daunting one for all developed countries, with ominous portents for the stability of future political society if lasting solutions are not established soon. This book is a useful contribution to the debate.

Ian Neale
Aries Pension & Insurance Systems,
Northamptonshire, UK