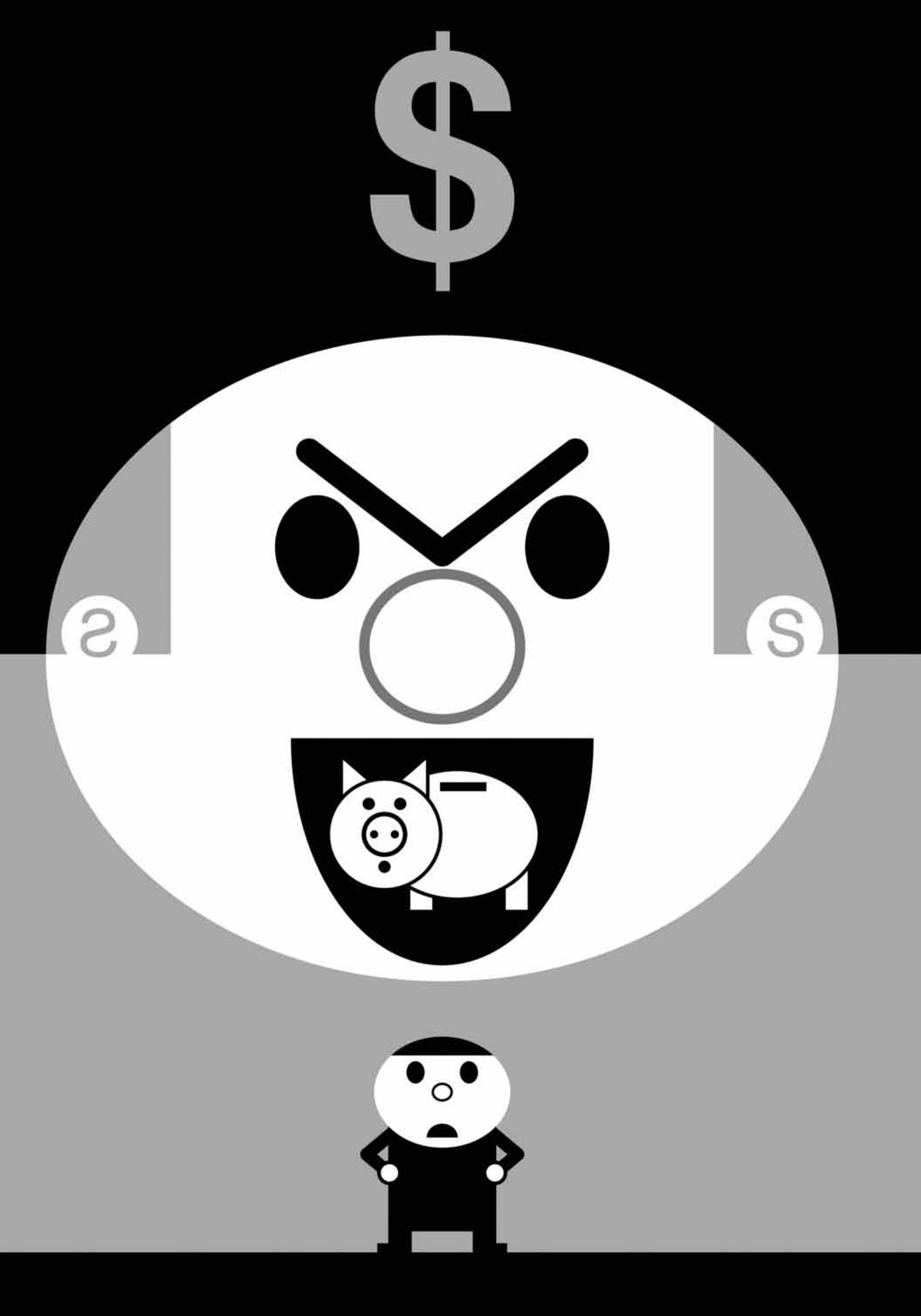

RETIREES
THE NEW GLOBAL SECURITY THREAT

BY THOMAS J. HEALEY AND CATHERINE M. REILLY

One great threat to social, economic and political stability around the world has nothing to do with extremism or authoritarian rule. It is that most governments currently lack the means to ensure comfortable lives for ballooning growing numbers of retirees without shortchanging the young or bankrupting public coffers.

There are troubling signs everywhere you look. Public pension systems that were never designed to cope with rapidly aging populations are struggling to meet their obligations – and some are already cracking under the strain. Meanwhile, the rise in government debt-to-GDP ratios that followed the global financial crisis, along with paltry interest returns on the fixed-income portfolios of retirement systems, has exacerbated the problem.

To be sure, the pension imbroglio manifests itself differently from country to country. Brazil has an extraordinarily generous system that, for example, allows daughters of military personnel to keep their fathers' pensions after the fathers die. This kind of largesse has served to ramp up inflation, fray public finances and suck resources from productivity-enhancing investment.

By contrast, in South Korea, a mere third of retirement-age citizens have pensions. Couple that with the fact that Koreans are backing away from the tradition of providing for elderly parents, and you have a recipe for political and cultural conflict. One grim consequence is already in evidence: faced with the prospect of living out their final years in poverty, Koreans who are too old to work are committing suicide at a rate that's tripled over the past 15 years. Indeed, for this and other reasons, South Korea now has the highest suicide rate of any high-income country.

Brazil and South Korea may be polar opposites in their shortcomings in retirement planning, but they share a formidable challenge. In both countries,

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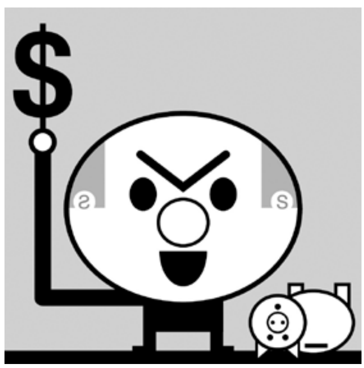
the number of people over 65 is expected to grow threefold by 2050, leaving their current pension systems increasingly inadequate or unviable, or both. To identify the sorts of pressures and problems governments face – as well as to pinpoint remedies based on best practices employed by the most-foresighted nations – we studied pension systems in 33 countries across five continents.

We uncovered a host of practical ways in which countries could provide for retirees without pushing already-stressed government budgets to the brink. Doing that, however, calls for a difficult balancing act in which nations improve both the *sustainability* and the *adequacy* of their pension systems.



Countries are often good at one task, but seldom both. For example, South Korea, China and India rank among the top-five most-sustainable – that is, their programs place the least burden on public finances to provide the benefits promised. By no coincidence, though, they also rank among the lowest five in terms of adequacy, as measured by their capacity to ensure sufficient income to retirees, which we defined as providing at least 60 percent of the average wage to those who retire at 65. (Since pensions can originate from either the public or private sectors, we included both sources of funding in our study.)

Moreover, a pension system that is apparently fiscally viable but inadequate to the task still poses a risk to public finances in the long run. Even if the fiscal burden is not currently great in countries like South Korea, China and India, they could eventually pay a steep price when their governments are forced to provide public assistance to increasing numbers of the elderly without the means to make ends meet. In other words, low levels of pension-system adequacy may eventually translate into equally low levels of sustainability.

On the other side of the coin, the pension systems of countries including Austria and Hungary are among the most adequate – but also among the shakiest in terms of sustainability. While they've promised ample income for retirees, that generosity will come at a price. The projected burden on public finances is so heavy that unless these countries seriously address sustainability, they will almost certainly be unable to keep their promises.

By our reckoning, the U.S. system falls within the inadequate group of pension programs. This may come as something of a surprise because this country relies so heavily on private pension assets, which masks inadequacies in the public retirement realm. In truth, though, the U.S. system is highly fragmented, combining government-provided Social Security, corporate- or state-sponsored defined-benefit (annuity-like) pension plans and tax-sheltered direct-contribution plans like IRAs and 401(k)s, as well as personal savings. Thus, while aggregate private pension

THOMAS HEALEY, a former assistant secretary of the Treasury and former partner at Goldman Sachs, is a senior fellow at Harvard's Kennedy School of Government. CATHERINE REILLY, formerly chief economist of Pohjola Asset Management in Finland, is a student in the Master of Public Administration program at the Kennedy School.
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savings is impressively high, roughly half of the working population has no access to employer-sponsored plans and little in the way of private savings. Large numbers will thus be dependent on woefully inadequate Social Security checks.

Other countries whose benefits appear inadequate to meet the needs of retirees include Mexico, Indonesia and Australia (in addition to the previously mentioned China, South Korea and India). Australia, incidentally, registered the lowest spending on public pensions as a share of GDP of all the developed countries we studied.

European nations, on the other hand, can boast of high levels of pension adequacy. However, with a few notable exceptions, including Switzerland and the Netherlands, they have done little to ensure sustainability through advance funding. At the other end of the adequacy spectrum are developing countries with typically meager public benefits and few private pension resources.

Which countries, then, can be considered the world's top pension stewards, balancing sustainability and adequacy to land in the efficient space mapped out in our study?

The Netherlands is clearly a leading innovator in pension-plan design. Its pension system is built on a combination of a universal flat-rate pension and quasi-mandatory occupational pensions covering 95 percent of the working population. Employers and employees alike contribute to the occupational pension fund. Employers must fund their actuarial obligations each year, but after that bear no further risk. Pensions are paid as a career-average-income-based annuity, but employees share the risk, as payments can be lowered if the plan fails to meet its solvency requirements.

Other high achievers include Switzerland, Denmark, Sweden and Britain. A number of former Eastern Bloc countries – Poland, Estonia and both the Czech and Slovak Republics – also reside within the efficient category. That's a two-sided coin, though, since their efficiency follows from the fact that, on average, retirees collect pensions for a shorter period (generally 15 to 20 years) because life expectancy is lower than in high-income countries.

TOP AND BOTTOM COUNTRIES ON SUSTAINABILITY AND ADEQUACY

	SUSTAINABILITY INDEX		ADEQUACY INDEX	
	COUNTRY	SCORE	COUNTRY	SCORE
TOP FIVE	S. Korea	82	Luxembourg	97
	Australia	75	Russia	83
	India	74	Hungary	74
	Indonesia	72	Netherlands	74
	China	70	Austria	67
BOTTOM FIVE	Italy	12	Germany	30
	Austria	11	China	22
	Greece	10	Mexico	20
	Hungary	9	S. Korea	4
	Belgium	9	India	2

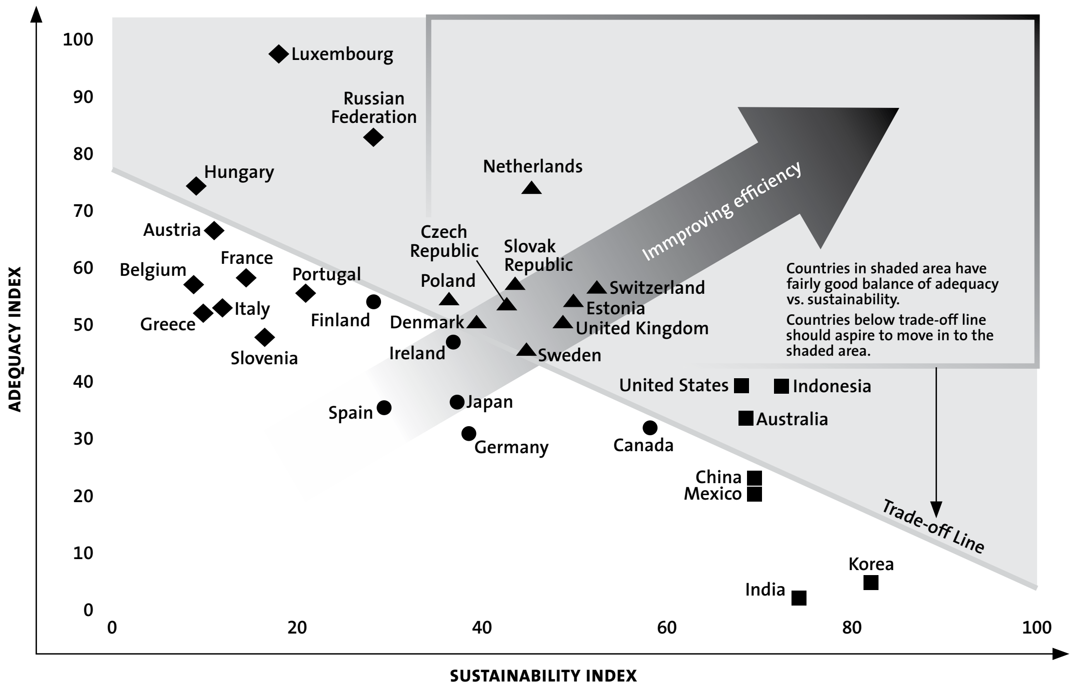
SOURCE: World Bank

WHAT CAN BE DONE?

As policymakers in the United States have learned over the past half century, there is no set-it-and-forget-it formula for calibrating the sustainability and adequacy of pension systems. The recipe will differ by country based on differences in demographics and plan dynamics, and may require politically difficult midcourse corrections. Before weighing what reforms might work, however, it's helpful to look more closely at the nature of the problems they're intended to address.

One core reason that government pension systems are under so much stress, particularly in Western countries, is that they were designed predominantly on a pay-as-you-go basis. In a pure pay-as-you-go plan, current revenues cover current pension benefits. If

ADEQUACY VS. SUSTAINABILITY: THE TRICKY TRADE-OFF



SOURCE: Authors' calculations

the share of the population receiving benefits remains stable, that is a perfectly reasonable way to fund a pension program. The logic behind such plans suffers, however, when the demographic profile changes. Case-in-point: the Baby Boomers.

Because this post-World War II generation is far larger in numbers than its predecessors, the share of population in retirement is increasing rapidly in many parts of the world. Combine this with another shifting dynamic, the increase in life expectancy, and you're left with a precipitous decline in what's known as the old-age support ratio – that is, the ratio of working-age people to the population over 65.

In plain English, there are fewer people available to pay for pensions and more people receiving them than there were in the past.

Gilding this poisonous lily is the fact that, even as life expectancy is rising, the retirement age is falling in many countries, increasing the expected time spent as pensioners for countless millions around the globe. As if this weren't enough, the problem is further compounded by the fact that so many public pension plans offer fixed monthly (and in some cases, inflation-indexed) payments, with little if any automatic adjustment to the plans' capacities to actually sustain those payouts.

The math is simple and the conclusions troubling: the population still working will have to shell out ever-larger sums to cover the cost of pensions. Indeed, barring unanticipated gains in productivity, the burden on the working population will surely become intolerable. In most of the countries we studied, that breaking point is forecast to occur between 2030 and 2040.

Early retirement is a particularly big problem in Europe. France, for example, has one of the lowest retirement ages and one of the highest life expectancies, leading to an expected retirement duration of 25 years. By comparison, in countries that fit our efficient parameters, the maximum expected duration is 20 years. The inescapable conclusion for countries like France? They need to raise their retirement age.

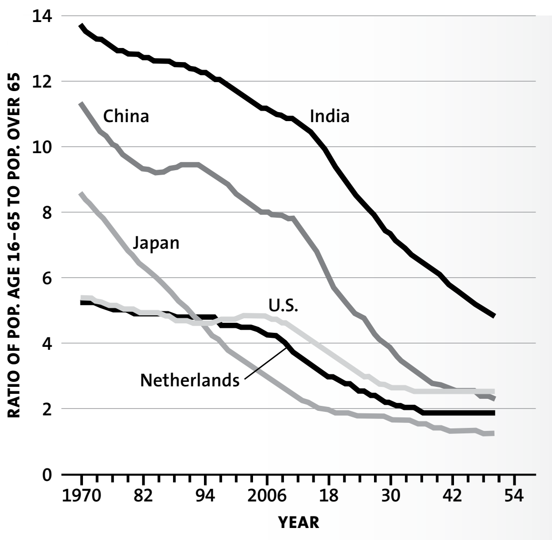
Hiking the age of retirement to track increases in life expectancy (and thus stabilize average years in retirement) is, indeed, an extremely powerful tool for improving the sustainability of pension systems. Even relatively small increases could have a large fiscal impact.

The catch, of course, is that raising the retirement age is hugely unpopular. In fact, some countries (including France and Germany) have actually moved in the opposite direction, reversing previous increases in the minimum age of pension eligibility. However, there does appear to be a growing awareness in the countries we studied that something must give. A crucial step, we believe, to getting from here to there without a serious backlash is to raise the retirement age in gradual increments.

There are other sound approaches policymakers could deploy to ensure that pension costs are in sync with increases in life expectancy. One is to introduce a longevity coefficient into the pension-benefit calculus. The concept is rather simple: as life expectancy rises, the expected monthly payment for new retirees automatically falls sufficiently to offset the expected rise in cost. Finland and Italy currently use longevity coefficients, and other governments are exploring their potential.

Adding longevity coefficients alone, however, would not put pension plans on a sustainable footing if the underlying entitlements are excessive. Traditionally, benefits have been

OLD-AGE SUPPORT RATIOS ARE DECLINING GLOBALLY



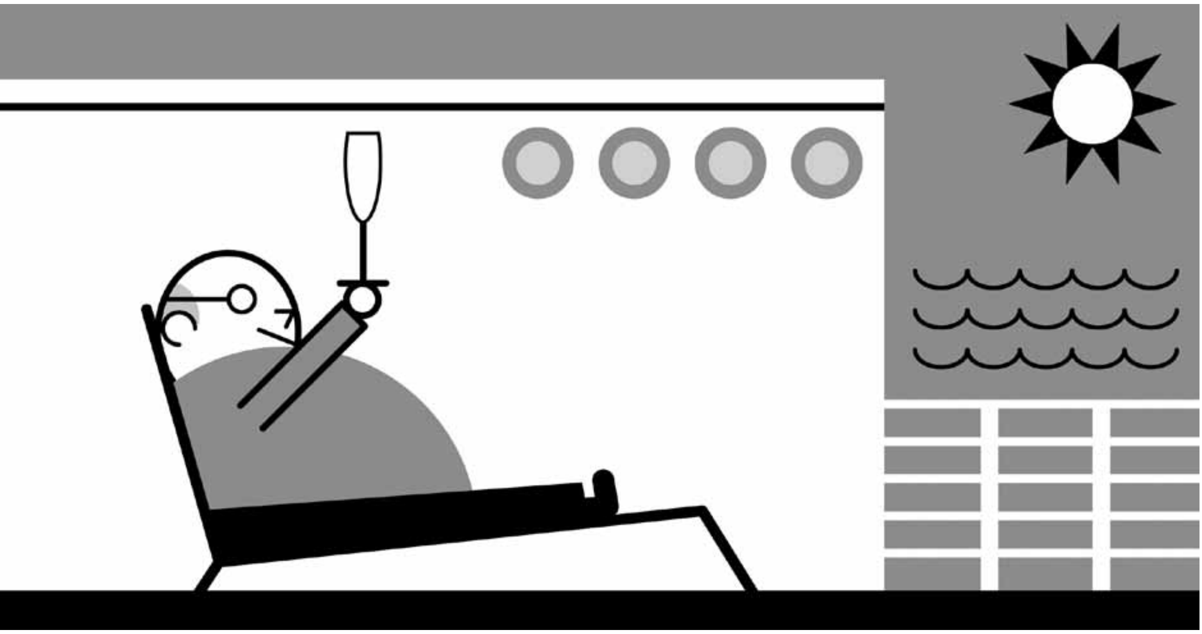
SOURCE: Authors

linked to final-year earnings – a practice that opens the systems to gaming at the expense of the funders. Happily, a growing number of countries are shifting to benefit formulas based on lifetime earnings. This fundamental change is not just aligning payouts with actual employee contributions, but significantly reducing expenditures across entire pension systems.

Another route to improved sustainability, of course, is to increase workers' incentives to stay on the job longer. To that end, Finland and Britain have experimented with offering higher pension-accrual rates to those who prolong their careers. Sweden allows employees to choose their own retirement ages with no upper limit, adjusting monthly pension entitlements accordingly.

TOWARD BROADER PENSION COVERAGE

Countries have inadequate pension programs either because the share of the population that is covered is low or the promised payout



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is insufficient to meet retirees' needs. In the United States, for example, just half of employees are covered by occupational pension plans. And the proportion is even lower in Canada and South Korea, with 40 percent and 30 percent coverage, respectively.

Clearly, one key to protecting more people is to take the decision out of their hands – saving for retirement is an area in which households make notoriously myopic choices – by introducing compulsory or, at a minimum, opt-out enrollment as part of well-designed pension programs with adequate contribution rates.

Governments also need to ensure that employees have easy access to pension systems they can take with them as they change employers. Under U.S. regulations, 401(k) plans effectively become portable after five years on the job. Meanwhile, Britain has introduced the National Employee Savings Trust, which gives workers who lack access to an employer-sponsored plan a low-cost, portable retirement savings account with automatic enrollment. Meanwhile, Australia is considering a plan to introduce compulsory annuitization of retirement savings, preventing retirees from imprudently putting their core savings at risk and eliminating the chance they will outlive their nest eggs.

President Obama's proposal for myRA accounts, while modest, is also a step in the right direction. These accounts would give people without employer-sponsored plans such as 401(k)s access to affordable retirement savings accounts with automatic deposits from their paychecks.

BUILDING TO LAST

The ultimate reward for countries optimizing both sustainability and adequacy is improved pension efficiency. Improving efficiency is of particular interest for countries in our less-efficient bracket – among them Ireland, Japan, Germany, Spain, Canada and Finland. First, they must build strong and durable links between payments and long-term sustainability into their pension systems. This means both sponsors and beneficiaries must share the risks, a characteristic clearly at odds with traditional defined-benefit plans in which plan sponsors (and sometimes government pension insurers) bear the lion's share of the risk.

Two intriguing new approaches in this vein are "notional defined contribution plans" and "collective defined contribution plans." With an NDC, contributions are recorded as notional accounts, to which a rate of return (typically the rate of GDP growth) is applied. The balance in the account is then converted to an income stream upon retirement. By linking contributions to GDP growth, notional accounts prevent the pension burden from outstripping the economy's ability to fund them. They are typically used for reforming pay-as-you-go systems.

Under collective defined contribution plans, which are used in conjunction with advance or prefunded plans, proceeds are pooled in centrally administered investment funds rather than put in individual accounts. Beneficiaries thus bear both market and longevity risks collectively rather than individually, giving the plans some of the risk-sharing characteristics of traditional defined-benefit systems. Since the pool contains members in different phases of their lives, the fund is able to maintain higher investment rates and thus deliver better returns over the long run than individual plans. Benefit payments are calculated on the basis of lifetime contributions and annuitized upon retirement.

It makes eminent sense for plan sponsors to seek to maximize returns on advance-funded assets within acceptable risk parameters. But some collectively managed pension funds – including some of those in the United States, China and Japan – are constrained by requirements that they invest their funds in domestic government bonds. This means they are not reaping the full potential rewards of advance funding their pension assets. For collectively managed pension programs to achieve the best results, the assets should be invested in diversified portfolios that include risky assets. For plans in which beneficiaries have discretion in investment choices, it is important to provide savers with appropriate, low-cost default portfolios, as many savers lack the financial literacy to make optimal investment decisions for themselves.

BEACONS OF ENCOURAGEMENT

Despite the political and economic complications of changing entrenched public pension systems, extensive reforms have in fact been achieved by a handful of progressive nations. The Netherlands and Denmark, for example, have introduced collective defined contribution plans in which payouts are adjusted if solvency limits are breached. Sweden now has a notional defined contribution plan in which benefits depend on GDP growth, while Britain and Poland have expanded their direct contribution systems.

For most countries, though, the shift from inadequacy and/or unsustainability to high efficiency will be considerably more difficult. In Europe, for example, many countries with steep pension liabilities are also saddled with high government debt. While raising the retirement age in line with life expectancy would clearly help put these systems on a more sustainable course, it would first require major labor market reforms to make it easier for people to extend their working lives.

If inefficient pension systems are to stand any chance of survival over the long term, sponsors must step up now and push for dramatic change. They can take inspiration from governments that have already retooled public pension systems to reflect changing demographics, while drawing on best practices from other systems. Successful pension reformers can and should serve as beacons for policymakers everywhere.