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Plunging Pensions
and
the Credit Crunch

Jay Ginn

Centre for Research on Ageing and Gender

University of Surrey

j.ginn2@gmail.com

Re-examining the orthodox view of past 30 yrs

View of World Bank, ECOFIN, OECD, policymakers and govt. economists:

A. State pensions unsustainable due to population ageing and declining support ratio, so unfair to future generations

B. Reduce state pensions and expand role of private pensions – the Anglo-American model – to solve problem

C. Private pensions increase national savings and hence economic growth

D. They encourage self-reliance and personal responsibility

More balanced discussion, as in:

- Schokkaert and Van Parijs (2003) *Debate on social justice and pension reform*, JESP13:3.
- Howse (ed) *Ageing Horizons* (2004) Issue 1.

The financial crisis prompts a critical re-examination of the arguments for market pensions

A Critical View of Funded Pensions

1. Funded pensions invested in the stock markets have inherent weaknesses – highlighted by the credit crunch

- decline of scheme viability
- inequality and poverty in retirement and poorer prospects for workers

2. Challenging the orthodox view

- analysis of 4 tenets by critical social scientists

3. Conclusions

Crisis in funded schemes - DB

1. Defined benefit schemes

1997-2005. UK Scheme membership among employees fell from 34% to 19%

2002. Many UK scheme closures

2005. Pension Protection Fund based on scheme levies set up to compensate members when schemes fail

2007. Scheme deficits = £21bn; more schemes close to new members (NAPF)

2008. Total deficit of 7,800 UK private sector schemes = £97.3bn, from FTSE fall of 37%. 84% of these schemes in deficit. Shell scheme fund lost 40%.

2009. 75% of DB schemes in UK closed to new members. 25 major companies to switch to DC scheme. Call for taxpayers to underwrite PPF (NAPF)

2009. In US, assets of public sector pension funds are 30% less than liabilities but the crisis is obscured: many states are selling bonds to mask their pension deficit, delaying flak but increasing debt on future taxpayers (Bloomberg)

2009. Pension Protection Fund rules (section 75) to be relaxed allowing employers to reduce pensions in payment (UNITE)

2009 Ireland states it cannot offer a PPF for Irish DB schemes

(2009. UK liabilities of *unfunded* public sector DB schemes estimated as £650bn - £915bn)

Crisis in funded schemes - DC

2. Defined contribution schemes

2007-8. New employees often restricted to DC occupational scheme.

2008. Most individuals' funds lost 30-40% in 2008 from share price falls

2009, Price Waterhouse Coopers estimate that:

- Over past 20 years, DC scheme returns were no better than interest in cash savings account
- Over past 10 years, funds are ***less*** than total contributions, even before charges

Pensioner poverty and inequality; also grim outlook for workers

EU pension reforms followed OECD/World Bank script;

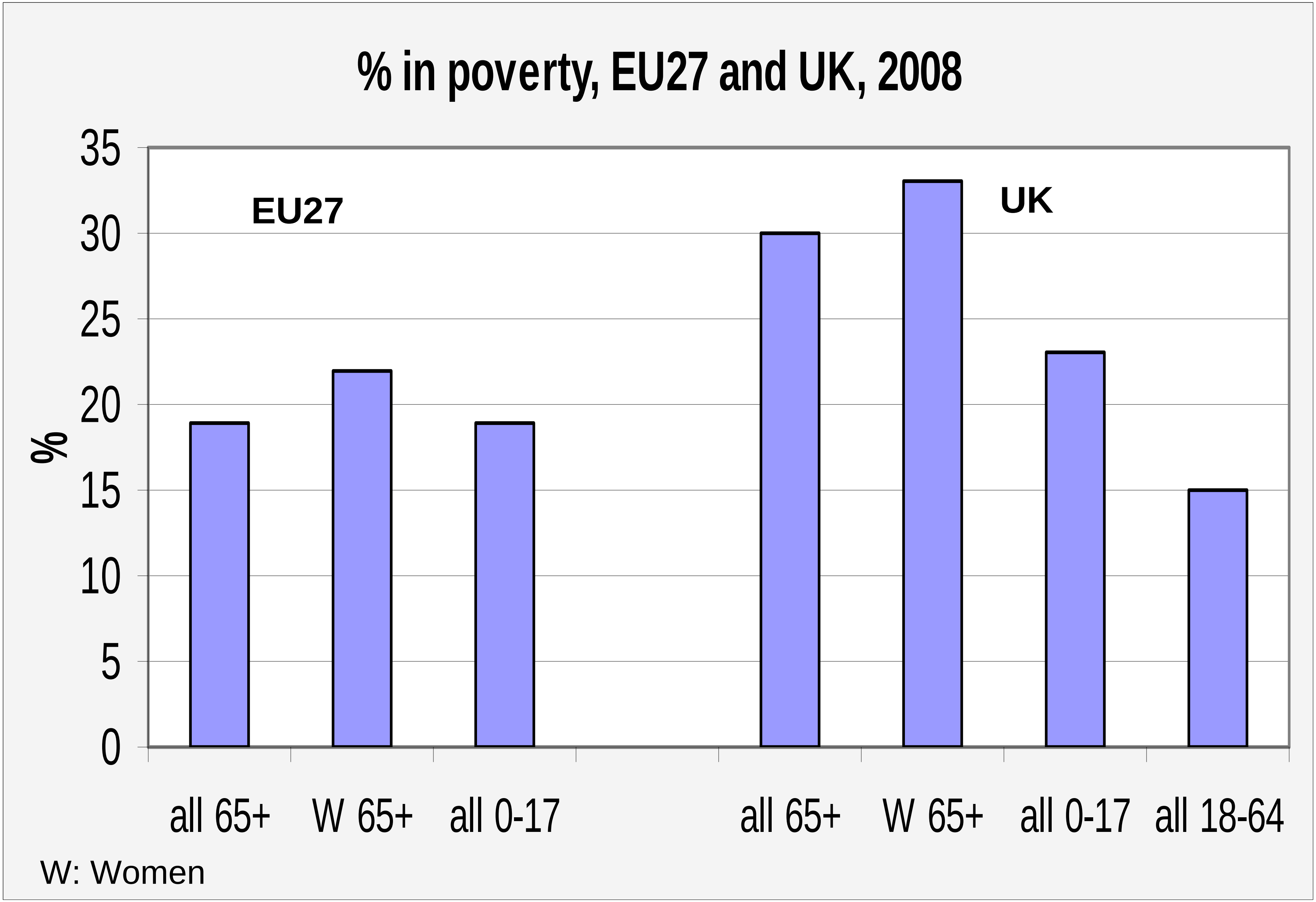
- **Cuts in state pensions**
  - reduced accrual and/or indexing
  - longer duration required for full pension

- **Resources shifted towards private pensions**
  - social insurance contributions diverted to private pension schemes.
  - growth of tax subsidies for saving in private schemes

- **Employers changing from defined benefit (DB) to defined contribution (DC) schemes**
  – market risk transferred to workers
  - job cuts as pension deficits exceed companies' assets (eg BA, BT)

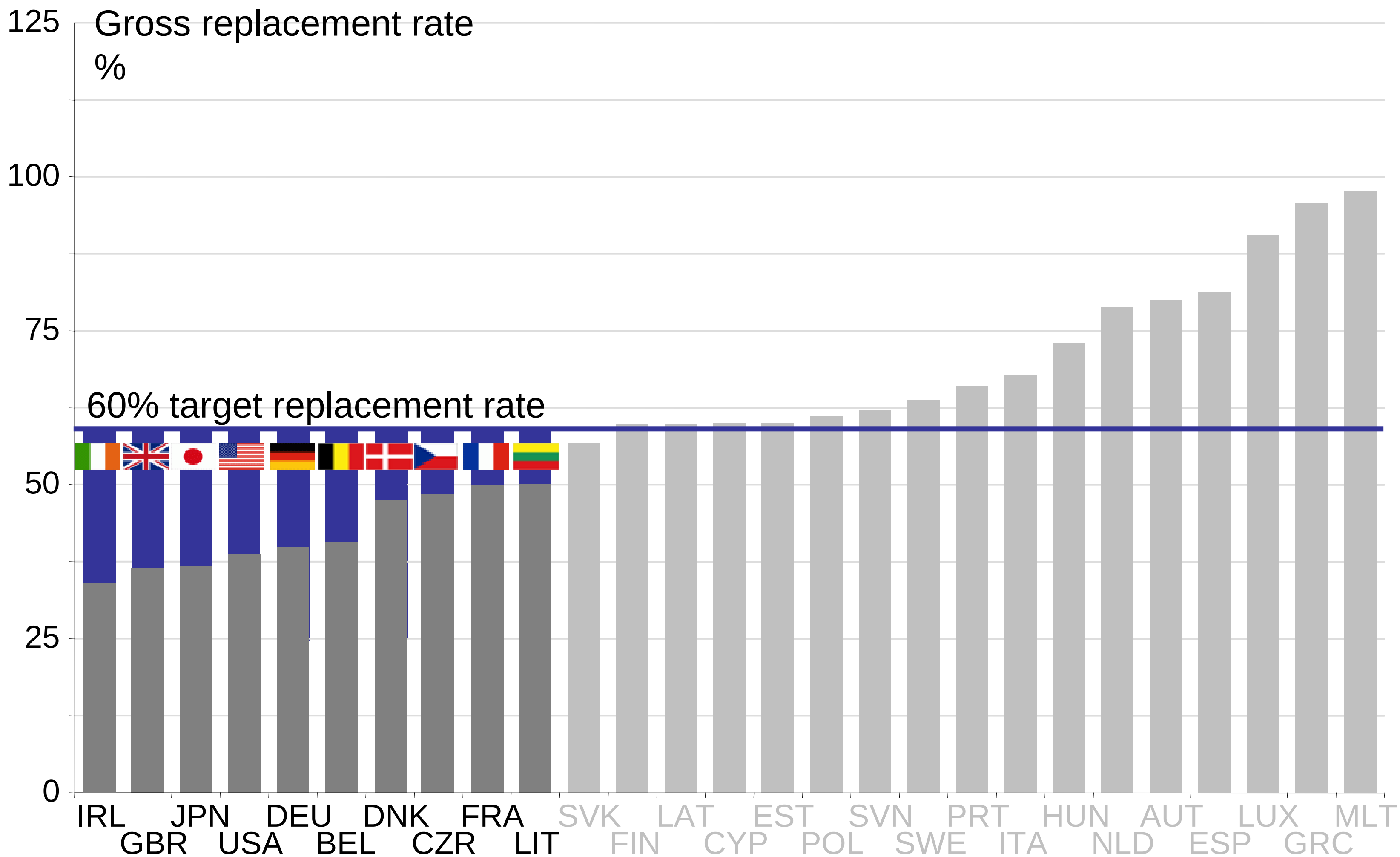
Following reforms, average pension promise in 16 OECD countries fell by 22%, 25% for women (OECD.org.els)

1980s: UK led the way in moving from state welfare towards occupational and fiscal welfare
1997-8 Labour indicated it would continue this policy

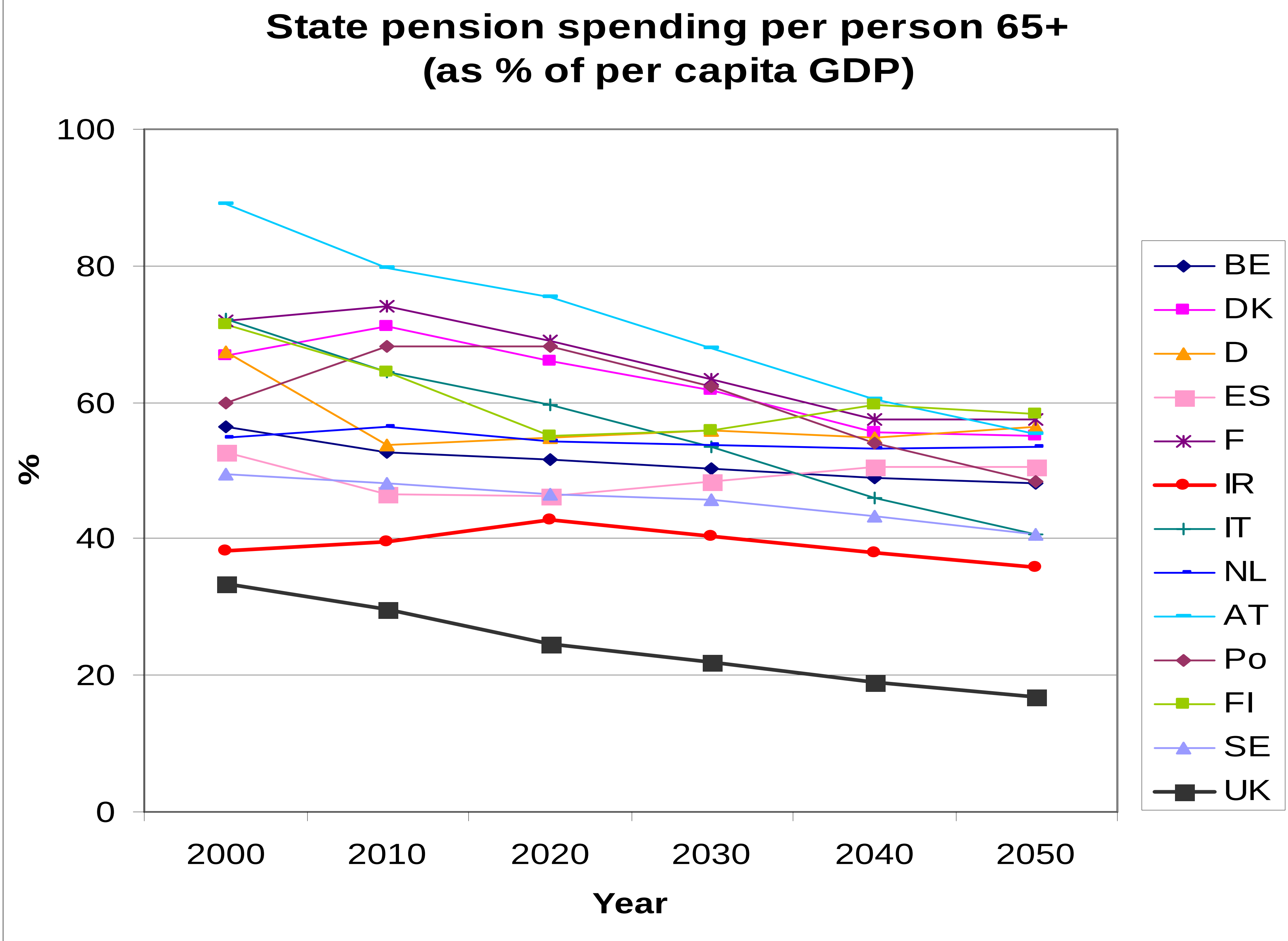


Source: http://ec/europa/employment_social/spsi/docs/social_inclusion/2009/

Gross replacement rates (state pensions) and 'pension gap' for average earner



Pearson, OECD 2006



Hughes and Stewart 2000: But UK spending set to rise following 2007 Pensions Act

Some financial inequalities, 2008

Annual income, 2008:

• Pension Credit recipient	£6,448
• National Min Wage	£11,000
• Senior council admin salary	£100,000
• Tony Blair's pension	£123,000 (2007)
• Fred Goodwin	£8 million

Other amounts, 2008:

• Bankers bonuses	£15bn
• Taxpayers' bail out to banks	£500bn* (so far)

Up to 2008:

• Direct cost of Iraq war to US	$750bn
• Total cost "	$1,864bn

- **£70bn = UK education budget, or**
  - **most of UK state pension budget, or**
  - **2x UK defence budget, or**
  - **GDP of Morocco, or**
  - **over £5,000 to each person in Zimbabwe…**

Growing critique of funded pensions

Recognition grows that funded pensions:

a) aren't immune to population ageing

b) are hostages to the stock market

1993: 'hardly any concern about the long-term prospects of the funded pension system' (Schieber & Shoven)

2000: '[Its] assumed that …the funded system..will remain insensitive to these same demographic changes.. [but] …longer LE as costly for the funded systems as for PAYG'

'returns …extraordinarily high in last 10-20 years' (Merrill Lynch, *Demographics and the Funded Pension System*)

A. 'State pensions are unsustainable with population ageing'

<u>Minns and others:</u>

- 'Apocalyptic demography' emphasises age ratios, not economic activity
- Employment rates are higher than in the past (especially among women), so economic support ratio only declines modestly
- Boomer bulge is temporary (peak 2030-2040)

<u>Mullan (2001) and Tomorrow's Company</u> (2005)

- Rising productivity will absorb the modest fall in support ratio, as in past.
- Average worker will be 2x as productive in 2045

  (assuming 1.75% pa rise in productivity)

<u>Taylor (2000) and Myles and Pierson (2001)</u>

- Rising cost of social insurance partly due to early exit; so tackle this

<u>Sinfield (2000) and Agulnik & LeGrand (1998)</u>

UK tax subsidy to private pensions is regressive:

1/3 cost of state pensions and over half benefit to top 10% of earners

UK National Insurance Fund has a surplus of nearly £50bn in 2009

B. ‘Funding solves the problem of population ageing’

<u>Crawford</u> (1997: 39, economist), also **Barr**:

‘Funded and unfunded pensions alike have to be provided out of …contemporary real resources which pension funding cannot alter’

<u>**Minns (**2001**),** also **Willmore:**</u>

- Funded pensions, like unfunded, are adversely affected by increasing longevity
- When baby-boomers liquidise their assets (ie sell their stocks and draw their annuities) the effect *will be to reduce stock prices and annuity rates*

C. ‘Funding increases savings, hence growth’

<u>Feldstein</u> (US, pro-privatisation):

- **Social Security (PAYG) has reduced national savings (1974 on).**
- **Without extra savings, the case [for privatisation] falls (1997)**

<u>Lesnoy and Leimer</u> (US, against):

- **Feldstein’s calculation based on a computer error.**
- **No conclusions can be drawn about effect of Social Security on savings (1987)**

<u>Hughes</u> (Ireland, against):

- **‘The balance of evidence does not show that ….funded …pensions significantly increase [savings] (2000)**
- **Many cannot afford to save. Those who can save switch between pensions and other forms**

C. 'Funding increases savings, hence growth'

UK Pensions Commission (2005)

- **90% of new investment funds come from corporate profits, not savings**

New Economics Foundation (2008)

A maximum of 15% of private pension saving is used for new investment in the UK economy; the rest goes to the City for speculative dealing; in 2002 the entire value of the London Stock Exchange changed hands in <7 months. In 1962, 50% of funds was invested in government bonds but in 2003 it was less than 7%

Minns (2006):

- **National productive industry may be unable to absorb extra funds or to provide a high return. A glut of savings depresses interest rates, eg Japan**
- **Extra saving means reduced spending on goods and services, limiting economic growth**
- **The search for highest returns leads to investment in risky markets eg Argentina.**

Pension fund assets are 43% of world GDP.
So how are they invested?

Toporowski (2000, *The End of Finance, ch 3*)

- Expanding pension funds are ‘footloose capital’, inflating stock market bubbles
- They inject large amounts of savings into capital markets, but need ever-expanding contributions to sustain the financial dynamic; a Ponzi process
- As savings decline with LM flexibilisation, capital market liquidity falls
- Faster transaction speed and churning increase volatility
- Pension fund saving (cheaper finance) adds nothing to the productive capacity of the economy

Foster and Magdoff (2008, *The Great Financial Crisis*)

- With saturated markets and falling profits from production, funds were invested speculatively in the finance sector, creating ‘fictitious’ capital

- From 1982-2006, the richest 400 Americans increased their wealth from $92bn to $1.2 trillion, mainly through financial operations

Source: Bank of International Settlement Records (Hetzel 2009, *The Future of the Economy*)

D. Private pensions encourage self-reliance

- An ideological position, with moral overtones
- Implies reliance on social insurance is irresponsible
- Ignores adverse impact of private pensions on the vulnerable (women, other carers, ethnic minorities, sick, low paid) who cannot save
- At odds with solidaristic values of EU population

Conclusions

– Private funded pensions are an irrelevant response to population ageing

– The financial crisis, in which stock market-based pension funds played a part, will incur costs to future generations

– Private pensions have adverse effects for pensioners, workers and the economy as a whole, compared with reliable and redistributive state PAYG pensions

'The trend towards private pensions which have no redistributive functions, will reinforce disadvantage…today's crisis demonstrates that [such] pensions cannot substitute for the responsibility of the state to ensure adequate pension provision'

(AGE Europe, 2009)

'Arguments for privatisation …are political arguments for changing the distribution of costs and benefits'

(Willmore 1998)

Some references

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