Editorial
Pension Policy: Weathering the Storm

The headline figures are frightening. The financial crisis has meant that private pension funds lost 23% of their investment's value, or some USD 5.4 trillion on aggregate in the OECD, in 2008. Stock markets fell further in 2009 before recovering to reach a level 6.4% higher on 21 May 2009 than at the start of the year. Across the OECD, economic output is expected to fall by 4.3% in 2009 and growth is not expected to return until 2011. Projections of unemployment rates show an increase from a trough of 5.6% in 2007 to 9.9% in 2010 in the OECD area. Thus, what started as a financial crisis has become an economic and social crisis.

Private pension schemes face the most immediate and visible problems from the fall in equity and property prices. The impact is obviously greatest in those countries where private pensions already play an important role in providing old-age incomes, such as Australia, the Netherlands and the United States. But no country and no pension system is immune from the crisis. Public pension systems will also encounter financial trouble as contribution revenues dwindle and benefit expenditures increase in the wake of higher unemployment and lower earnings. In addition, their reserves too have faced investment losses and pressure is mounting to use pension reserves for crisis mitigation, as witnessed most recently in Ireland and Norway where reserves are being tapped for bank recapitalisation and public works programmes.

Many people have lost a substantial amount of their retirement savings, in pension plans and other assets. The situation is particularly traumatic for older workers. Not only is it much harder for them to find a new job if they become unemployed but they also have little time to wait for the value of their pension savings to recover, before they have to start drawing down their assets. Income from savings, including private pensions, on average makes up a quarter of retirees' incomes in OECD countries. In seven of them, it accounts for more than 40%.

Will these losses lead to a resurgence of poverty among retirees? Many OECD countries have programmes that act as "automatic stabilisers" buffering the impact of investment losses on overall retirement incomes. Means-tested benefits, for example, will provide for people whose pensions fall below critical thresholds. But in some countries, old-age safety nets are, or will be, insufficient during times when the income from private savings drops. A temporary strengthening of safety nets, to weather the current crisis, is appropriate in these cases. But some countries had weak safety nets and high rates of old-age poverty before the crisis hit.

The short-term political pressure on governments to deliver immediate solace is immense and goes beyond simple prevention of old-age poverty. One clear danger in the present situation is that policy makers may be tempted to reduce the numbers of older unemployed by transferring them to long-term sickness or disability benefits or by

reopening early retirement schemes. Past experience shows that such schemes are very difficult to close down and measures intended for the short term tend to persist, imposing a very heavy cost on the public purse. Such measures should be avoided: they give the wrong signal and divert from the needs to increase effective retirement ages to offset the impact of population ageing. Nevertheless, countries have so far resisted.

The crisis has reinforced our view that further reform is needed in both public and private pension schemes. Among the top priorities are careful reviews of public retirement-income programmes to ensure that they provide effective protection against poverty, both now and in the future. But another look also needs to be taken at the automatic pension adjustment mechanisms which many countries have introduced to link pension expenditures with life expectancy, wage growth or the level of assets in reserve funds. These mechanisms were designed during times of sustained economic growth. In some countries, applying the rules during the recession would mean cutting benefits, in some cases even in nominal terms. Governments will have to consider carefully whether the rules should be applied now, whether they should be suspended temporarily until economic recovery starts, or if they may be best applied selectively by exempting the most vulnerable groups of retirees.

Confidence in private pensions is at an all-time low. In a number of OECD countries, there have been calls to move away from mixed pension systems back to an exclusive reliance on public pay-as-you-go schemes. In the Slovak Republic, for example, workers covered by the new defined-contribution plans have been allowed to switch back to the public system and similar roll-backs of reform have been proposed elsewhere in eastern Europe. This is the wrong way to go. The financial and economic crisis has moved the centre of attention away from the demographic challenges that pension system are facing. But these challenges have not disappeared nor have they become less urgent to address.

To prevent a backlash and the reversal of past reforms, it will be important to restore people's faith in private pension saving. The crisis has made the need for changes in the way private-pension schemes operate painfully clear. These include better regulation, more efficient administration, clearer information about the risks and rewards of different options and an automatic switch to less risky investments as people near retirement. If policy makers do not succeed in making a convincing case for diversified retirement income systems, combining public and private, pay-as-you-go and funded, individual and collective elements, they will be thrown back to square one in their efforts to maintain prosperity in ageing societies.

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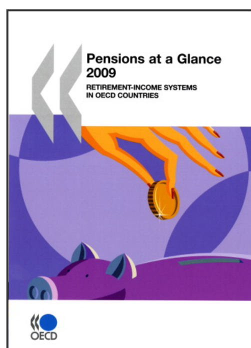

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