The Pay-As-You-Go Pension Problem

What would happen if nobody could die? The popular TV show *Torchwood – Miracle Day* poses this interesting hypothesis. Setting aside the fact that all of the actuaries would be out of a job; life insurance would become worthless, pension funds would go bankrupt in a matter of weeks and generally, despite something which is mostly a benefit to humanity, the financial world would self-destruct.

Although this is an extreme example, Miracle Day highlights a serious problem faced by the UK and other European countries today. Increasing life-expectancy, combined with falling birth rates and early retirement ages, is stretching their public pension systems almost to breaking point. Many of these countries have not accumulated enough funds to pay their future liabilities.

The majority of public pension schemes run on a pay-as-you-go system, where each generation's retirement benefits are paid directly by the workers of the following generation.

There has been no problem with this in the past, when contributions from the current workers easily outstripped the benefits paid to retirees. Now, however, the demographic changes experienced by Europe are increasing the benefits, as pensioners retire at the same age but live longer, and the contributions from new/future members cannot keep up. Though similar changes are happening in Australia, it is less of an issue here due to the advent of private fully-funded superannuation.

Unfortunately the solution isn't as simple as switching to privately-funded superannuation, as this would mean the current workers must save twice – once to finance the current retirees, and again to finance themselves.

When the schemes were enacted, the first generation of retirees will have received a free pension having contributed nothing or very little. So now, in order to switch away from this system, benefits would have to be taken away from today's generations. In a world free of politics there would be a number of potential solutions for these pension schemes – all of which are bad for one of today's generations. Amongst these is increasing the retirement age, thereby forcing would-be benefit receivers to remain contributors for longer. A second is to increase the contributions through higher taxation, and a third is to decrease the benefits paid to retirees.

The issue is we do not live in an economics classroom and so any of these solutions are extremely hard to implement. If you try to change things for long-term benefit at a cost to one generation, that generation of voters are going to be extremely unhappy. The French situation is a prime example, where President Sarkozy attempted to raise the retirement age by two years. The resulting riots were plastered all over the news.

With the baby boomer generation approaching retirement age it is clear that something needs to be done. The majority of governments' responses incorporate a number of these different measures – and though they are extremely controversial, they are necessary.

James Capretta outlines in his report *Global Aging and the Sustainability of Public Pension Systems* the ways in which different governments are tackling this issue:

Belgium's plan is to run sustained budget surpluses for a number of years in order to save for the time when their pay-as-you-go pension scheme runs at a massive deficit. Though this is one way to go about it, if the savings are used by future governments in other areas this could lead to disaster! In addition to this, all the money that European countries are needing to contribute to bail out the banks and the weaker members of the European Union are making saving much more difficult; but that is another story.

The Spanish government's response has been to largely ignore the problem, despite having one of the highest expected costs of any pay-as-you-go scheme in the world.

Italy, as one of the countries most at risk with its rapidly aging population and generous retirement benefits, has been successfully implementing reforms to scale back benefits since 1992. There is, however, a tendency for these reforms to have a very long transition period to protect current and near-retirees, thus minimising short-term political fallout, which causes the desired results to be a long-way down the track.

Unfortunately the current situation is such that it will take rather radical reformations to these pension schemes in order to maintain their viability under the new demographic conditions. It remains to be seen whether the various European governments successfully implement their respective strategies, or whether they back down under the intense political pressure. ▲

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