

Chronicle of a Disaster: Pension Privatization and the Credit Crunch

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We live in an ageing world – by which I mean that the proportion of those over 60 or 65 has risen and is projected to continue to rise. Public and private pension arrangements involve huge financial flows because they are required to cover increasing sections of the population. The course of globalisation itself has been shaped by institutional investors, many of them pension funds. At the present time systematic pension provision is largely confined to the richer countries but it is gradually dawning that pension arrangements are needed everywhere – and faltering or failing everywhere. Public pensions survive better but their finances will be strained as rising unemployment weakens their contributor base. Many governments have favoured commercial pension producers but the latter are reeling from stock markets which were ‘a disaster for savers’ (Economist 2008) Many of the banks which orchestrated the speculative orgy themselves became its victim as they have had to absorb many billions of losses. But that still leaves several trillions of losses to be accounted for and among the worst hit have been pension funds of every type, both collective and individual. An OECD report in October 2009 calculated that pension funds incurred losses of \$5,400 billion in 2008. The following year saw some recovery allowing the funds to claw back \$1,500 billion of these losses. But losses of nearly \$4 trillion across two years cast a chill shadow over a world about to experience dramatic ageing. Worst hit were pension funds in a variety of countries where the pension funds had been persuaded to rely heavily on equities.(FTfm, Financial Times, 26 October 2009).

The ageing of the population is rooted in a global rise in life expectancy and a global, if uneven, decline in the birth rate. Young women’s desire to have fewer, few or no children is a key factor. In most developed countries the birth rate has fallen below the level at

which it reproduces the existing population. Life expectancy in these countries is growing by about two years in every decade. Japan's population is already shrinking. China has gone through a similar demographic transition and it is spreading in most parts of the developing world. Trends like this cannot be extrapolated endlessly into the future but they have been established long enough to make very likely the overall growth of the proportion of the elderly in the total population.

An Ageing World

By 2050 the UN Population Division expects there to be 2 billion persons aged 60 or over worldwide, with 1.6 billion of these in the less developed countries. Ageing is most marked in Europe and Asia but it is advancing elsewhere too. By 2050 the size of this older group in Africa is set to quadruple to reach 207 million, comprising 10.3 per cent of total population. Africa will have more older persons than Latin America and the Caribbean (with 187 million aged 60 and over), and nearly as many as Europe (with 229 million of that age). By 2050 Asia, a category that includes India and China, is expected to have no less than 1,249 million older persons, comprising a fifth of the total population in India and as much as 28 per cent in China. (UN Population Division 2006)

Today women comprise 55 per cent of those aged 60 and above worldwide, 65 per cent of those aged 60 plus in North America and 70 per cent of those aged 60 plus in Europe. World-wide women comprised 63.5 per cent of those aged 80 and above in 2005, a figure that is expected to drop slightly to 61.4 per cent by 2050. The frail and vulnerable 'old old' are the most rapidly growing age cohort in all parts of the world. There were 88 million persons aged 80 and above worldwide in 2005, a figure that is projected to rise to 402 million by 2050 according to the UN Population Division mid-range projections.

The ageing trend will already be evident long before 2050. Ageing will double the number of US citizens who are 65 or older from 35 million in 2004 to 70 million by 2035. Because of both projected immigration and a somewhat higher birth rate than Europe the share of the old in the US proportion will not quite double but rise from 12 to

20 per cent. India's over-60 cohort will number 175 million by 2024. By 2040 there are expected to be 98 million persons aged 80 plus in China, 47 million in India and 13 million in Brazil. These people are all already born, a circumstance that gives the projection a high degree of probability.

There are few countries which have arrangements fully adequate to the rising future need for the care and support of the elderly. In the developing world and poor countries many of the aged are sunk in absolute or extreme poverty. A UN report, *Development in an Aging World* (United Nations 2007) observes:

The demographic transition poses an enormous challenge . . . For the unprotected the notion of retirement does not exist; they must continue to rely on their work, which is a greater challenge for those in advanced age (80 years or over). To survive, older persons also count on the support of the family and the community, which, if also resource-constrained, may not be able to offer solid social insurance. In this regard, older persons who are single, widowed or childless (particularly women) face an even higher risk of destitution.

The ageing process is more advanced in the richer countries of Western Europe, Japan and North America and this is matched by much stronger pension provision. Nevertheless, as we will see below, an increasing number of the aged in these countries are likely to suffer relative poverty if current arrangements are not improved. As aged populations double or treble both these problems will grow. As the baby-boomers retire the number of the aged will double in two or three decades. Rising health costs are a special problem. The over-60s are today fit for longer than used to be the case but their health expenditures tend to be four times as great each year as those under 60. (Reinhardt 2001)

Less than a quarter of the world's population have arrangements in place to pay them pensions when they are old. While the old in the OECD group of rich countries enjoy the best coverage, some are much better covered than others. Nearly every advanced country

has a public old age pension system, usually financed by a pay-as-you-go system of pay-roll taxes or insurance contributions. During the working life of the famous postwar 'baby boom' some of these schemes built up a trust fund. Japan and Singapore used such contributions to finance large-scale investments in public infrastructure in the 1950s and after. More recently a number of other states – notably Norway, Australia and China – have established state pension funds in order to be able to supplement pay-roll contributions in the future. Such funds can also be used to promote macro-economic stability.

The Rise of Public Pensions

The public and the private have long had a stake in pension provision, sometimes a clear division of labour, sometimes, as recently, in stark competition with one another. Since at least the mid-18th century the rich could purchase pension annuities from banks and insurance houses and in 1853 William Gladstone, the British Chancellor of the Exchequer, made contributions tax deductible. The first state-supplied social insurance schemes were introduced to fill the yawning gaps left by commercial suppliers and to furnish at least a measure of social security to all at times of general economic distress. Commercial suppliers of pensions and company retirement schemes did not aim to cover the whole population, and often failed their beneficiaries in economically troubled times. Between 1914 and 1950 political and economic shocks – war, Depression, hyper-inflation and bank collapse - destroyed many pre-second-world-war pension schemes and revealed others to be vulnerable or incomplete. The Second World War was a watershed after which universal public pensions schemes spread within most of the industrial nations. Universal coverage was expensive but the war had shown that huge sums could be raised from taxation.

In the US Social Security was widened in 1949 to embrace the whole population while in Western Europe and Japan around this time universal provision of old age pensions was put on a new and, as it turned out, viable basis by resort to pay-as-you-go financing principles. As contributions flowed into the new schemes from a pay-roll (national

insurance) tax, these revenues were paid out to cover the first pension entitlements. It helped a lot that the size of the workforce was growing while the ageing effect was checked for about three decades by the postwar baby boom. Pay-as-you-go was also sustained by strong economic growth, so that revenue streams from the pay-roll tax easily kept pace with, or outstripped, retiree entitlements. And so far as the future was concerned the government was able to pledge its taxing power to promise that the entitlements created by current contributions would be redeemed by future streams of revenue. Private pension providers could not match this pledge. They needed to build up a fund before they could make any pay-outs. And while citizens were confident that there would be a government in fifty years time, financial concerns were vulnerable to market upsets. The Harvard economist Paul Samuelson, later to be awarded the Nobel Prize, published an article confirming the soundness of pay-as-you-go financing (Samuelson 1958).

When Gosta Esping-Andersen published *The Three Worlds of Welfare Capitalism* in 1990 he was able to chart the advance of public pension provision in most European states, earning them a correspondingly high rating for the 'de-commodification' of protection in old age. By this he meant that the aged had rights in a public pension scheme so that they did not need to buy it as if it were a commodity. Typically every employee paid into such a scheme and every retired person had a pension. While those who contributed more usually received a somewhat higher pension the differentials were low and there was significant redistribution from the higher paid to the lower paid.

The United States, Britain and a few other states (Netherlands, Switzerland) still had commercial pensions. These states, with their 'mixed' or 'divided' pension regime, had long-established stock markets and politically-influential financial corporations. Their pension systems were not purely private since they benefited from tax relief on contributions made to the plans. They also had pre-funded and tax-favoured occupational schemes sponsored by employers, both public and private. In most other countries commercial provision made a negligible contribution to pension provision, though it is

common for public sector employees to have pension entitlements, often paid from a fund to which they and the employer contribute.

The high tide of public pensions was reached in about 1980 – the date of the main data in Esping-Andersen's research - after which determined efforts were to be made to weaken public provision in a pattern that has been called 'implicit privatisation', since the mass of citizens were urged to look to commercial pensions to make up for the public shortfall. While Esping-Andersen showed that public systems, whether social democratic (Sweden) or social conservative (Germany), could generate impressive levels of public pension provision, the more surprising finding was that private pension delivery still had an elite rather than popular character in the United States and Britain, generating pensions amounting to only about 1 per cent of GDP in 1980 (Esping-Andersen 1990). While pay-as-you-go had immediately generated large streams of pension payments, the commercially-funded approach would take decades to mature and until it did its efficiency and reliability remained unclear. However the very success of public provision seemed alarming to some observers, especially free market economists like Milton and Rose Friedman who attacked US Social Security as a socialist cuckoo introducing an alien collectivism to the cosy nest of US capitalism. (Friedman 1980). The woes of capitalism in the 1970s and 1980s were laid at the door of a collectivism that was crowding out capital accumulation.

From Implicit to Explicit Privatisation

Margaret Thatcher was the first to take a small but significant step towards what came to be known as 'implicit privatisation'. In 1980 the indexation of Britain's already modest Basic State Pension was switched from earnings to prices. In 1987 the returns to the State Earnings Related Pension (SERPS) were slashed. While public pensions shrivelled, new opportunities and tax breaks were opened to commercial suppliers. Members of occupational schemes, whether public or private, were encouraged to leave them and to establish individual pension pots instead. This laid the basis for a gigantic 'mis-selling' scandal in which one and a half million savers were able to sue the commercial pension

suppliers for having promised, but not delivered, better returns than the occupational schemes they had been persuaded to leave.

The relative value of the British state pension declined remorselessly – worth 20 per cent of median earnings in 1980 it dropped to 14 per cent by 1997. The incoming New Labour government made no move to restore its value. This steady decline in public provision meant that employees needed to take out a private plan if they wished to avoid the breadline in old age – the logic dubbed ‘implicit privatisation’ by Paul Pierson (Pierson 1996). In the 1990s and 2000s fund managers found a ready market for their tax-favoured pension plans. London’s facilities as an international financial centre, helped them to distribute the money entrusted to them amongst a wide range of investments throughout the globe.

While the UK showed what ‘implicit privatisation’ could achieve, a small South American state was to be hailed as the model for ‘explicit’ privatisation. Chile suffered hyper-inflation and a military coup in the 1970s and then a deep depression in the early 1980s. The public pension scheme was drastically weakened. José Pinera, the finance minister appointed by the military dictatorship, spotted an opportunity to apply the market-oriented ‘Chicago School’ approach he had imbibed while studying at Harvard. He proposed that contributions to the state pension scheme be made voluntary, with employees who agreed to leave it being required to join tax favoured privately-managed accounts instead. Those who remained in the state system were warned not to expect more than a modest subsistence denominated in a still weak currency. Pinera believed that a private, funded scheme with a wide membership would solve two problems at one stroke. It would lift much of the burden of pension provision from the public budget while simultaneously deepening local capital markets. The pension contributions were to be invested in property, shares and other marketable assets. In contrast to many developing states Chile had long-established financial institutions. Following introduction of the new scheme, these could rely on a steady stream of business. The AFPs offered ‘defined contribution’ benefits – whatever income could be obtained by the

savings in the personal account - so their members were directly at risk from high charges and rocky markets.

The banks and insurance houses set up pension associations (AFPs) which received the pension contributions, managed the resulting funds - and would be responsible for paying pensions when they became due. There were many competing AFPs, based on financial and professional networks, but also eager to attract contributions from as many as possible. While the scheme of pension privatisation was market-oriented in conception it was also state-sponsored, with the AFPs able to claim generous tax relief on contributions. However one feature of the AFP arrangements was inspired not by neo-liberalism but by the heritage of Latin American developmental economics, namely a requirement that the AFPs had to invest in the local economy. The hope was that the new pension regime would channel resources to the Chilean banks and stock market helping to promote domestic growth. (Riesco 2006) Chilean employees opted out of a state scheme in which the government itself had no confidence. By 1990 70 per cent of the country's regular work-force had enrolled in an AFP and the savings rate was rising. (Ferguson 2008, 216).

While the Chilean scheme was to become famous, a less-heralded pension reform, in Switzerland in the 1980s, was based on mandatory membership of an occupational scheme operated by one of the country's insurance houses. (Leimgruber 2008) The Swiss version of compulsory contributions was not so appealing to privatisers for two reasons - because it did not replace the state pension and because it offered savers a guaranteed minimum annual rate of return of 4 per cent. Given the strength of the Swiss franc contributor risk was very limited, a fact which rendered the scheme unattractive to commercially-minded 'pension reformers'. (In 2003 the guaranteed return dropped to 2 per cent but was still a feature that savers in US or UK pension plans might envy).

The 1980s and 1990s were marked by a gathering process of financialisation as the financial services industry offered sophisticated new products which, so it was claimed, would help customers to negotiate the longer life course and would also furnish new

revenue streams to the finance houses. Such instruments included student loans, ‘baby bonds’ and credit card debt but the real money related to housing mortgages and pension funds, especially personal pension plans. (Blackburn 2006 [a] and 2006 [b] 20-9, 172-77)

By 2006 the US mortgage market, inflated by a housing bubble, was worth \$11 trillion. The global value of all assets in pension funds in December 2007 was \$26 trillion, compared with global GDP of \$55 trillion. In 1998 the value of equities held by pension funds was around \$5 trillion. (Monks 2001) By the end of 2007 this had grown to around \$15 trillion of equities and \$11 trillion of other assets. The tripling of pension fund equity holdings in a decade reflected both continuing net contributions to these systems and a stock market peak. While US pension funds might place around ten to twenty per cent of their investments overseas, the European states often placed a half or more of their investments in foreign, often US, capital markets. By 2007 the US and British funds still managed about a third of all pension assets, but public funds in Japan, China, Singapore and Norway, as well as the US and UK, accounted for 67 per cent of the pension assets held by the world’s 300 largest funds (Watson Wyatt 2008).

The Resilience of US Social Security

French insurance houses and German banks wanted legislation that would prune back public pensions and encourage savers to go for individual accounts by giving tax relief. The campaign for pension privatization certainly reflected the banks’ hunger for new business but there was also a strong ideological component as free market think tanks identified public pension systems as a drag on capital accumulation. Privatisation would widen capital markets and would diminish the role of the state in redistribution. However those who wished to cut state provision right back still demanded tax concessions and a degree of compulsion. Around the year 2000 tax concessions on pension saving cost the US Treasury about \$100 billion a year while the UK Treasury lost about £14 billion annually.

Most US neoliberal or conservative think tanks supported Social Security 'reform'. The Cato Institute, with an endowment worth \$300 million in the early 2000s, was the most energetic and persistent. However the privatising lobby in the United States found that there was fierce resistance to even partial privatisation of Social Security. When George W. Bush proposed in 2004-5 to divert a portion of the pay-roll tax to 'individual accounts' to be invested in the stock market they encountered stiff resistance from the American Association of Retired Persons (AARP). Raising a public loan of \$2 trillion to fix the transition problem – maintaining payments to today's retirees while building the personal accounts of today's workers – seemed a risky procedure. What would be the terms of the loan? And what if the stock market tanked? Republican Congressmen quickly learned that Social Security reform alarmed their voters. The programme transfers income from rich to poor both within states and between them. Large, rich states, like New York, are net contributors while poor ones, like Kansas, are net recipients. Republican representatives from poor and small states saw no reason to jeopardise these arrangements.

Current retirees worried that there would be less income flowing in to pay their pensions while their children did not want to put at risk either their parents or their own pension entitlement. The White House pet project was dropped like a hot brick. The rebuff to George W. echoed the defeat of earlier schemes to part-privatise Social Security. Reagan abandoned an attempt to downsize Social Security in 1983 while in 1999 President Clinton junked an elaborate plan to establish private accounts drawn up by his Treasury Secretary, Lawrence Summers, the former World Bank Chief Economist, who, as we will see, was a strong partisan of pension privatisation. In this case the improbable saviour of the programme was Monica Lewinsky – Clinton had the political instinct to see that he could not escape impeachment if he tried to tamper with Social Security. (Blackburn 2002, 2006) It will be interesting to see whether, following these debacles, any new attempt is made to 'save' – that is downsize or part privatise - Social Security.

The World Bank Focuses on Privatisation in Richer Markets

Though checked at home the US privatising lobby, together with local allies, vigorously pursued their cause overseas. While US administrations could not persuade their own electorate to swallow the medicine of pension privatization they had much more success in foreign lands. The collapse of Communism in Eastern Europe and the Soviet Union in 1989-91 supplied a shock which was registered far and wide. The cause of pension privatisation was given priority by the World Bank, with strategic support from the IMF and USAID, Washington's own development agency. While these institutions took the lead in promoting the replacement of public by commercial pension provision the neo-liberal think tanks and the big banks played a supporting role, helping to cover the cost of seminars, surveys and position papers, and undertaking a major promotional effort once legislation was imminent. (Orenstein 2008).

The rationale for the campaign of pension privatisation was given by a landmark report issued by the Bank in 1994, *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth* (World Bank 1994). The Bank claimed to address the global ageing problem but in practice it had little to say about preventing destitution among the elderly in the poorer and less developed countries. If one considers the plight of the world's two billion poorest inhabitants, living on \$2 a day or less, it is clear that they are not a realistic target for financial products and that expecting highly-paid fund-managers in the world's financial centres to handle their money would be a grotesque mismatch. In fact it would be much more appropriate to levy a world-wide Tobin-style tax on financial transactions – or a share levy on corporate profits - in order to fund a global old age pension of, say, one dollar a day. (Blackburn 2007) But this was the very last thing on the minds of the World Bank.

The World Bank's real focus was instead on middle income states in Eastern Europe and Latin America - and on developed states with a 'dominant' public pension system. The former Communist states were already shaken by free market 'shock therapy' and were consequently less resistant to drastic neo-liberal reform than, say, the Asian 'tigers'. In Latin America the recent experience of hyper-inflation, military dictatorship and 'structural adjustment' traumatised public opinion and prepared the way for privatisation:

public pensions had already become practically worthless and few rallied to their defence.

The Bank's idea was to replace exhausted public pension systems with 'mandatory' (i.e. compulsory) individual pension plans offered by commercial suppliers. Finance ministers in middle income states in Latin America and elsewhere that had recently experienced hyper-inflation and 'structural adjustment' programmes proved quite receptive to the sales pitch of the privatisers. With drastically reduced social budgets they were interested in a strategy that lifted from them the responsibility to finance better pensions. Instead they continued to pay debased pensions as a species of poor relief.

One of the thorniest problems faced by the advocates of pension privatisation was that of explaining how the transition from pay-as-you-go to funded personal accounts could be negotiated. The case for privatisation stressed that it was far better for pension contributions to be invested in the stock market than used to pay current pensions. The returns would be better and the arrangement would not be vulnerable to big differences in cohort size, with a small working age cohort obliged to fork out ever higher contributions to pay pensions to a large retired cohort (such as the baby-boomers). But if pay-roll taxes were paid into personal accounts they would not be available to pay the pensions of current retirees in the public system. This was a political as well as economic problem since voters would worry about the fate of their own entitlements. Peter Ferrara of the Cato Institute urged that governments could take out a huge loan to enable US Social Security to continue to pay pensions while much of its former income stream was diverted to individual share accounts managed by a commercial supplier.(Ferrara 1998) As we have seen this idea failed to gain acceptance in the United States but was even less viable in states that were not in a position to float huge loans. However in Eastern Europe and Latin America the transition problem was much less daunting, as we have seen, because of the devaluation of public pension promises. With diminished expectations, the incomes of the elderly were allowed to dwindle and attention was focussed on the new private funds.

The European Prize

The campaign for pension privatization was to win its first victories in Eastern Europe and Latin America but the real prize was a change of regime in the world's richer countries, with their potentially valuable contributor base. Japan was an unrealistic target. It already possessed a mixed regime of public and private pensions and the nineties - the aftermath of the collapse of the 'bubble economy' of the late eighties - was scarcely the right moment to compel citizens to put their life savings in the stock exchange. But Europe was another matter. There was unhappiness at the performance of the European economy. Strong public pension systems were blamed for labour market 'rigidity' and high unemployment. Pension systems in Germany, Italy and France offered pensions to which all employees contributed and paid out pensions which all could claim. Though quite complex, with special schemes for different types of employee and some reliance on employer support, these arrangements were all overseen by, and backed by, the state.

The advice offered by the World Bank proposed a variant of the Chilean 'model', whereby all employees would be required to save in commercially-managed individual pension accounts (and with no Swiss-style guarantee). The public pension would be cut right back until it offered only a safety net. The citizens of the European Union were suspicious of the World Bank's market-friendly message but the centre left and left parties seemed to have reached an impasse and could not see an alternative. It made a demoralising accommodation to market economics. The failure of Gorbachev's reforms weakened the Left everywhere.

Most countries belonging to the European Union still had little commercial pension provision. The publicly-mandated schemes in France, Germany and Italy had close to universal coverage and delivered a pension, together with occupational supplements, of 60-70 per cent of pre-retirement earnings. These deeply entrenched public pension systems, and the collectivist welfare arrangements of which they were a part, represented a hold-out against the now triumphant formulas of free market economics. At the same time they acted as a barrier against the ambitions of the global financial services industry

- unless it was breached the impetus to financialisation would be kept at bay in the world's second largest – soon largest - economic zone.

Since the Christian Democrats and the Gaullists had helped to build Europe's collectivist welfare capitalism, weaning them away from these arrangements would not be easy. The only reason that there was any hope of this happening was that the European economy had been underperforming for some time, with lower profits and rising unemployment. Germany was struggling to finance the heavy costs of reunification. And at Maastricht in 1992 the member states had adopted a sternly deflationary programme in preparation for the launch of a common currency. This made a major contribution to subsequent stagnation (Boltho 2005) The custodians of financial orthodoxy argued that the priority was to promote labour flexibility, restore profit levels and keep down social costs. Some sections of the European financial services industry, notably the French insurance houses and some of the German and Swiss banks, became strongly committed to pension reform since it would open up impressive new business opportunities. Some French Socialists and German Social Democrats urged the need for a grand scheme of Keynesian expansion but the Bundesbank vetoed this. However politicians still hesitated to question popular and well-entrenched welfare programmes. Powerful arguments and moral support would be needed to stiffen the confidence of politicians before they would be brave enough to take the cause of pension reform to the people - and risk being mowed down by their opponents in the process. The World Bank report on pensions and ageing helped to supply the needed arguments and legitimacy.

Averting the Old Age Crisis had been commissioned by Lawrence Summers, the Bank's Chief Economist. Pensions absorb so much public money that their financing is bound to have large implications for the overall economic pattern. While simulating balance and judiciousness the report was, in fact, quite boldly prescriptive, with implications for the core developed OECD states, with their ageing populations, as well as for 'young countries', 'emerging markets' and those 'in transition'.

The starting point of the report was a species of demographic determinism. The advance of ageing meant that public pay-as-you-go (PAYGO) systems were ‘financially unsustainable’ and had to be cut to the bone or even phased out. The report quoted some unguarded comments by Paul Samuelson, the economist who had explained the success of PAYGO pensions and given them credibility amongst his colleagues. In a 1967 *Newsweek* article Samuelson wrote: ‘The beauty of social insurance is that it is actuarially unsound. Everyone who reaches retirement age is given benefit privileges that far exceed anything he has paid in...How is this possible? It stems from the fact that the national product is growing at compound interest and can be expected to do so for as far ahead as the eye cannot see. Always there are more youths than old folks in a growing population. More important, with real incomes growing at some three percent a year, the taxable base upon which benefits rest in any period are much greater than the taxes paid historically by the generation now retired.’ These breezy remarks now looked to be based on false assumptions. The numbers of the old folks were set to rise everywhere and the advanced countries were dogged by lower growth and stagnant earnings. The report was able to cite a contrite Samuelson himself warning about the ‘primrose path’ of unfunded, or inadequately funded, pension programmes, when population and income growth had stalled. (World Bank 1994).

The World Bank Model

As the analysis of the report unfolded public pension provision, and the payroll taxes used to finance it, were indicted for being major culprits generating stagnation, firstly because of the economic distortions they generated and secondly because they stood in the way of private pensions which would expand the capital market: ‘behind the government’s fiscal crisis lies the deeper crisis of labor and capital markets that are malfunctioning, preventing the growth that is ultimately the only way out of these difficulties.’ (World Bank 1994 138) Payroll taxes deterred employers from taking on workers, leading to unemployment and a growth of the ‘informal sector’. Combined with generous public pensions they promoted early retirement and, especially in Europe, a consequent decline in labour participation rates for those over 50. Moreover the early

retirement of skilled workers was a dead loss to the economy; younger, unskilled workers did not take their place. And the impact on capital markets of overweening public systems was as nefarious as the impact on labour markets, squandering savings, deterring private entrepreneurs and blocking the inventiveness of the financial services industry.

The report advocated a change in the weight and importance of the three pillars of pension provision. (1) The first pillar was the tax-financed public pension, which was to be reduced to a safety net. (2) The second was occupational pension schemes, which were to move from 'defined benefit' to 'defined contribution' (on which more below) and to be managed by the financial services industry. (3) The third pillar was personal savings, which were to become mandatory, with contributions channelled to and managed by commercial suppliers .

The prescriptive bias of the report was thus directed against the 'dominant public pillar', which was the problem, and towards mandatory personal savings plans, which were the solution. (World Bank 1994 107) State pension entitlements needed to be cut right back. They were cursed by increasing dependency ratios, overgenerous and ill-thought-out benefits, overmaturity and negative side effects. Existing schemes were 'financially unsustainable' because they could only be paid for by doubling or trebling payroll taxes that were already too high. The 'tough choices' imposed by the 'unsustainability' of the PAYGO systems included cutting back benefit levels, raising the retirement age, raising taxes - and moving to a new regime where state pensions no longer bore the brunt of retirement provision but instead acted as a safety net. The occupational pillar was treated with a little more respect but with an emphasis on moving to a fully commercial basis. Overall the retention of the re-assuring and time-hallowed image of three 'pillars' – each of which was meant to be strong – accommodated a shift to an ungainly structure with a weak first pillar, a shifting second pillar and a dominant third pillar.

The Bias in Favour of Personal Accounts

While the report emphatically supported private over public provision it also favoured personal accounts, organised on the ‘defined contribution’ (DC) model, over occupational schemes, organised on the ‘defined benefit’ (DB) model. (In the former the pension is whatever annuity can be purchased with what is in the pension pot at retirement; in the latter the level of the pension relates to salary and is guaranteed by the employer that sponsors the plan). The second pillar was preferably to be organised on a Defined Contribution basis. Already some employers were phasing out their DB schemes and replacing them with DC plans. In doing so they were transferring market risk from the company to the employee. If a DB fund was unable to honour its pension promise then the sponsoring company and its assets were liable. The report obviously did not like this aspect of traditional DB arrangements. Requiring employers to guarantee the level of future pensions made the beneficiaries of these schemes into residual owners of the corporation. DC schemes usually had (and have) a lower employers’ contribution, but they were more likely to be portable. An advantage of the traditional occupational schemes was that contributions could be easily implemented through payroll deductions. If employees were to have a choice of personal pensions, as in the US 401(k) DC-style schemes, then this would lead to extra marketing and administrative expenses. However by making deductions mandatory at least some of these costs could be reduced, allowing the report blandly to conclude: ‘Overall, personal savings schemes would seem to have the edge for the privately managed mandatory pillar.’ (World Bank 1994 246).

The case against ever-higher payroll tax rates was, by itself, not without merit. Unlike income tax, payroll taxes are not ‘progressive’, that is they do not take more from the rich than the poor. Analysis showed that the workers actually bore the cost of so-called ‘employers contributions’ to the payroll tax. But the decisive argument against high payroll taxes – say above about 15 per cent of salary – is that this would sap demand and raise labour costs, leading to unemployment. The deflationary policy pursued by the monetary authorities was a factor here but there is evidence that a total ‘tax wedge’ of about 40 per cent on European incomes – half of it connected to pension finance – did explain about a half of the rise in unemployment as the European average rose above 10 per cent of the registered labour force. (Directorate General 2003, 12).

Public Funds Can Supplement PAYGO

However, the criticisms made by the report strained logic and credulity when they claimed that the answer was pension privatization and mandatory membership in commercially-managed schemes. The demographic challenge, in itself, yielded absolutely no conclusions about the best way of delivering pensions. If the proportion of over 65s is set to double over three decades, then either the money going to pensioners as a whole rises, say from 8 per cent of GDP in 2004 to 16 per cent of GDP by 2034, or individual pensioners will drop behind the growth in prosperity. If the proportion of GDP available to the over-65s stays roughly the same (we will see below that this is forecast for the post-reform EU) then relative poverty will grow sharply. While public pension systems have met the challenge of raising great chunks of GDP, private pension funds have yet to equal this ability. The greying of the population does indeed demand supplementary sources of finance – perhaps the taxing of capital not labour - but this does not require commercial fund management. Already in 1994 there were many successful public sector pension funds.

Notwithstanding the historic success of payroll taxes in raising pension revenue, the argument that they were counter-productive or inefficient above a certain level was a serious one. It would imply both finding the best level for efficient pay-roll taxes, and a search for other taxes - on high incomes, financial transactions, property or capital – to take up the shortfall. As globalisation advanced inequalities in income and wealth within states was growing. There was a strong argument from social justice to close tax havens and increase taxes on the wealthy. (Blackburn 2006 [b]) The report did not address the problem that compulsory contributions would themselves function very like a payroll tax, for example by reducing demand and raising labour costs.

In fact the case for allowing pay-as-you-go (PAYGO) to remain a major source of pension finance was never squarely addressed. It was claimed that PAYGO was ‘unsustainable’ when it really meant that pay-roll taxes were likely to raise something

less than 100 per cent of the target level, instead of being grateful that PAYGO could raise 80 or 90 per cent of needed revenues and looking for a supplement. It also neglected the efficiency of pay-roll taxes. The deduction of such taxes at source – and without any need for the expense of choice between different commercial suppliers – made such public schemes very cost-effective. In the US the Social Security administration – with a staff of just 65,000 - collects contributions from 120 million employees and then pays out pensions to 44 million beneficiaries. By comparison, even post-credit-crunch, a single large US bank or fund manager would employ more people – and on higher salaries.

While the authors of the report rule out tax increases as politically unfeasible, they instead assume that citizens will accept compulsory deductions from their earnings so long as they are put into approved, tax-favoured personal or occupational funds. At this point their argument could have concluded that social insurance contributions should go into a publicly-managed fund or network of funds and not be treated as another tax and that the social funds should be visibly more accountable to those they were supposed to benefit. Likewise the report could have suggested that taxes on corporations or the rich could have been called on to make up for shortfall in pension receipts. But the report is, in fact, hostile to such approaches. Instead it insisted that pension funds had to be commercially managed and subject to lighter public regulation. It claimed that those forced to pay contributions will see them as the price they are paying for a purchase and that this perception will banish all the negative aspects of payroll taxes.

The Cost Disease of Private Pensions

While singing the praises of privately furnished pension schemes the report seemingly balanced this by conceding some of their limitations. It was admitted that the coverage of private pension funds is usually too narrow and that is why a mandatory approach is needed. The report urged that pension funds should be freed from political interference and that they should be ‘liberated’ - an ‘idea whose time has come’ - from such irksome restraints as minimum holdings of public bonds or controls on the export of capital. It

helpfully explained: ‘Easy capital outflow helps to stimulate capital inflows, because a prime concern of international investors is to be able to get out of a market quickly when the need arises.’ (World Bank 1994, 219).

Employees would accept the obligation to pay a proportion of their earnings to the financial services industry because of the promise of good returns from the stock market. The capital markets would receive a much-needed boost and the employment-harming effects of high taxes would be avoided. Tax breaks were to continue. The pension fund industry, having been created in its present form by lavish tax concessions, was thus now to be further boosted by compulsory, government-subsidised contributions from the entire workforce. The report’s recommendations supposedly applied to a swathe of developing countries too. It was urged that lack of trained administrators need be no obstacle: ‘The shortage of local expertise in many developing countries may be overcome by using foreign fund managers in joint ventures with local firms. Developing countries reluctant to use joint ventures may have a hard time assembling the expertise needed to run pension funds well, especially in the early years.’ (World Bank 1994, 139-40)

The report, as we have seen, mildly favoured personal savings plans over occupational funds, but strongly favoured private funds of any description over state sponsored provident funds - despite what was admitted to be the higher administrative and marketing charges involved in the former. Administrative charges in the Chilean system had been heavy to begin with and remained rather high in 1990 at 2.3 per cent of assets. Over forty years a 1 per cent cost ratio brings a 20 per cent reduction in yield so the 1990 rate would imply substantial erosion. Although employees had to join a scheme they could choose from more than a score of AFPs and, if they became unhappy, could switch. This led to intense competition between rival sales teams and consequent expense. Costly promotion led employees who already contributed to switch from one supplier to another but did not widen overall coverage. Enrolment was meant to be universal but actual contributions remained stubbornly stuck at around half of the total labour force, with scant participation in the rural sector or in the poorest urban districts. There was also great inequality of coverage within the ranks of those enlisted, so that

many have only a nominal pension to look forward to. In 2006 the state pension system which had been 'frozen' in 1981 was still paying out more in pensions than the AFP and the Chilean government was obliged to introduce a basic state pension. (Riesco 2007)

By contrast the Central Provident Fund of Singapore had near-universal enrolment and annual administrative costs of only 0.16 per cent of assets a year in 1990. And the Malaysian Provident Fund had expenses of only 0.18 per cent. However the investment returns of the Chilean AFPs had been 7.5 to 10.5 per cent in 1990 while the Malaysian return was 4.82 per cent and that in Singapore 2.86 per cent. (World Bank 1994, p. 224) The AFPs had yet to pay out any pensions, which should have reduced costs. And the Singapore CPF, as the report noted, had a remit to help participants buy their dwellings or meet other permitted expenditures (e.g. training fees), lowering the current rate of return but with some returns to come in the future. These contrasts, already observable in 1990, were to become even more marketed in the subsequent decade and a half.

Averting the Old Age Crisis did not explore the successes of provident funds in Singapore and Malaysia, nor that of the huge contribution of similar state-sponsored saving in Japan. Japan's remarkable postwar growth had been greatly facilitated by public retirement funds which had paid for huge infrastructure investments in roads, harbours, railways and airports. By the early 1990s this phase of Japanese growth had come to an end but this was no good reason to ignore its huge role in the preceding four decades. (Ecclestone 1990, 97). Instead of scrutinising the East Asian model *Averting the Old Age Crisis*, dwelt on the failures of state-sponsored pension systems in Africa and parts of Latin America. The report failed to register that stock markets and private savings in these same countries had also delivered miserable results.

The report offered a strategically located table on investment rates of return which signalled the superiority of private over public fund management - though in fact no information was given on administrative charges. It was not noted that the public funds in question were obliged to invest almost exclusively in specially denominated public bonds. Covering periods of between five and ten years in the eighties the table showed

that the rate of return in Peru, Zambia, Venezuela, Egypt and Kenya had been negative, sometimes strongly so; but no information was supplied on conditions in these countries, including rates of return on equity capital. The public bonds given to the funds in exchange for contribution income had steadily lost value, usually because of inflation. This funding device was, in effect, a way whereby the governments concerned treated pension contributions as tax income. The table, not surprisingly, showed better rates of return for the advanced countries, though once again public funds have often been required to invest in special government bonds. The surplus in the US social security account was allotted interest of 4.8 per cent annually. Again this was a reflection of a government-sanctioned Treasury dictat. The investment income reaped by privately managed funds was higher, according to the table. During the eighties Dutch occupational schemes returned 6.7 per cent annually, compared with 8.0 per cent for US occupational funds and 8.6 per cent for those in the UK. The Singapore CPF return averaged 3.0 per cent in the eighties and the Malaysian CPF 4.6 per cent while the Chilean AFPs came top of the class with 9.2 per cent. The conclusion: 'Privately managed funds beat publicly managed funds hands down' (World Bank 1993)

In fact this conclusion was produced by fixing the contest in advance, with no account taken of charges, no information on the returns of personal pensions in the UK or US and the exclusion or misattribution of evidence concerning public or social funds that were not commercially managed. If information had been given concerning individual pension plan holders in the UK and US some would have shown negative or very low returns where participants had been penalised for not maintaining payments. And the figures given in the table lumped the rather successful public sector pension funds in Britain, the United States and the Netherlands into the 'privately managed' category. The exclusion of costs also tilted the comparison against the public funds.

The report did not completely ignore over-charging and competitive waste in privately-run schemes. It also noted that commercial fund managers could be guilty of 'short-termism', herd-like behaviour and elitism vis-a-vis the local or small-scale. But whereas the failures of private pension schemes posed 'regulatory issues' which could be

addressed, those of funded public schemes were irredeemable, so they should be abandoned. In fact the 'public funds' to which the report paid most attention scarcely deserved the name but were simply accounting devices used by public treasuries. If the record of public sector funds had been scrutinised no doubt some problems would have been encountered but financial performance would not generally have been among them. However the report was not interested in exploring ways of improving non-commercial pension funds. Indeed the very possibility that pensions funds could be pre-funded and run by public trustees, or by autonomous non-commercial social institutions, was scouted. This would, it warned, pose a threat to free enterprise capitalism. The report worried that if 'centralized provident funds' were to 'invest in corporate equities, public officials could gain control of corporate affairs, a back door to nationalization'.(World Bank 1994, 93-4)

The message of the report offered a one-size-fits-all recipe. But the main pre-occupation was not reaching out to the majority of the world's population who have no pension coverage, but rather to concentrate on dismantling public provision in richer countries where this might deliver new business to the fund managers. Notwithstanding the references to the 'multi-pillar' approach, few readers could miss the emphasis on, and the novelty of, the proposal for mandatory personal savings plans. Indeed the strong standpoint emanating from the report and the wide range of evidence it marshalled helped, together with the Bank's authority, to make this a bench-mark study.(Ney 2001) Joseph Stiglitz, a later Chief Economist at the World Bank, became alarmed at the the new dogma of pension privatisation and co-authored (with Peter Orszag) a trenchant critique of *Averting the Old Age Crisis* in 1999. Some of the Bank's operational staff admitted that there were risks in scrapping public provision and placing all resources in vulnerable commercial funds. But the momentum of the privatization campaign was only momentarily disturbed. Shortly thereafter Stiglitz was removed from his post. (Stiglitz and Orszag 2001, Stiglitz 2002)

The report had strong bureaucratic backing in the Bank and IMF and from the Clinton administration, where Summers, who had commissioned the report, was successively

Assistant Treasury Secretary and then Treasury Secretary in the years 1995 to 2000. Summers remained widely influential and the critiques did not prevent ever more ambitious attempts to ram through ‘pension reform’ in a widening circle of countries. Governments coping with the aftermath of free market ‘shock therapy’ and wrestling with the aftermath of IMF-sponsored ‘structural adjustment’ were persuaded to commit to pension reform, especially if they were middle income (Mexico, Poland) and/or resource rich (Kazakhstan, Nigeria). In many cases hyper-inflation had destroyed pension reserves and left employees with miserable benefits. Privatisation often meant that public pensions could be cut to the bone and pay-roll taxes converted into contributions to a local branch of the international financial services industry. Whether stock market investments would really lead to better pensions in the future was something that only time would tell - for the moment it meant one less headache for the authorities. Meanwhile the World Bank and IMF offered expert assistance and conveyed the message that governments that followed their advice would get better credit scores and favoured treatment from international lenders.

Classic accounts of public pension provision in the first industrialising countries stressed that public provision had been forthcoming in response to pressure from labour movements and from employers who did not want to be encumbered by running their own schemes. Different national traditions and labour markets have also set up a degree of path dependence. Esping-Andersen had identified three types of social security regime – conservative, social democratic and liberal – with the evolution of each country’s welfare regime reflecting dominant values and structures.

In the debate on the origins of the welfare state a central idea became the importance of ‘path-dependence’ in pension systems. Those who had accrued entitlement in public pay-as-you-go pension systems had a strong interest in their continuance and in the indexing of benefits to national prosperity. On the other hand ‘liberal’ regimes, which had granted tax relief to private savings, also create a vested interest in continued public subsidy of commercial saving. (Hacker 2002) The rapid spread of something quite close to the ‘liberal model’ in the 1990s and early 2000s challenged the path dependent model.

Former Communist countries switched from a completely public (though semi-‘conservative’) regime to almost complete reliance on commercial provision and the market. In Latin America and Eastern Europe the World Bank model was widely adopted contrary to the ‘path dependent’ model. Just as the consolidation of modern public systems in mid-century reflected the collectivist response to depression and war so the privatisation of social protection was made to seem a plausible solution by political ruptures which seemed to discredit the welfare state and socialism. Neo-liberal discourse insisted that there was only one effective response to globalisation, that which sought to replace social guarantees with the canny commercial bets of ‘responsible risk takers’ (Giddens 1997, 119-20). Pension reform was made to seem attractive and responsible to political leaders in many countries – especially after they had been instructed in how advantageous this would be by emissaries from the World Bank.

In July 2001 the director of the Bank’s Social Protection unit claimed that ‘(t)he World Bank has been and remains one of the main drivers behind the pension revolution’ and noted that mandatory private schemes now operated in eleven Latin American countries and three former Communist states.(Holzman 2001) In a study of pension privatization published in 2008 Mitchell Orenstein found there to have been 30 instances where World Bank help had been influential. (Orenstein 2008)

Notwithstanding popular opposition, the decade 1995 to 2005 witnessed major gains for the cause of pension reform in the core countries of continental Europe. One of the most surprising gains was in Sweden where 1995 saw the enactment of a pension reform that removed the previous ‘defined benefit’ offered by the public pension and substituted a so-called ‘notional defined contribution’ model which offered a proportionate share of the income that would be raised by a static payroll tax. On top of this two and a half per cent of income was to go to a personal accounts system which would invest in funds offered by the main commercial suppliers. Sweden had been badly shaken by an economic and financial crisis in 1992 and this undoubtedly helps to explain the decision of its political elite to make a sudden - and secretive - lurch in the direction of implicit privatisation. The public pension authority retained oversight of the pension system and

insisted on cost ratios - around 0.3 per cent of assets - that contrasted with the two per cent or more which the finance houses were able to charge in Hungary and Poland. Nevertheless for Europe's most famous welfare state to adopt such a measure was a symbolic gain for the privatisation cause. Around the same time Norway was also hit by a financial crisis but the government responded by taking over the banks and setting up what became the State Pension Fund, an entity that was to build up assets of \$240 billion by 2008.

The 'privatizing' of pensions matched the privatization of public assets that was already underway. Shares in privatised railways and telecoms could be purchased by the fund managers with money supplied by scheme participants. This offered lush new grazing grounds to banks, insurance houses, fund managers and stock exchanges. The fund managers would also be able to purchase US securities, adding zest to the US exchanges. To call this a recipe for wild capitalism would not be fair since, as we have seen, it required a new regime of publicly-mandated, publicly-organized and publicly-subsidised contributions from the mass of employees. Governments were not only to offer handsome tax incentives but were often expected to turn public bodies into collection agencies for commercial concerns. However, even the magic of financial engineering finds more difficulty in conjuring a profit out of public obligations than out of public assets. While undervaluing the latter led to the brisk take-up of shares, the devaluing of public pension obligations by no means ensured that commercial funds would be able to take their place.

Private Pensions

Supposedly Western Europeans could replace lost public pensions by taking out private pension coverage. Fearful of popular reaction, and aware that it would aggravate the deflationary climate, their governments had declined to make commercial provision compulsory. Those who reach retirement age around 2030 are headed for a double short-fall. Their public pension has shrunk and accumulation in commercial funds will not be able to take their place. The advocates of pension privatisation claimed that savers could look forward to an annual rate of return of 7 per cent or more in real terms. But this is a

delusion. The roller coaster of the stock markets in 1997- 2008 – ending close to where they began - have confounded such expectations. The loss of a decade of growth will be very difficult – perhaps impossible - to make up prior to the retirement of the baby-boomers. Financial crises have not been external to the regimes of financialisation and globalisation but integral to it. (Brenner 2006, Glyn 2006, Turner 2008). The credit crunch of 2007-8 was the forty second major financial crisis since 1971, when the Bretton Woods system was abandoned. If the difficult but necessary work of negotiating a new global financial regime is carried through – which will have to fully involve such states of Brazil, India and China – and if such challenges as climate change and world poverty are properly addressed, then pension funds should be happy with less than half of the rate of return postulated by the privatisers.

Despite tax concessions fund managers have failed to demonstrate that they can generate the huge sums needed to avoid pensioners falling further and further behind the rest of the population. In the United States or Britain, with their long history of private provision, commercial pensions are on course to make only a very modest contribution to future pension income. While the UK state pension and the US Social Security pension will furnish 5-7 per cent of GDP in the 2030s, their financial services sector is on course to supply about a third of this. The first report of the UK Pensions Commission estimated that private pensions were on course to supply pensions worth only 2 per cent of GDP and the figure for the US seems very similar. There is little sign that the authors of *Averting the Old Age Crisis* were thinking in comprehensive or realistic terms since at no point did they estimate the size of pension fund needed to supply a target level of GDP as pension income. The UK Pension Commission never managed to fill the hole it identified but had the candour to acknowledge that the pension system would need to raise 14 per cent of GDP by mid-century, if it was to maintain the relative income of those of pension age, but was only likely to raise about 10 per cent of GDP. Projections made for the US in the period 2040 to 2050 show a shortfall that is also around 4 per cent of GDP. (Pensions Commission 2004 17; Blackburn 2006 [b] 61-74). These shortfalls suggest that the incomes of the old will lag the growth of average income by about a third.

The cause of social security or pension ‘reform’ might be attractive to financial lobby groups but usually inspired great reserve amongst those who had already built up entitlement in an existing public regime. However, as we have seen, Eastern Europe and Latin America were softened up for pension reform, by some combination of military dictatorship, hyper-inflation, ‘shock therapy’ and structural adjustment, as noted above. Pensions had become almost worthless and in some cases were only paid months late. Fragile new governments found themselves the targets of a high-powered campaign of persuasion.

In *Pension Privatization*, Mitchell Orenstein notes that the World Bank identified key political leaders, state officials and opinion-formers and invited them to conferences on pension privatization in ‘attractive locations’. The World Bank paid for public relations campaigns - \$1.4 million in the case of Poland. He adds: ‘The World Bank not only seconded or released its own employees to participate in the reform teams for pension privatisation.... it has also hired prominent [local] pension reform officials onto its staff.’ (Orenstein 2005 91). The IMF played a different but complementary role. In another dimension of what Orenstein terms ‘resource leverage’ it indicated that loans would not be forthcoming unless and until pension reform was tackled. Loans to assist transition costs, on the other hand, were made available by the Bank not the IMF. The free market think tanks and USAID also furnished help focussed on ‘norms teaching’. Only in a few cases – Poland being one - did the campaign meet open resistance. In the Polish case Solidarity and the Ministry of Labour both had marked objections to features of the reform but did not come together with an alternative. (Solidarity wanted the concurrent privatisation of state industry to be effected by distributing shares to the work force). In a number of former Soviet republics authoritarian structures smoothed the path: ‘The solution Kazakhstan adopted was heavily influenced by transnational actors [ie World Bank, IMF] but was facilitated by the small number of veto actors in its strong presidential political system’ (Orenstein 2008 130).

‘Resource leverage’ had more limited application in Western Europe where there was anyway still much support for generous public pensions. Rather than the grand slam approach which prevailed in Eastern Europe and Latin America Europe’s pension reformers adopted ‘salami tactics’, with successive moves to cut back on public provision. The first attempts to weaken the public programmes led not simply to massive demonstrations and strikes but to the downfall of three centre-right governments in the mid-1990s – the governments of Silvio Berlusconi in Italy, Alain Juppé in France and Helmut Kohl in Germany. Even in Britain pension scandals and disappointments contributed to the downfall of John Major’s government in 1997 and disenchantment with Margaret Thatcher’s legacy.

The centre-left coalitions which replaced these governments acted with great circumspection. They sought to avoid a head-on clash over most existing pension commitments and entitlements but nevertheless harped on the need for ‘reform’. They singled out a few instances of apparently excessive pension generosity and then proceeded to a general - but strategically delayed - downsizing. Europe’s stagnation and unemployment was blamed not on the policies of central banks obsessed by monetary union, or on the regressive features of payroll taxes, but on the burden of pension and welfare provision. The Dini centre-left administration in Italy negotiated a major instalment of reform in 1995 when it severely cut future entitlements while respecting those of workers aged forty and above. This formula of longitudinal ‘reform’ was eventually adopted, notwithstanding much resistance, by the Schroeder government in Germany and the Raffarin centre-right administration in France. The failure of the centre-left governments to come up with an effective response to mass joblessness undercut and demoralized opposition to successive doses of ‘implicit’ privatisation, often accompanied with legislation offering tax relief to those who signed up with a private supplier.

Already in 2001, prior to a new wave of cuts in the next few years, projected public expenditure per person aged 65 plus by EU states was planned to shrink dramatically from its former level. In terms of expenditure per head as a percentage of GDP per head the drop was to be from 72.0 per cent in France in 2000 to 57.5 per cent in 2040; in Italy

from 72.3 per cent of GDP per head in 2000 to 45.9 per cent in 2040, in Germany from 67.4 per cent of GDP per head in 2000 to 54.8 per cent in 2040.(Math 2004, 122)

This was simply a first instalment of downsizing with more to come from Raffarin, Berlusconi, Schroeder and Merkel in the mid 2000s. A February 2006 report by the European Commission and its Economic Policy Committee predicted declining ‘benefit ratios’, that is a decline in the ratio of per capita pension benefits to per capita output, for 2030 and 2050. It showed that in terms of per capita GDP, public pension income per aged citizen is expected to drop year by year until by 2050 it will be only a little over half its level in 2004. In absolute terms public spending on old age pensions, elder care and health creeps up but numbers of the aged roughly double. The EU-wide projections, covering 25 countries and some 450 million people, show overall public pension spending growing even more slowly despite a rapidly increasing aged population. (European Commission 2006). Most of the new member states switched from public to private provision with haste and their funds were nearly wiped out in 2008.

The cuts made to pension provision in ‘old Europe’ left a gaping hole that the private suppliers sought to fill. But the perennially hopeful financial services found it tough going. Reforming governments boasted that public pensions were affordable but failed to make it brutally clear to their citizens that they were on their own now. Not only did they need to save a tenth or more of their earnings but they also needed to find a reliable and efficient savings vehicle. Failing these two tests they would have a pinched old age at best. Legislation was introduced to give tax favours to DC-type pension accounts but the choice amongst them could be bewildering. In boom times the suppliers implied that their skill explained the growth in their funds and gave scant information on charges, yet studies show that charge ratios are the best predictor of yield. (Blackburn 2002). Only a few had access to the most efficient schemes, applying to a whole occupation group but with transferable benefits. The US money managers had greater marketing expertise and, for a while, their individualised products seemed attractive. Local banks and insurance houses resented the competition.

An article in the *Institutional Investor* magazine explained: ‘Money managers have stormed the continent. But so far they are fighting over scraps.’ Italy had introduced a new law in late 1998 allowing personal pension plans, but ‘without the tax incentives that make them exciting’ and with a high hurdle for foreign money managers. It worried that ‘The fledgling equity revolution in Europe is at risk, along with the future of economic and monetary union.’ The timid response of European governments was a poor recompense to all the interest that had been shown: ‘Take a seat on an airplane going to one of the capitals of Europe and the chances that a fellow passenger is a salesman or investment manager is high.’ Among those who had set up ‘base camps’ were Goldman Sachs, Morgan Stanley, J.P. Morgan, Invesco, Vanguard and Merrill Lynch. They encountered stiff competition for the modest business available from BNP-Paribas, Caisse de Depots et Consignations, Westdeutsche Landesbank and Dresdner RCM Global Investors. The regulations imposed by European governments were generally too tough on the managers and too timid with the employees. The Swedish public pension fund offered only a ‘paltry’ 0.2 per cent management fee for funds of \$3.5 billion or more. ‘The bad news for investment managers is that Sweden could become the template of Europe.’ This treatment could not be in harsher contrast to Eastern Europe: ‘In Poland, at least, the fund managers have been helped in recouping their costs by management fees as high as 10 per cent.’ There was also the problem that the European governments had left too much discretion to employees. An Italian occupational scheme was found wanting on these grounds: “‘The sign-up for the funds was less than people had hoped for,” says Alan Rubenstein, managing director of the pensions group at Morgan Stanley Dean Witter. “The new system needs to be made obligatory”.’ (*Institutional Investor* 2000) Here was a business arrogant enough to believe that purchase of its products should be compulsory!

In subsequent years more progress was made but the money management industry in Europe failed to take off. One problem was that it was essentially a vehicle for making high-cost individually-packaged investments in the United States when, firstly, this was a disadvantageous way of investing there, and secondly, European investors might have better prospects elsewhere. Investing in the US via Fidelity or Pimco meant incurring

heavy marketing and admin charges. It also locked the investor into US asset bubbles like the dotcom and housing booms. Investing at home or in the Far East might have made better sense.

Nevertheless, the pension fund managers did help to attract a flow of European capital to the US and thus to cover current account deficits that were placing great pressure on the financial systems. The Harvard economist Martin Feldstein was a prominent champion of pension privatisation. He also worried about the huge inflow of capital into the US. (Blackburn 2002 392-99). This was less inconsistent than it might appear. If the US needed an inflow of funds to offset its deficits then better that it should be in the form of penny-parcels managed by US finance houses than that it take the form of the purchase of entire corporations, as happened with Japanese investments. However from the standpoint of the European savers, prospects were bleak. When the crash came in 2007-8 many European banks and insurance houses were left holding toxic assets. Those who had invested in the new pension schemes found that the value of their funds had fallen by a half or more.

It is a testament to the persuasive powers and 'resource leverage' of the financial services industry and the free market think tanks that they persuaded so many governments to jettison public systems that simply needed supplementary finance (on which more below) and instead plumped for private systems which were a recurrent source of scandal in the US and UK, and whose returns had always been poor. The global growth in pension funds was part of a wave of financialisation which helped to generate a succession of asset bubbles and their eventual collapse.

The Private Pension Bonanza 1990 to 2007

In the US and Britain de-regulation of financial institutions and privatisation of non-commercial entities allowed for a dramatic expansion of commercial money management. DB schemes were withdrawn by many employers and DC pension plans

took their place. Britain's mutually-owned building societies became banks like Northern Rock and TSB. Repeal of the Glass-Steagall Act in 1999 allowed Wall Street's investment banks to get into the field of retail finance.

Already by the 1990s pension funds of various sorts had become major investors and potential customers for the new structured finance products and Special Purpose Vehicles offered by the banks and brokers. Around this time US pension funds held assets worth about \$7 trillion. The types of funds included public and private sector employer-sponsored occupational funds (worth about \$3.4 trillion), usually organised on a DB basis, and individual savings plans, operated by money managers like Fidelity, Pimco and Vanguard, offering DC pensions. So far as private sector employees were concerned the DC schemes grew steadily from the early 1980s using the tax advantages offered by the 401(k) clause of the Internal Revenue Service schedule. Employers needed to sponsor these schemes but had no responsibility whatsoever for supplying any given level of pension. By 2007 some 45 million US workers had 401(k)s, though the average holding of about \$59,000 was not going to buy more than a modest supplement to the Social Security pension. Employees were also encouraged to hold large proportions of their employers' shares. The highly paid made disproportionate gains from the 401(k)s. The top ten per cent of savers received 50 per cent of all tax relief (Hughes 2004) and their larger holdings attracted lower charge ratios.

Meanwhile there was the slow agony of the well-established DB funds at the large steel plants, airlines and auto-makers. These had mostly sponsored their own DB plans since the 1950s but now ran into trouble as the number of retirees massively outnumbered the numbers of workers paying into the schemes. The plans each had a fund but sponsoring employers often allotted themselves a contribution holiday when the stock market went up. In the UK, companies with DB schemes skipped contributions worth £28 billion between 1988 and 2001. The plan trustees were mainly appointed by the employers and the company's chief financial officer would work closely with the executive manager of the pension fund (they might even be the same person). In working out the scheme's liabilities much depended on the choice of the discount rate used to make the estimate.

The US authorities left the corporations great latitude in estimating future liabilities since to have done otherwise would have risked pushing them into bankruptcy. Nevertheless several giant steel, airline and auto companies were driven close to bankruptcy. This created a new type of entrepreneur, the ‘vulture capitalist’ who bought up troubled companies, and took them into Chapter 11 bankruptcy protection. They then applied to the bankruptcy court to allow them legally to transfer the company’s pension and health care promises to the Pension Benefits Guarantee Corporation (PBGC), a Federally-mandated insurance scheme set up in 1974. On average the PBGC pays out about 70 per cent of the benefits promised by the schemes it has taken over. If the courts agree to this transfer of liability, as they usually do, then the value of the company rises and it can be sold for a healthy profit. This operation is colloquially known as ‘scouring the barnacles’. Hundreds of thousands of workers find that their pensions have shrunk – and some may lose their jobs too. While this spectacle is a wretched one the brutality of the vulture capitalists is only part of the problem. The root flaw is that the pension fund is sponsored by a single employer which, over a few decades, may go from blue chip to a basket case. (Blackburn 2006 [a] and [b])

Public sector workers have been in a somewhat stronger position since their employers find it more difficult to escape the promises they have made. They have also had the advantage of cost-effective and sometimes enlightened fund management. Given their huge size – Calpers, the California Public Employee Retirement System has a fund of about \$250 billion in 2007 – they tend to invest in everything in order to achieve diversification. US pension funds began investing overseas on a large scale in the 1990s and foreign pension funds have increased their US holdings. However portfolio theory urges funds to avoid currency risk and place their main investments in the currency area in which their liabilities are denominated, so domestic securities dominate the holdings of most types of pension fund. However the speculative fevers of financialisation communicated themselves to even staid pension funds and they began to take stakes in hedge funds and private equity partnerships. While some of these might do well others

went bust. Even the successful bets came with heavy charges under the ‘two and twenty’ formula (an annual 2 per cent of fund value and 20 per cent of any capital gain).

The individual plans beloved of pension reformers have been the most vulnerable to poor returns and the gaming of the small saver. The years 2001 to 2008 were marked not only by market fluctuations but also by an extraordinary succession of scandals associated with insider dealing, phony accounting, off balance-sheet entities (SPEs), back-dated executive options, exorbitant bonuses, bid-rigging by insurers, and fund managers permitting after-hours arbitrage at the expense of their own customers. The term ‘grey capitalism’ evokes important features of a financial regime riddled by insider abuse and in which pension beneficiaries do not know what is happening to their savings. Fund managers were not responsible to policy holders and CEOs were not accountable to share-holders. (Useem 1996, Bogle 2006) The term also sought to draw attention to the murky practices of financialisation, including the growth of an unregulated secondary banking system. (Blackburn 2006 [b] and 2008).

The Credit Crunch

So we arrive at the credit crunch and the swooning stock markets of 2007-8. At its core the crisis was caused by politicians who believed in the magic of markets and in the exemplary qualities of business. They did what the consultants and special interest lobbies told them made business sense. Tame regulators were found who contemplated great mountains of debt with equanimity, and who found nothing amiss in ‘self-cert’ mortgages, buy-to-let bubbles, CDO pyramids, and an entire, off-balance-sheet, shadow banking system.

Huge global imbalances – China’s mountainous surpluses and the chasm of the US deficit - prompted the US Federal Reserve Bank to adopt absurdly low interest rates in 2001-6, which in turn led to 120 per cent mortgages, a shower of gold cards and a proliferation of structured finance products, better thought of as instruments of mass self-deception.

US households were cast as the world's 'customers of last resort' but had to go deep into debt carry this off. But not only households. The banks and hedge funds took on huge amounts of 'leverage' and companies taken over by private equity groups were burdened with massive debt. Politicians helped the party along by de-regulating and privatising. Investment banks were no longer barred from retail finance and the pressure to financialise became ubiquitous. People were encouraged to see themselves as two-legged profit and loss centres. Households were meant to behave like businesses, businesses to behave like banks, and banks to behave like hedge funds. By taking on leverage one supposedly did away with 'unrewarded risk'. Giant companies like GM and GE now made their profits not from selling their products but from arranging the accompanying consumer finance.

The derivatives revolution made poor people's debt the caviar of the finance houses. Sub-prime mortgages could be bundled and tranced as Collateralized Debt Obligations (CDOs), and then sold on to institutional investors which were themselves the repositories of the savings of those on middle or even low incomes. But already in 2006 many institutions – especially public sector pension funds and college endowments - became stand-offish and the banks found that they had large unsold stocks of their complex credit derivatives. But the bankers and rating agencies had long ago learnt that the mere absence of paying customers was no bar to obscene fees and bonuses. They booked fees in advance and used 'over the counter' transactions to sell off the credit derivatives to the unwary - or simply to their own off-balance sheet entities – at 'model' prices. They borrowed money from wholesale markets to finance the acquisition of CDOs and other collateralised receivables. (Blackburn 2008, Turner 2008). Yawning inequality made for shaky structures. If China's workers and farmers had been better paid the international imbalances would have been more manageable and if there was less poverty in the US there would not have been such a large pool of sub-prime and Alt A mortgages to turn sour.

Free market economists had always warned that planned economies could not work for long because they used administered prices. Clinton, Blair and Brown completed the work of Thatcher and Reagan, ‘liberating finance’ and cultivating a market in everything from public services to student debt, baby bonds to air traffic control, water to pension products. Yet in the end they created a world whose ‘light touch’ regulation allowed the heart of the financial system to be clogged up with non-performing – and unpriceable – assets... a predictable recipe for a heart attack. By 2007 the value of credit derivatives valued at model prices held off-balance sheet by the major banks exceeded their equity capital.

No one knew the problem better than the banks themselves. A spate of defaults in summer 2007, led them to refuse to lend to one another. The central banks sought to revive them by offering great dollops of liquidity. But offering easy loans to institutions suffering from insolvency simply delays the day of reckoning.

The Scandinavian experience of 1988-92 showed that governments needed to use their bail out powers and cash to enforce recognition of losses, to take over the large banks and then to use public credit to revive the real economy, with an emphasis on investing in infrastructure and the knowledge economy. The US and British authorities adopted a more partial and less effective response.

Anglo-Saxon economics was based on the centrality of a national debt. The folly of financialisation compounded this with massive levels of personal and finance-sector debt. The states that thrive today are those which balance a public debt with a sizeable – often larger – publicly-managed pool of assets, like Norway’s State Pension Fund, Australia’s Future Fund, Singapore’s Provident fund, or Sweden’s national research foundations, established in 1992 with the assets of social funds set up a decade earlier with the proceeds of a levy on corporations.

While the term ‘grey capitalism’ draws attention to the lack of accountability and transparency in the financial and corporate worlds it remains to explain how collective

social funds could be organised in a way that would help to cover future social expenditure on pensions and health. Firstly they would have to be universal in character. Serious resources could be raised by exacting a share levy on all corporations equivalent to 10 per cent of the profits each year. Companies could discharge this obligation simply by issuing new shares, without any need to subtract from their cash-flow. The shares would not be sold but held to generate future dividend income (which is less volatile than share price). Rudolf Meidner, architect of the Swedish welfare state, urged arrangements of this sort to foster agencies of economic self-government as well as supplementary pensions. (Blackburn 2006 [b] 245-9, 272-99)

The purposes and nature of the fund would be laid down in legislation and monitors established to see that they were strictly adhered to. For example the funds should only be used for the paying of pensions and that these should reflect common criteria across the system. I have elsewhere suggested that the funds should constitute a regional network within and between states. The management boards of these funds would be elected at regular intervals. They would have some scope in the use of the investment income accruing to the fund and would have to explain this to the citizens of their region. They would be allowed to – even encouraged to – vote the shares they held at AGMs. This would allow them to pursue policies on carefully chosen topics, such as executive remuneration, energy use or labour contract norms.

The privatised model of pensions provision has been engulfed by the onset of the credit crunch. Tens of millions have been persuaded to invest in commercially-managed schemes that have lost much of their value. Recession and/or unemployment has forced many to raid their savings to meet current living expenses. Those who run the financial services industry have been suffered a setback but show every sign of attempting to get back to ‘business as usual’ as soon as possible. Nevertheless the crisis has witnessed a resort to collective solutions that could point in a quite different direction. States which still have a pay-as-you-go system of pension finance will want to protect it. Even before the ravages of the credit crunch were clear the government of Chile, responding to a public campaign, moved to strengthen the remnants of the state pension and to establish

a modest, non-contributory public ‘solidarity’ pension, financed by taxation, to those with no pension entitlement.

In many countries, including the US, it no longer seems wise to denounce PAYGO as ‘unsustainable’ when all that is meant is that it can supply 80 or 90 per cent of pension needs, not one hundred per cent. The restoration or continuation of PAYGO will make a huge contribution to meeting ageing costs but social funds financed by taxes on capital could furnish a useful supplement. In Argentina the government of Cristina Fernandez nationalised the private pension system in September 2008 and gave a guarantee its beneficiaries. Since governments come and go those hoping for a pension would be better placed if there was an autonomous public agency administering the new arrangements. It would also reduce the pressure on public budgets if the new regime was able to build up a trust fund - Venezuela’s Bolivarian Constitution envisaged such arrangements though as of 2008 no such trust fund had yet been set up.

The recession, aggravated by the credit crunch, has delivered a body blow to almost all pension funds. *Global Pensions* cited a study estimating that US pension fund losses of all types had lost \$3.4 trillion - \$2 trn for the DC schemes and £1.8 trn for the DB schemes – between January and October 2008. (Legorano 2008) The shock to non-US funds could be larger or smaller depending on their portfolio and currency. In December 2008 The Economist reported that someone who had contributed a steady \$100 a month into a pension pot for ten years would accumulate a fund worth £1,068 less than they had paid in. It also observed that in Italy and Spain investors had withdrawn funds equivalent to 24 and 25 per cent respectively of total mutual holdings. As pension funds roughly halved in value in one year the Economist cheered up its readers with the thought that this dark cloud had a silver lining: ‘Falling stock markets mean that, without doing much, a lot of savers are less exposed to equities.’ Echoing a standard objection to PAYGO it also conceded: ‘In demographic terms, asset markets could be seen as a pyramid scheme, in which each generation aims to sell its accumulated savings to the next.’ (Economist 2008)

As the recession shrinks the labour force and earnings, the yield of PAYGO pension systems will also be reduced. The answer is to find measures that restore the health of the economy and to introduce efficient and benign taxes that pump extra resources into the pension systems. Poverty helped to create the credit crunch, both the domestic poverty of subprime borrowers and the low earnings of China's workers and farmers, since the latter led to huge global imbalances. (Blackburn 2008, Turner 2008, Glyn 2006). Rising unemployment will reduce the yield of PAYGO schemes but these remain in a far healthier state than all DC, and most DB, schemes. The best solution would combine (1) some extra resources for the PAYGO schemes, (2) a new publicly organised layer of funded second pensions, absorbing existing DC and DB arrangements. The existing PBGC in the US and PPF in the UK - if reorganized on new principles - could become the nucleus of such a second tier. A well-balanced pension regime could contribute to redistribution and better governance, helping to mobilise investment resources in needed directions.

Following the credit crunch the siren song of privatisation is now likely to be muted. However it would be foolish to suppose that schemes of implicit or explicit privatization will not again be pressed as solutions to the pensions crisis. Such proposals are backed by powerful lobbies and will not disappear until the underlying pension challenge has been met.

Acknowledgement: I would like to thank Matthieu Leimgruber and Manuel Riesco for comments on an earlier draft. They are not, of course, responsible for my errors or interpretations.

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