

The National Pension Reserve Fund: A Prudent Measure?

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Ivan McAdam O'Connell investigates whether Charlie McCreevy's National Pension Reserve Fund is a wise response to the demographic time-bomb of unfunded pension liabilities. The prospects for this fund are investigated and the Irish response is compared with the response of other countries. The conclusion reached is that the fund is the most prudent response to the uncertainties of future pension liabilities.

Introduction

When Otto von Bismarck enacted the state pension in 1889, with retirement at 65, life expectancy was 45. Today life expectancy is 76 in the Organisation for Economic Co-operation and Development (OECD), countries and rising. This illustrates the extent of the dilemma facing many governments across the developed world, which face huge unfunded pension liabilities as their populations' grey. The Irish government faces unfunded pension liabilities of 25 billion at present and this figure will rise considerably in the near future.

The government's response has been the creation of a budgetary reserve fund with the aim of part funding the future liabilities incurred by the social welfare and public service pension schemes. To this end over €6 billion has already been deposited in the newly created '*National Pension Reserve Fund*' (henceforth the 'fund') and legislation has been enacted committing future governments to deposit 1% of GNP (approx. €750 million in 2001) into this fund until at least 2055.

This commitment of such a large amount of public funds to the purchase of financial assets for investment marks a new departure for the role of the government in the Irish economy. The economist ¹Danny McCoy (of the Economic and Social Research Institute) has put the scale of this expenditure in context, as being equivalent to a holiday in Spain for every worker in the country. So while the fund may be relatively uncontroversial in today's relatively benign economic climate, it has important implications for the Irish economy going forward in areas such as taxation, the role of the state, equity and many others. Corrigan (2000) estimates that this fund will equal 42% of GNP by 2025, so it can be seen that the scale of this

¹ Speaking in Trinity College in February 2001.

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fund is so large for our small economy that it cannot but have implications for the Irish economy going forward. We all hope to grow old some day and we trust that the state pension system will provide a safety net against poverty in old age. The sustainability of this system is now inextricably linked to the success of this fund. Therefore its implications for the economy need to be carefully examined, particularly in light of the present deterioration of the public finances, the global economic slowdown, the constraints placed upon the economy by the Stability and Growth Pact and the Irish economy's reliance on capital mobile multinationals for much of our prosperity. Whether this fund can help smooth the path of the Irish economy or constrain it further is therefore the important question.

In this essay I intend to address these questions and others arising from the establishment of this fund. Firstly I wish to examine the extent to which the fund is a necessary and an appropriate response to the problem of unfunded pension liabilities. Then I shall examine the important consideration of whether this fund, as proposed, is fair and equitable to those involved, particularly on intergenerational grounds. Finally I will look at the implications this fund will have for the Irish economy in light of the unprecedented economic boom of the past decade and the uncertainty of the future.

Do we need a Pension Reserve Fund?

In the press statement accompanying the establishment of the fund, the Minister for Finance sets out the reasons for the fund's establishment as a prudent response to the "demographic time-bomb" of unfunded pension liabilities. The reasons mentioned by the minister are that the ratio of those in the active proportion of the population to those aged 65 and over will go from 5:1 today to 2:1 in 2056. The cost to the exchequer of maintaining pension provision at today's level will be 8.1% of GNP in 2026 and 12.4% of GNP by 2056 compared to the present cost of 4.7%. The CSO report 'Population and Labour force projections' (1996) predicts that the number of over 65's will increase from 414,000 (11% of the population) in 1996 to 1,018,000 (27% of pop.) in 2056. Perhaps a more shocking illustration of the scale of the problem is that over the period to 2056 contributions to social insurance would have to increase by 19% to maintain current levels of pension payments in real terms, but by 227% if, as may turn out to be the more realistic case, pensions were to keep pace with earnings.

This would seem to be a scenario that would place an unsustainable burden on those working and possibly undermine the viability of the Irish welfare state. Social

security might then be seen as being so heavy a burden that it would be seen to be *'worsening the problem it tried to solve'* (The Economist, Oct. 1998). The high social security contributions in this scenario would act as a severe tax on jobs, lowering employment and depressing the entire economy. But as any economist knows statistics can be used to tell any story you want. Could it be that the minister has not taken all factors into account?

A debate surrounds this issue, and the fund has certainly been controversial among politicians and is likely to become more so as an election nears and the public finances are stretched further. A number of economists have questioned whether the situation is really as bad as the minister contends. Some even contend that the minister is jumping on the bandwagon and *'making an invalid extrapolation from international trends'* (McCarthy, 1995). When looking at support ratios it is important to take into account the numbers of dependants under 15 as well as those over 65. When these various dependants are given a weighting in terms of their cost to society (i.e. pensioners cost more than children), it is found that over the next few decades while OECD countries in general will experience support ratios lower than anytime in their histories, Ireland will be no worse than in 1990 and better off than in 1960. Ireland has faced such difficult times before, in 1986 there were 170.7 dependants for every 100 people in the labour force and 227.7 for every 100 in work, this figure will have fallen to 154.9 by 2006. Reflecting these findings, a World Bank report predicted that dependency ratios will peak for OECD countries as a whole in 2036, but dependency ratios will not peak in Ireland until the very distant 2150. Also while contribution rates for PRSI may have to rise here, rates are only 13.4% of average labour costs compared to 26% in the Euro zone as a whole and a staggering 37.2% in Italy (Colm Rappelle, The Irish Times, March 2001).

The extent of the problem faced by the Irish economy is therefore likely to be much less severe than in other countries, especially in Europe, due to the structure of our pension system. In Ireland at present, like in the U.K., the social welfare pension is largely seen as a poverty prevention measure. Benefits are only equivalent to 28.5% of the average industrial wage and we have no earnings related pension, whereas in economies such as Germany's pension benefits are targeted at being 70-75% of previous earnings. This is reflected in the relatively large scale of private pension provision in Ireland, the industries funds are equal to 45% of GNP compared to just 6% in more generous Germany. Other economists such as Disney (1997) express the belief that it is not the increase in the number of pensioners that should be of concern, but rather the scale of improvement in pension payments. By his predictions if the economy was to expand at 2% (below the ESRI forecast for the

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Irish economy) and pensions were linked to the Consumer Price Index (CPI), that the cost of providing pensions would fall as a percentage of GNP from 4.7% today to 4.1% in 2035.

These figures present an alternative view to that of the minister, the reality though is probably closer to the minister's projection. Pension payments have already been increased above the CPI during the ministers term and as the economy grows and politicians seek to appeal to the growing grey vote, it is hard to see them resisting pressure to increase payments further. The re-distributive effects of such increases may even be desirable. It would not in my opinion be desirable to see pensions fall to as low levels as predicted in the UK. The UK has taken a firm line on encouraging private pension provision and their policy of increasing payments in line with inflation only will see pensions drop to as low as 8% of average incomes. Also remarks by Hughes (1996a) that *'population projections are subject to considerable margins of error and the error is likely to increase with the length of the projection period'* mean that there is a considerable risk to the economy from unfunded pensions and it would indeed be prudent to make provisions for this risk and the ministers decision is all the more understandable given the healthy state of the finances at the time of the funds establishment. The argument is not as strong in light of the recent deterioration in the state's finances but most forecasters predict a return to surpluses and a rosy outlook for the Irish economy over the medium term. So this may indeed be a fortuitous window of opportunity to make provision for a liability we know with reasonable certainty will materialise.

Are the government's proposals the most appropriate response?

If we accept that pension provision poses a significant threat to the Irish economy in the near future, then we should ask whether the 'National Pension Reserve Fund' is the most appropriate response. The Budgetary strategy for ageing group report (July 1999) estimates that the fund will only provide 1/3 of the cost of future pension liabilities during the expensive years around 2050. Therefore is this the best means of saving for these costs?

The size of the government's contribution is less than 1/3 of the interest payment on the national debt in 1999. The question of whether refinancing costs on the national debt, which this money could have paid back, will be more than the return on the funds assets is a crucial one for establishing the merit of the project. Prof. Feldstein in his book *Privatising Social Security* (1998), claims that social security contributions are much more productively employed in a pension fund than in the

government coffers. In Ireland the return on private pension funds have averaged 10.9% p.a. over the last 10 years but only 3.8 - 4.4% p.a. since 1964. It is probably unrealistic to expect as high a return from a government run pension fund than from commercial pension funds to which Prof Feldstein is referring. Iglesias and Palacios (2000) have found that returns are inversely related to the degree of political interference, for this fund this should be minimal as the fund is managed by an independent commission, though it is probably unrealistic to rule out all interference when the commissioners selection and appointment will be a political decision. Consideration also needs to be given to the costs of administering the fund as well as the monetary and non-monetary returns from alternatives such as investing in education, infrastructure or lowering taxes. This debate has been enlivened by pre-election calls from Fine Gael to use the fund for various projects around the state. This is just the sort of interference that will hamper the fund though and only public opinion and all-party commitment to the fund will be able to safeguard the funds independence, which is vital to its success.

Aside from the strict return from the investment, the fund has a number of macroeconomic benefits compared to a normal budgetary approach. It helps diversify public expenditure (especially useful during the surpluses of the past few years) and this may help keep public pay demands down and curtail economically dubious projects such as the "Bertie Bowl". The high visibility of the fund may also make both employees and employers aware of the costs of pensions and recruitment. The fund will also perform a stabilising role, taking more out in a boom and less in lean years. There is also concern coming from America's debate over how best to use surpluses that paying down all of the national debt may have detrimental effects on an economy, as government debt performs a useful role in financial markets. Fears remain though about the prospect of governments owning large proportions of private firms through such investment funds and whether this would be a backward step in freeing up the economy. To many, such as the Chicago School of economists, this is a blatant overstepping of the state's role as facilitator in the market, allowing the market to function efficiently but not interfering. In the opinion of John McHale (2000) though, by setting up the fund already the government misses the macroeconomic benefits to leverage pension pre-funding to achieve wage restraint by public sector workers.

The potential pitfalls of the fund's administration has already been illustrated by the Jefferson Smurfit group's submission to give a higher weighting in the fund's portfolio to Irish equity, such as Jefferson Smurfit stock (Jane Suiter, *The Irish Times*, March 2001). An equivalent fund the 'Norwegian Government Petroleum

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Fund' is precluded from investing in its home market and from holding more than 3% of a firm's share capital to prevent such interference by the government in the market as warned of above. This example has unfortunately not been followed in the Irish case, as it would certainly cut down on political interference and lobbying, though the manager of the fund has stated (March 2001) that the fund's weighting for Ireland will be 1%, close to its weighting in the international equity market.

While the fund may suffer from a number of deficiencies and possible hazards as outlined above, there is probably very few alternative uses for the money that offer value for money and do not suffer from more in-efficiencies, the Irish economy is still running close to full capacity and construction inflation is such that it is difficult to identify alternative worthwhile uses of the money. The decision to create the fund should therefore be analysed in light of the economic situation. It may have been as much a political decision about how to deal politically with budgetary surpluses as a plan to deal with the pension "time-bomb". If the macroeconomic benefits such as control of government expenditure materialise, it may prove to have been a tool of astute economic management as in the long-run *'policy options which encourage low unemployment and economic success are likely to be more important in ensuring that future pension costs can be financed than the precise form of the pension system'* (Fahey and Fitzgerald, 1997).

Is this an equitable response?

'Social insurance is an instrument of social democracy' (Aaron, H., 1992), it is a key provision of the welfare state, which sought to boost the productivity and equality of society by freeing citizens from concerns about their welfare. The fund may have merit and value, but that should not preclude consideration of whether it is fair or not. The social insurance model is based on an intergenerational contract whereby each generation has agreed to fund the previous generation's retirement in return for a promise that the next generation will make adequate provision for their retirement. The government's fund while probably affordable appears to break this contract. This generation is now being asked to fund both its own pensions through contributions to the fund as well as maintaining the pay-as-you-go pension system for the previous generation. It is questionable whether such intergenerational transfers are equitable or, using Danny McCoy's analogy, whether the government has the right to take the option of that holiday to Spain away from today's workers.

The method of generational accounting developed by Auerbach and Kotlikoff is particularly useful for examining this inequity. This form of analysis is a more

useful measure of the various costs and benefits to each generation than simply looking at yearly flows of transfers. As welfare systems grew in the last century retiring workers were able to receive larger benefits than they had paid for as ever-larger numbers of workers supported them. This process is now reversing itself, painfully so in 'baby boom' countries such as Germany that, as already mentioned, provides very generous benefits. The next generation of pensioners now has expectations of benefits that a smaller workforce will not be able to afford as easily. Research by Raffelhieschen and Walliser (1999) using generational accounting in Germany found that future generations will face a 156% higher burden than the present generation in supporting pensioners, this translates into a very unaffordable lifetime tax rate of 54.5%!

This calls into question the very integrity of the existing welfare state transfers on an equity basis (McCarthy, 1995). There are already imbalances in the demands being placed on different generations, though less so in Ireland than in other developed countries. The imposition, on top of this of the cost of the pension reserve fund would seem to place an unduly heavy burden on the shoulders of one generation. Such intergenerational inequity may place the continuation of the welfare state in danger. The climate engendered by the notion of the "demographic time bomb" is conducive to abandonment of public pension provision completely. Such sentiments are growing in economies such as America, but the cost of such a move though would unfairly fall most heavily on the poor. It is important that the extent of the challenge facing industrial economies is not overplayed, as this may cause a shift towards pure market provision, and private insurance provision is known for market failure. To what extent the governments fund aggravates or alleviates this danger to the less well off in society cannot be ascertained at this stage but warrants monitoring.

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The economic implications of the fund for Ireland?

This fund holds out the possibility of easing substantially the pain that will inevitably occur as our population ages. We may be spared large fluctuations in the government's finances and it should help our economy maintain a competitive labour tax regime. All these are very worthwhile goals but 2055 is a very long way off and any projections of economic growth and population over this period are only educated guesses. Who knows how the global economy will fare over the next half century and the spectre of global terrorism has made the situation all the more unpredictable. 1% of our GNP is now locked away for the sole benefit of future pensioners regardless of any relative needs of others during the intervening period. Is it wise to have tied our hands in this manner?

A doomsday scenario would see us having to cut back spending in other worthwhile areas such as health or education, or borrow at high interest rates in order to pay the contribution that is fixed by legislation. Is this really so unlikely, we would have had to borrow for this year's budget if it were not for the creative accounting of Charlie McCreevy. Do we help future generations support the costs of pensions better by leaving them financial assets or by investing in badly needed infrastructure which will boost the productive capacity of the economy and make future liabilities more affordable? As the present world downturn has shown, recessions are very hard to predict, therefore can we say now that we can afford to put this money away every year? It may happen, that instead of the fund helping to keep taxes down, that we may be forced to increase taxes in order to pay the contribution. Given Ireland's present reliance on low taxes to attract Foreign Direct Investment a mistake in the fund's design could hamper our economic development severely.

The 'Stability and Growth Pact', which limits budget deficits within the Euro-zone to no more than 3%, has important implications for the fund. The government's choice of a budgetary reserve fund rather than a strict social insurance contribution pension fund means that any draw downs from the fund during the demographic squeeze will not positively affect the general government balance, which is the measure used by the EU to measure the budget deficit. So any help from this fund will not give us any greater flexibility than a 3% budget deficit even in the years of the highest pay-outs, which will probably be a time of large expenditure on other areas such as health care as well. The format of the fund appears to have constrained the country's budgetary position as much as it has helped it, whereas paying down the national debt would at least lower the cost of interest repayments and help the

budgetary balance. Two German Lander (states) set up similar funds to ours in 1995. Three years later Schleswig-Holstein had to abandon its fund due to poor economic conditions. It had been forced to borrow to fund its contribution at considerable cost. This should be a warning about the dangers of such a fund; while our budgetary position is relatively strong at the present our fund does not even have the option of abandonment if it were to become too expensive.

The build up of such a large fund may also breed complacency about the payment of the other 2/3 of the large and growing pension liability. If this were the case it would make it more difficult to make reforms to the pension system to make it more affordable, such as reversing the trend towards retiring earlier and earlier. Between 1994 and 1997 the rate of increases in pension payments at 20.3% only lagged behind earnings increases by 0.1%, it may now prove difficult to stop this scale of increase if the public could look at a large fund available to pay for the increases.

Conclusion

It is a very difficult task to predict the future course of the Irish economy as the last few months have shown. This implies risk and this fund should at first slightly increase that risk and then most importantly hopefully reduce the risk to the economy. This is how the fund should be judged and to the extent that I believe that the potential cost to the economy is smaller than the damage the greying of the population could inflict, I agree with the minister that this fund is a prudent response to the challenges ahead. While there is a large body of evidence which downplays the potential risks of the "demographic time-bomb", I'm mindful of facts such as that emigration has been the norm for Ireland for a long time and its resumption is possible and would significantly increase dependency ratios and financial pain here, as would an increase in unemployment. We have not yet in my opinion proved that we are capable of maintaining our prosperity and therefore we should put some of our present wealth away for that rainy day. I also believe that this fund is probably the most useful and beneficial use of our money that politicians are likely to come up with.

The fund also has positive stabilising effects for our growing economy, when compared to even more capital expenditure or lower taxes. Whether the fund will generate much of a return seems more doubtful. This is money that could pay down debt, so it must at least make a return that equals the cost of interest on the national debt not repaid. Already there is much pressure to have the fund used for less than sound projects dreamed up by politicians and the high returns on equity seen in the 1990's are not likely to be repeated any time soon with corporate profits languishing

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in a trough. While the National Treasury Management Agency has proved the worth of such autonomous agencies in managing state finances by saving millions by prudent management of the national debt, this is a more challenging proposition as the funds visibility will make it too good a target for parish pump politicians to resist.

In terms of intergenerational equity the fund does seem unfair, but in so much as the cost of these pension liabilities must be met at some time, it is probably least painful to do so now with the fruits of the Celtic tiger years still with us. Any time we lose will just put the cost on a smaller number of people.

As a stakeholder in this economy I hope that this fund is successful and if it does prove to be, the prospects for the Irish economy seem very positive indeed especially in comparison with our European neighbours. I also believe that the fund is politically ambitious and imaginative and should be commended, many other countries with more to worry about have dodged the issue. I for one shall be watching the development and evolution of the 'National Pension Reserve Fund' very closely over the next 50 years.

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