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FINANCIAL INSTITUTIONS & ECONOMIC SECURITY (FIES)

POLICY BRIEF

Retirement Security

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September 2009

This policy brief has been produced for The Open University *Innovation, Knowledge, and Development (IKD)* Centre by Professor William Lazonick and Mr Öner Tulum with assistance from the participants in the IKD Conference on *Financial Institutions and Economic Security (FIES)* held in London, UK on 21-22 May 2009. The FIES conference considered the influence of financial institutions on employment security, retirement security, and housing security, as well as the interrelations among these forms of economic security in North America and Europe. The outputs of the FIES conference around the subject of *Retirement Security* are summarised in this brief. For further information on the FIES project, working papers and upcoming events, please email: ikd-enquiries@open.ac.uk

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Financial institutions – such as investment banks, stock markets and hedge funds – have a major impact on employment, housing and retirement security and their policies can either support or undermine a person's ability to earn money, pay a rent or mortgage and meet the costs of retirement.

At the Financial Institutions and Economic Security (FIES) Conference held in London (May 21-22, 2009), researchers from around the globe explored the issues surrounding the 'financialisation' of the major Western economies and the implications for industrial innovation and stable and equitable economic growth.

The recent financial crisis has caused an enormous loss of household wealth in developed nations, even putting many households with previously sound finances face-to-face with poverty.

Before the crisis, analysts of retirement security pointed to the so-called "three pillars" of retirement income – state pensions, company plans, and individual savings – as constituting a structure that, in combination, could provide older people with adequate incomes through their retirement years.

The biggest issue seemed to be whether these funds could last over the lengthening period of "old age". Now the issue is whether, even for a limited number of retirement years, the streams of income from the "three pillars" will be sufficient to provide retirement support.

At the heart of the issue is the erosion of state pensions and company-sponsored defined-benefit (DB) plans, with more weight being placed on sources of individual savings such as the defined-contribution (DC) plans known in the United States as 401(k)s. As state and company pensions diminish, a single pillar system emerges where retirees rely increasingly on individual retirement plans alone. Today, rather than thinking of retirement schemes as "three pillars", we might visualise them as "three-legged stools". The decline in state and company pensions has rotted two legs of the stool, leaving retirees balancing on the remaining leg - their own individual savings. When, as has happened recently, the returns on individual retirement plans erode, retirees have to perform an even more difficult balancing act. Understanding the risk exposure of retiree households is critical to the development, implementation and evaluation of retirement systems.[1]

Prior to the financial meltdown, most retirement savings came from the appreciated value of family homes as governments encouraged people to consider home ownership as a form of economic security for retirement.[2] These asset-based welfare systems are increasingly popular in those developed nations where income inequality is more pronounced and visible. More generally, the instability of financial markets wreaks havoc not only with home equity but also with the value of DC accounts, such as the tax-deferred individual retirement accounts (IRAs) and 401(k) plans popular in the United States. Under DC plans, current and future retirees are exposed to longevity, labour-market and idiosyncratic risks that may result in an inadequate level of retirement support.

In a world of highly volatile financial markets, marketised retirement plans, whether funded by governments, companies or households, are unable to bear the weight of people's retirement needs. Proponents of marketised retirement such as the World Bank stress the benefits of permitting people to manage their own retirement accounts.[3] Yet in the United States currently, there is a general feeling of relief that both the Clinton and Bush administrations failed in their attempts to transform the pay-as-you-go social security system into a marketised system. According to Christian Weller, the risks of DC plans can be reduced through enhanced diversification and decreased leverage in individual accounts, by increasing the annuitisation of

[1] Christian Weller, "Risk Matters: Retirees Exposed to Growing Risks", paper presented at the conference on Financial Institutions and Economic Security, London, 21-22 May, 2009.
[2] Karen Rowlingson, 2006, "'Living Poor to Die Rich'? Or 'Spending the Kids' Inheritance'? Attitudes to Assets and Inheritance in Later Life", *Journal of Social Policy*, 35:2, pg 175-192.
[3] Richard Minns, "Missing the Point: Financial Crisis Are Not The Issue, At Least for Pensions", paper presented at the conference on Financial Institutions and Economic Security, London, 21-22 May, 2009.

retirement savings, and developing more stable market options for older workers. The elimination of the risk would require a guarantee of a sustainable rate of return to these plans.

Theresa Ghilarducci has argued that the government should be the trustee of such accounts.[4] If Ghilarducci's proposal of a government-managed guaranteed income IRA were to be adopted, US retirees would be sitting on a stool with a greatly strengthened "household" leg and a still viable pay-as-you-go government leg. Indeed, if these two legs could be made solid and wide enough, it might be possible to do away with company-based pensions, thus turning the three-legged stool into a two-legged bench.

However, these two legs assume a record of relatively continuous employment at good pay. People who, for lack of such employment records, cannot construct a sturdy retirement bench would still need a third leg of the stool in the form of a welfare supplement to provide them with retirement security.

People today are struggling with the uncertainty of generating income to ensure their economic security during their retirement period.[5] If the retirement system is left to continue in the direction it has been heading, only those who are able to obtain and sustain stable employment will be able to save for their future and maintain their economic security in retirement. Yet, even with stable employment, marketised non-state retirement plans have been shown to be inadequate for providing economic security to retirees. The recent financial crisis should be the wakeup call for policy makers to recognise the perilous situation of future retirees who are left alone, encumbered with risky marketised retirement schemes. Policymakers may benefit from shifting their vision of retirement security from a crumbling three pillared structure to a more sturdy and sustainable two-legged bench where state-backed retirement plans supplemented by individual retirement accounts ensure economic security and provide sustainability throughout retirement.

The Financial Institutions and Economic Security conference was sponsored by The Open University's Centre for Innovation, Knowledge and Development (IKD), and the European Commission's €1.5 million Seventh Framework Finance, Innovation, and Growth (FINNOV) project. Findings from the work of IKD and FINNOV are disseminated at national and international level towards policymakers, non-government organizations (NGOs) and key industries.

[4] Theresa Ghilarducci, "Save Pensions" and "The Impact of the Financial Crisis on Workers' Retirement Security", papers presented at the conference on Financial Institutions and Economic Security, London, 21-22 May, 2009.
[5] Pierre Concialdi, "Retirement Security and Pensions: The French Experience", paper presented at the conference on Financial Institutions and Economic Security, London, 21-22 May, 2009.