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The Case for  
GCC Pension Reform  
*From Sinking  
To Sustainable*



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## EXECUTIVE SUMMARY

*Pension systems in the Gulf Cooperation Council (GCC) are remarkably generous. People in the region retire well and they retire early: Ninety percent of men and effectively all women have retired in the GCC by the time they are 60 years old, with their state pensions paying, on average, 80 percent of what they were earning before their retirement. To the extent that the region's pension systems are intended to provide social welfare, they are certainly fulfilling their role.*

*However, the overemphasis on social welfare is at odds with the region's movement away from a pure welfare state model toward one that relies on steady diversification of the economy and growth of the private sector. The existing pension systems are also inherently unstable. In the next 25 to 40 years, they will be unable to meet their obligations unless there are changes to their current structure. GCC policymakers will need to undertake reforms that will make their pension systems sustainable for the long term. Successful reform will gradually shift responsibility toward workers and, ultimately, private fund managers, and thereby help to grow the GCC's financial markets as well as significantly reduce the role of government.*

## Key Findings

- The GCC's combined pay-as-you-go and partially funded approach to meeting its pension obligations will prove unsustainable in the long term because of demographic changes.
- The GCC's pension systems could ultimately help the economic growth of the region by contributing to the development of the region's capital markets and deepening the efficiency of labor markets.
- The GCC needs a reform model for its pension systems—one that will produce changes incrementally, giving private providers time to mature and assume more responsibility as the government reduces its role.

## THE GCC'S SLOWLY SINKING PENSION SYSTEMS

Pension systems, in any country, confer three potential benefits. One is the *social* benefit that allows well-to-do retirees to maintain their pre-retirement consumption and saving habits and, for the less well-off, provides a safety net against poverty. The second is the *financial* benefit. Pensions, after all, involve liabilities that accrue over decades and require long-term investments, which in turn can decrease the volatility of financial markets and deepen a country's capital markets. The worldwide financial crisis has reminded the world, if a reminder was needed, how important this is. The third benefit

of a pension system is *economic*: giving people another—for some a key—incentive to work, and thus bolstering the labor market and making the country as a whole more competitive. In effect, a country with a strong pension system signals that it supports the rights of laborers, and as a result attracts workers for the long term.

Not every country's pension system produces all three benefits, but pension systems in highly developed countries tend to provide benefits in most areas. In the GCC, however, the pension systems work primarily toward a social goal, and do little to further the economic and financial goals of the region. And although the systems are fully sustainable now, with 25 working people contributing to pension funds for every one person who pulls money out of them, by 2050 this dynamic will change dramatically. The ratio of contribut-

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ing workers to retirees will drop to approximately three-to-one in some countries. The GCC's pension funds will not be solvent if changes aren't made. Pension reforms are needed to strengthen the financial underpinnings of these funds, preserve their role as safety nets for citizens, develop the region's capital markets, and deepen the efficiency of labor markets throughout the region.

Pension plans in the GCC are extraordinarily generous to those they cover. Whereas many countries look at workers' lifetime earnings to deter-

mine their pension benefits, countries in the GCC use much shorter averaging periods, often the last one to three years of a worker's career. Income replacement rates in retirement also tend to be quite high—around 80 percent on average and even higher in some countries, such as Bahrain. Moreover, one doesn't need to work to a ripe old age in order to receive this replacement rate—in many countries, the 80 percent level is available to 40-year-olds.

Accrual rates—the percentages by which GCC workers' expected retire-

ment incomes rise each year—are constant. Thus, for workers who are 55 years old, income accrued for pension benefits goes up by the same percentage it went up when they were 25. Accrual rates in the GCC are also the same regardless of income level, meaning someone earning \$100,000 accrues future retirement benefits at the same percentage rate as someone earning \$30,000—resulting in the same replacement rate irrespective of income levels. This creates a particularly advantageous situation for the GCC's high-wage earners, who end up with retirement incomes that

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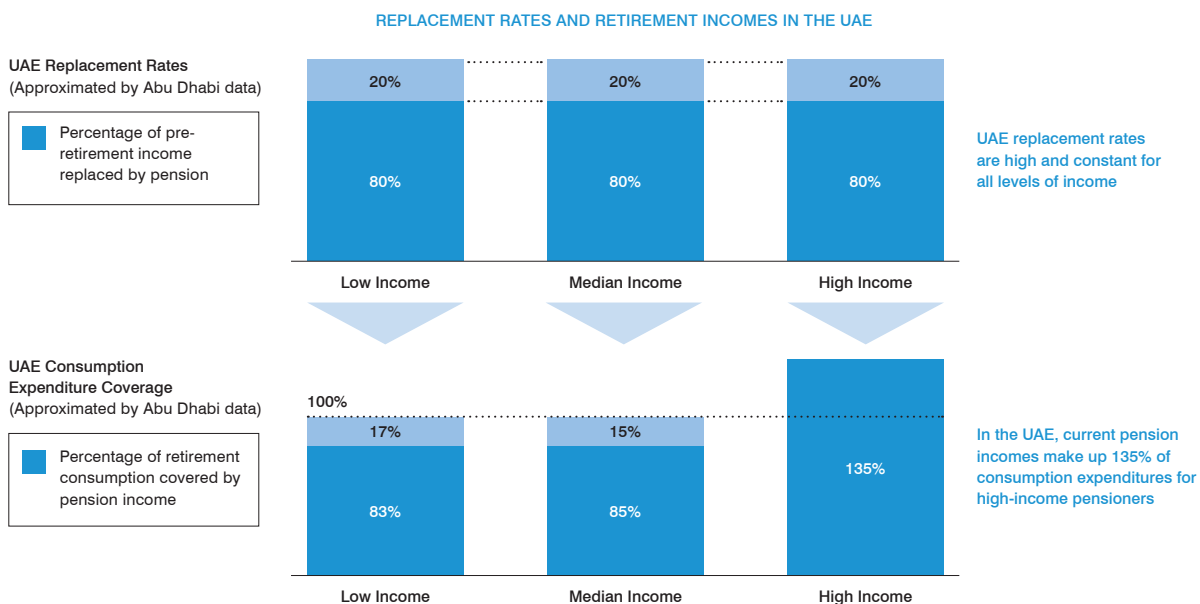
exceed their consumption needs (see Exhibit 1). Depending on a country's goals in pension reform, there are several options to investigate aside from constant accrual rates. A progressive accrual rate by years of work (tenure), for instance—often used in countries with more mature pension systems—rises as workers age, and gives workers an incentive to remain

in the workforce. Another option is a regressive accrual rate by income, in which accrual rates decrease by income level, ensuring a higher rate for low-wage earners and redistributing wealth throughout the labor force.

In short, the incentives in the GCC encourage workers to retire early

rather than stay engaged in the workforce and in the economic development of the region. Roughly nine in 10 male workers in the GCC region have retired by age 60, versus only one in 10 male workers in Organisation for Economic Co-operation and Development (OECD) countries.

**Exhibit 1**  
**UAE's Pensions Allow Retirees to Maintain Consumption Habits**



Source: Booz & Company analysis

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## Pension Glossary: A Guide to Seven Key Terms

**Fully funded.** A pension scheme in which assets are allocated today against some or all future obligations. These schemes therefore do not rely on inter-generational transfers like pay-as-you-go (see below), and should be financially sustainable. A fully funded scheme implies that there are enough assets to meet all obligations and that contributions are invested to expand the pool of assets.

**Partially funded.** A pension scheme in which (as in a fully funded scheme) assets are allocated today against future obligations, but assets are not likely to have to meet all obligations on any given day.

**Pay-as-you-go.** Pension schemes in which the benefits of today's pensioners come out of contributions from today's workers and employers. Pay-as-you-go schemes are essentially unfunded pension schemes, meaning the scheme accepts the responsibility of providing retirement benefits to participants, but does not set aside money to meet future obligations.

**Reserve funds.** Funds established by many countries around the world in order to partly pre-fund their social security systems, which are otherwise financed in a pay-as-you-go approach. Contributed funds are pooled and invested through reserve funds rather than being paid out directly. Reserve funds are common in more advanced economies, such as those of the OECD.

**Defined benefit.** An approach in which the worker knows with certainty, and in advance, what his retirement benefit will be. A simple example would be a government worker who knows his annual pension will be 50 percent of his average salary during his last decade of work. The burden of the pension benefit is borne by the sponsor.

**Defined contribution.** An approach in which there is certainty about the monetary contribution but variability in the benefit, depending on how successfully the money is invested. The advantage of defined contributions is that the worker has a chance of profiting if market returns are favorable. The disadvantage is that investments can also decline in value. The risk of the pension benefit is borne by the individual.

**Provident funds.** Retirement savings that may be mandatory. They are defined contribution schemes that pay out the contributions made and interest accumulated as a lump sum on retirement or according to other predetermined circumstances. Participants may have the choice of receiving part of their benefits in cash and part as an annuity.

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Another key issue in pension reform is the creation of savings vehicles—financial products that would help deepen the region's financial markets. Right now, GCC workers are not encouraged to save for their retirements; in GCC countries there is no equivalent of the voluntary retirement mechanisms that exist in more mature economies, like the 401(k) in the U.S. The high spreads at banks likewise discourage savings. And life insurance (which in most countries is part of the mechanism for paying out pensions) is still not widely owned in the GCC. Add to that a lack of sophistication in terms of investment knowledge among citizens, as well as a high consumption orientation (a recent study put Abu Dhabi among the nations with the highest consumption rates in the world), and one can understand the reluctance by workers to move from a welfare mentality.

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Perhaps most damaging of all to the GCC's future economic development has been the GCC's policy of excluding productive nonnational labor from its pension programs. This might be less of an issue in a region or country that didn't pin so much of its economic fortunes on foreign-born workers. But three-quarters of all employees in the GCC come from a country other than the one in which they work (*see Exhibit 2*). In the UAE and Kuwait, the percentages of foreign-born workers are even higher, at 83 percent and 82 percent, respectively. This amounts to a huge reliance on imported talent.

Other countries that have large percentages of foreign workers have looked for ways to include them, at least partially, in their pension systems. Malaysia, for instance, allows foreign workers who have been contributing to the country's so-called provident fund to receive a lump-sum payment if they leave Malaysia permanently. Singapore administers its pension benefits through what it

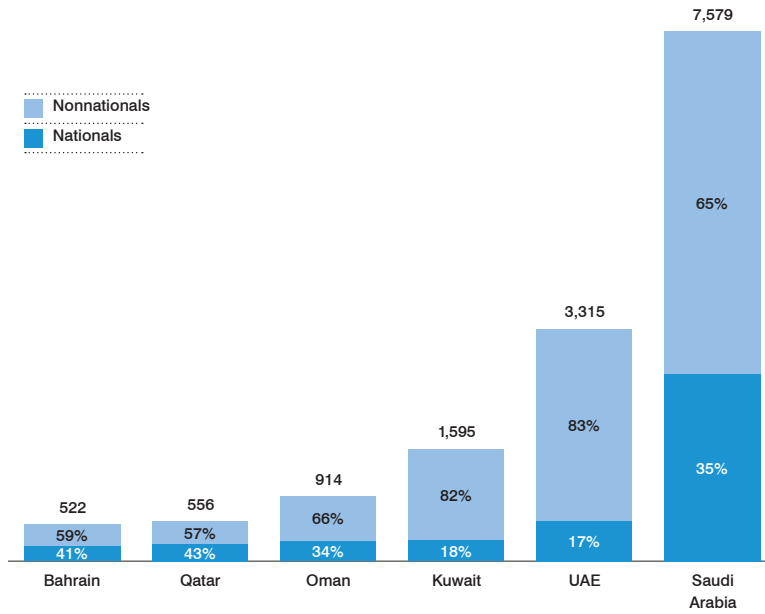
calls a Central Provident Fund (CPF). It allows expatriate workers to make voluntary, taxable contributions. The governments of the GCC, by contrast, have avoided even these concessions, thus limiting their countries' attractiveness as destinations for workers. As a result, some companies in the GCC have taken matters into their own hands. For instance, some UAE companies have set up private pension schemes out of concern that prized international managers might otherwise leave.

By not including foreign workers in their pension systems, the GCC countries also miss a significant opportunity to strengthen their financial markets. If the GCC expanded pension coverage to nonnationals, the contribution fund would in some countries be more than three times larger than it is now because so many more people would be contributing. Finally, the GCC's approach to its pension funding is almost certain to prove unsustainable in the long run. The GCC's pension systems are

partially funded, meaning some of the benefits are paid out of investments made with excess contributions, backed by a pay-as-you-go system, in which retirees' income comes out of the tax contributions of current workers. This approach is necessary because assets are not enough to cover long-term liabilities. Ideally, however, the region's pension systems should become fully funded. This means assets would cover long-term liabilities so that benefits would primarily come out of an invested pool of contributed money. To be sure, the pension systems' partial funding does not pose a problem at the moment, while the population of the GCC is very young. But as the demographics of the region change, modifications will be needed. Even in economic hot spots like Abu Dhabi, there simply won't be enough people in the workforce supporting retirees. The old age dependency ratio—that is, the ratio of people working to those in retirement—will drop steadily as the population ages (*see Exhibit 3*).

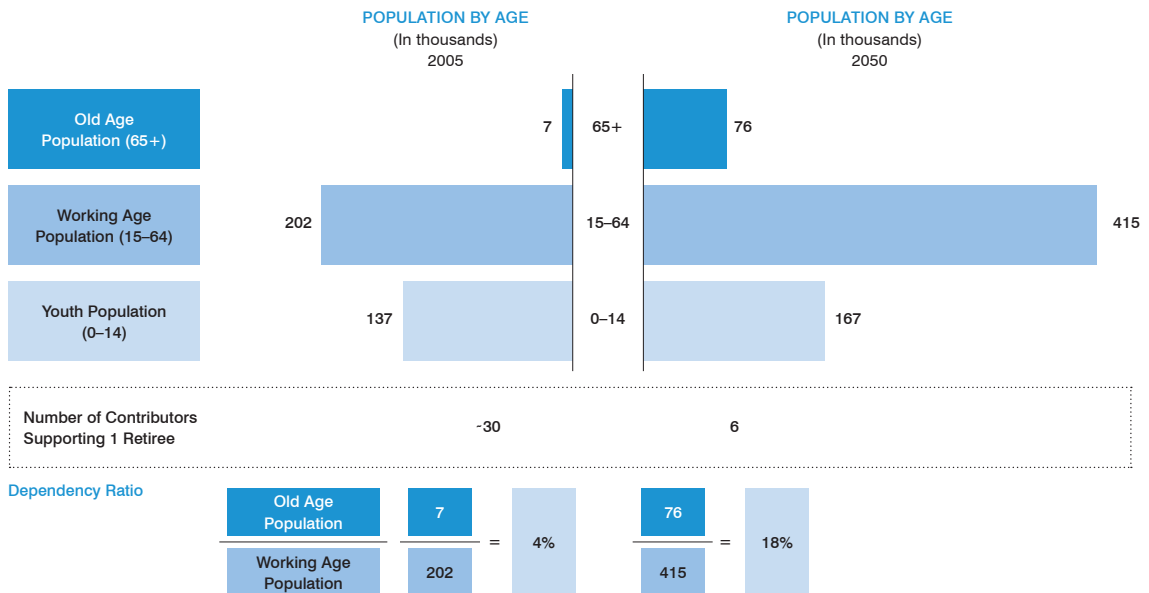
**Exhibit 2**  
**The Dominance of Nonnationals in the GCC Labor Force**

**EMPLOYMENT OF NATIONALS AND NONNATIONALS IN THE GCC**  
 (As a percentage of total employment; totals in thousands) (2005)



Source: United Nations data, 2005; Booz & Company analysis

**Exhibit 3**  
**Abu Dhabi Dependency Ratio Shifts, 2005 vs. 2050**



Source: Abu Dhabi Statistical Yearbook 2006, DPE Survey, 2005; D. Robalino, "Pensions in the Middle East and North Africa: Time for Change," World Bank, 2005

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## REFORM OBJECTIVES: WHAT THE GCC'S PENSION SYSTEMS REQUIRE

These issues are clear weaknesses that will eventually drive the GCC nations to overhaul their pension systems. So it makes sense to start thinking about reform at a time like the present when, demographically speaking, the pressure is less intense and changes can be made purposefully.

Among the most important reforms is opening up the GCC's pension systems to foreign-born workers and to the self-employed. This would substantially increase the size of the pension pool, making the system more financially secure and giving the region's capital markets a shot in the arm. A second fundamental reform—related, in some ways, to the first—is reducing government's role in administering pensions and taking care of workers in their retirement. It would be better for the economy if the GCC had a vibrant industry of financial-services companies, the kind that exists in many other parts of the world, to handle part of this work.

A third critical reform is the introduction of voluntary retirement savings, so that workers have the option of saving money above and beyond the mandatory amounts that their employers and the government set aside for them. Besides giving workers a convenient way to

automatically help increase their savings, such a reform would also set the stage for governments to ask workers to share more of the responsibility for their retirement savings. A fourth big reform would be to make workers' retirement accounts portable, so they wouldn't face the prospect of losing their pensions if they switched jobs or left the country. This would be a particularly useful policy change in a world in which business is global and mobility is here to stay.

There are, of course, a host of other, more tactical changes that GCC countries should consider. These include fine-tuning accrual rates to better redistribute wealth; lowering the guaranteed income replacement rate to levels more in line with highly developed countries; indexing pension increases to inflation; and reducing companies' mandatory pension contributions. In Kuwait, for example, those contributions amount to 25 percent of workers' annual salaries, an extremely burdensome figure that factors in to the hiring decisions of Kuwaiti companies. Indeed, there are so many possible areas of reform, some of them depending on individual countries' circumstances, that it is not possible to mention all of them here.

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## EXISTING ROUTES TO PENSION REFORM

The ways in which pension reforms can come about are important to understand. Most countries that have reformed their pension systems have gone about it in one of two ways—parametric reform or systemic reform.

Parametric or retrenchment reform involves changing the parameters of a country's pension system—things like retirement age, mandatory contribution rates, averaging periods, and the like—in order to ensure the system's financial stability. Germany's increase of the age at which a worker can retire with full pension benefits, to 67 from 65, is an example of a parametric reform. So is Slovakia's abandonment of its practice of using a worker's five highest-earning years to determine pension benefits (the Central European country now bases pension benefits on a worker's lifetime earnings), and Bahrain's lowering of mandatory employer pension-contribution rates to 15 percent from 21 percent.

Systemic reform is the more complex way to change pension systems. This often involves the introduction of multiple pension “tiers,” involving a retirement income that is guaranteed by publicly administered pension funds, often supplemented with a benefit provided by privately administered funds. A tier 1 system is a government-sponsored, mandatory pension fund (like Social Security in the U.S.); a tier 2 system is a mandatory employer-administered fund in which there are defined benefits (like General Electric's pension benefit). A tier 3 system is underpinned by defined contributions, in which workers voluntarily save an amount of their choosing and invest it as they please, over and above what the state and their employers are putting away for them (like an IRA or 401(k) in the U.S.).

The World Bank, in its capacity as an advisor to developing countries, has been a strong proponent of multi-tiering as a route to systemic reform.

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It gradually offloads the responsibility for retirement savings onto private citizens, and by so doing, makes pension systems more robust. When governments introduce nonpublic pension tiers, they typically do so with the goal of shifting responsibility to the worker and private fund managers, and lessening their own roles. The U.K. offers a good example of systemic pension reform: In 1986, the country began allowing workers to invest a portion of their mandatory retirement contributions in individual accounts, partly to reduce the government's future pension liabilities. The policy change (which has been refined several times since) was also intended to boost what had become a low savings rate in the U.K., and to give workers a chance to get the potentially higher returns available via the stock market.

Although parametric reforms are undoubtedly necessary in the GCC, the experience of other countries suggests they won't be sufficient. Take a parameter like mandatory employer contribution rates. In countries that have increased these rates, many

employers have responded by evading the requirement—for instance, by setting up workers as part-time contractors, with no pension benefits, instead of as full-time employees. And even in countries where parametric reform has helped, the value of the adjustments has tended to diminish over time. Germany, for instance, has made more than a dozen parametric reforms to its pension system; the initial reforms did not sufficiently account for changes in demographics and market conditions, and thus failed to secure the government's pension fund.

But systemic reform does not guarantee success either. The right socioeconomic conditions must be in place for it to work. To start with, a government undertaking systemic pension reform is less likely to succeed if it has a high deficit—as it may not be able to pay out the existing and implicit debt accrued on its old pension system when it breaks from that and moves to a tiered system. Second, a country undertaking systemic reform is again less likely to succeed if its underlying

income inequality is high and its financial markets or financial-services industries are immature. Income inequalities are accentuated by a system that emphasizes the market returns from worker contributions or a system that is oriented toward privately administered tiers. And immature financial markets make such reform efforts moot—there is no one to administer the private tiers.

For much of the last few years, as oil prices rose to record levels, the GCC was in an enviable position with respect to government deficits—it didn't have any. The sharp decline in oil prices could change that, however. Moreover, GCC nations still suffer from issues regarding income inequality, and its financial markets are still developing. The declining government surpluses and immature financial markets mean traditional systemic pension reform is no more of a sure thing in the GCC than parametric reform—both will fall short on their own. Thus, GCC nations must take action to bring about reform.

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## THREE TIERS, MANAGED BY GOVERNMENT

What's needed in the GCC is an alternative model of pension reform, one that uses the three tiers of systemic reforms (government-funded and mandatory; employer-funded and mandatory; employee-funded and voluntary) and embeds them in the individual public funds already being administered by each government. Due to the difficulty of moving to a three-tier structure, the government, initially, should run all three tiers. These can be spun off as employers get proficient at running corporate retirement funds (tier 2) and as capable financial-services companies arise to handle the employee-contributed funds (tier 3). However, because such financial-services companies aren't yet well developed in the GCC, it isn't realistic for the region's governments to hand off any of the burden of administering their pensions at this point. Instead, those governments should move forward with the "one

fund/three tiers" concept, and give financial players the time they need to lay down infrastructure and begin developing services. The long-term objective would remain to have the governments' parts of the funds serving mainly the social welfare function, ensuring that retirees meet a designated standard of living, while the corporate- and employee-funded areas contribute the financial and economic benefits, such as deepening financial markets.

To be sure, parametric reforms should also be part of the prescription. This Perspective has already mentioned the desirability of taking a fresh look at things like income replacement levels, averaging formulas, accrual rates, and enrollment criteria (especially with respect to the exclusion of nonnationals). Changes in those policies would go a long way toward ensuring the financial stability of these one-fund/

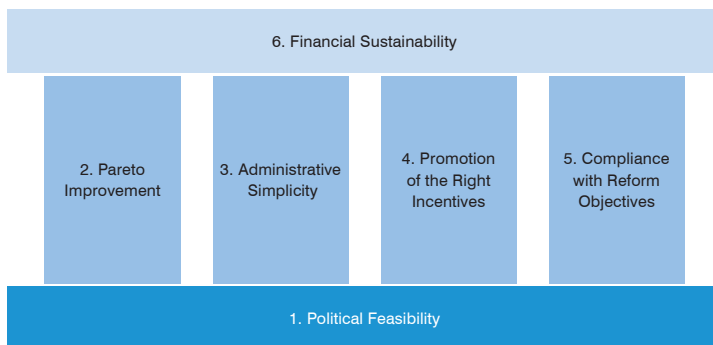
*What's needed in the GCC is an alternative model of pension reform, one that uses the three tiers of systemic reforms and embeds them in the individual public funds already being administered by each government.*

three tiers entities, allowing many of them to wean themselves off partially funded or pay-as-you-go schemes and move in the direction of being fully funded. Embedding the voluntary portion of the program in the existing public fund would also help jump-start the third tier; workers would feel more secure about putting “extra” money into retirement savings in a public fund they already know and trust. And, as money pours in via this third tier, it would create the conditions for capital markets to thrive,

hastening the day when defined contribution funds can be spun out in the GCC, and run by private companies.

Despite some fundamental similarities and the broad applicability of the one fund/three tiers approach, GCC countries won’t all end up with identically structured pension systems. There are six guiding principles, with their own inherent order, that policymakers from each country should bear in mind as they move toward remaking their pension regimes (*see Exhibit 4*).

**Exhibit 4**  
*Pension Reform Begins with Political Feasibility and Aims for Financial Sustainability*



- 1. Political feasibility.** Any reform needs to receive a critical mass of support from those it affects. In some countries, this may make seemingly sensible reforms impossible—at least at first.
- 2. Pareto improvement.** Each reform should meet this economic test, which says that any change should make at least one individual better off without making any other individual worse off.
- 3. Administrative simplicity.** The reforms will work best to the extent that they are simple to run, carry minimal operating costs, and make it easy to carry out future transitions.
- 4. Promotion of the right incentives.** Reforms should prompt participants to save more and retire later—otherwise, by definition, they will have failed.
- 5. Compliance with reform objectives.** The reforms should address the most significant problems in the current pension systems, including any funding gaps.
- 6. Financial sustainability.** The reforms should result in a pension system that is financially independent and self-sufficient, so there are no credibility issues and no uncertainty.

Source: Booz & Company analysis

## CONCLUSION

Without question, there will be some workers in the GCC who will be unhappy with a set of changes that will remove benefits they are counting on. But those changes can, and should, be phased in over a period of years, giving people who are still in the workforce time to adjust their thinking and modify their financial behavior. This, again, is the advantage of embarking on pension reform now, when the true pressure has yet to be felt.

The opportunity exists for the GCC countries to make reforms to their pension systems that would strengthen the financial underpinnings of those systems, preserve their role as safety nets for the poor, and allow low-income workers to maintain their consumption habits. The reforms could also contribute to the development of the region’s capital markets and deepen the efficiency of labor markets. Done right, these reforms could help the GCC’s pension systems advance from their rudimentary state and become among the best in the world.

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