WHITHER UK PENSIONS POLICY?

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While the UK may be facing much less serious pension difficulties over the next 50 years than other countries, the issue should not be ignored. Increasing the retirement age would be possible, but funded pensions are also an important option. The UK government has used marketing to encourage funded pensions, but policy changes would also help. Ultimately, the basic state pension could become funded.

The pensions time bomb

There is widespread concern that there may be a pensions time bomb: that within the next half-century we will reach the point where too small a proportion of the population will be working, so that only punitive levels of taxation would extract from them the money needed to pay the pensions of the retired. And even punitive taxation would not work because its adverse impact on the economy would reduce output and reduce the wages and profits available to tax.

This paper will not discuss how serious the problem is, or the extent to which some countries face bigger problems than others. Those questions have been extensively discussed, most recently in Budgetary Challenges Posed by Ageing Populations. However large the problem, it is both substantial and hard to solve, because people have unrealistic expectations about long periods of prosperous retirement. This paper examines the solutions which will do least violence to the free market which produces the best results for most of the people, most of the time.

There are several possible approaches, which are not mutually exclusive:

• People could either retire later or make do with less in their retirement. This approach places responsibility for each individual's circumstances on that individual. It allows any re-distribution of wealth, either between generations or between individuals within the same generation, to be greatly reduced. If most people (in any given generation and in successive generations) had much the same income and much the same wealth, it would be the obvious free-market choice. But incomes and wealth do vary widely between people within a generation and between generations, so we must at least consider other approaches.

• More saving for retirement could be encouraged, building up pension funds. This approach is being pursued by the UK government, which has introduced stakeholder pensions and proposes the pension credit. Success so far has been limited. This is unfortunate because funded pensions are in principle a good free-market approach. They give pensioners a claim on future income through the private-sector mechanism of owning stakes in businesses, rather than through the state mechanism of future taxation. But this approach also raises questions, including how people should be persuaded to build up their pension funds and whether the basic state pension (currently £72.50 a week for a single person and paid out of national insurance contributions) should also be transformed into a funded pension.

• Tax-funded state pensions could be increased, getting people used to the idea of higher taxation well in advance and reducing government debt in order to have room to increase it later if need be. This is the least free-market approach. It is also being pursued by the UK government through the creation of the flat-rate state second pension, which has a strong re-distributive element: contributions will be income-related but the pension will be the same for all who receive it. The government is likely to have far more short-term success in implementing this part of its strategy than in implementing the...
funded pensions part of its strategy, because
the state second pension and related changes
to the national insurance system can simply be
imposed by an Act of Parliament. Given the
interventionist nature of such initiatives, it is
very hard to justify them on economic grounds.
Any justification would be political, and this
approach is not considered further here.

None of these options may be of much interest
to employees who are members of defined benefit
occupational pension schemes. They can rightly
consider their position to be reasonably secure.
However, there has been a marked swing away from
defined benefit schemes. Many substantial employers
have closed their schemes to new entrants, offering
defined contribution schemes instead. They do not
want the investment risk of defined benefit schemes.
But whatever solution is adopted, the role of
occupational pensions will need to be considered. In
the UK at least, they will remain of great importance,
even if defined benefit schemes are largely replaced by
defined contribution schemes.

Retiring later or managing on less

Asking people to retire later, or to make do with
smaller pensions, would be very difficult politically.
But it would attack the problem of the pensions time
bomb at its root. However, the politics of asking
people to retire later are very different from the
politics of asking them to make do with smaller
pensions.

It is possible to increase retirement ages.
The UK now has legislation which will increase
the state pension age for women (currently 60) to
that for men (currently 65), over a period which
will run from 2010 to 2020. Clearly it was politically
important to announce this change well in advance,
and to phase it in gradually. So if the state pension age
is to be raised, the decision needs to be taken as soon
as possible. The state pension age should strongly
influence the age at which people will stop work, even
if they have private sector pensions, because many
people will need the state pension to supplement their
other pensions.

Asking future pensioners to make do with
pensions which are smaller in absolute terms than
those being paid to current pensioners, on the other
hand, is not politically realistic. But there is another
sense of ‘smaller’: smaller relative to earnings. A key
source of anticipated difficulties in paying future
pensions is an expectation that future pensioners
will see their incomes rise in line with the earnings
of people still in work at the time. (We are, of course,
here discussing incomes enjoyed by the average
pensioner: there is no suggestion that someone with
a pension well above the average should have any
guarantee that the whole of his or her pension will rise
in line with earnings.)

The UK government has made a rod for its own
back, by committing itself to a minimum income
guarantee which will rise in line with earnings.
The basic state pension, on the other hand, is only
expected to rise in line with prices, so that it will
become a diminishing burden as a proportion of GDP
so long as real GDP growth outstrips growth in the
retired population (which is likely, with a retired
population projected to grow at less than 1% a year
even on worst-case assumptions). It might well be
politically possible to guarantee pensioners a basic
income which only kept pace with retail prices.

The contrast between a link to earnings and a
link to prices becomes more dramatic, the longer
people live in retirement (and life expectancy is itself
increasing). If, for example, we assume 2.5% annual
real growth in GDP and earnings, a pension fund
invested in index-linked securities with a real rate of
return of 2% and a retirement lasting 15 years, then the
fund required to produce an income which kept pace
with earnings would be 1.22 times the fund required
to produce an income which kept pace with prices.
If the retirement period were 20 years, this ratio
would rise to 1.29. At 25 years, it would rise to 1.37.

If people only expected their pensions to rise in
line with prices, maintaining their absolute living
standards but not their living standards relative to
those of people in work, the challenges of future
pension provision would be much reduced. Pensions
from private sources might of course rise in line with
earnings, or even outstrip them, but that would be a
bonus. The bonus would not have to be guaranteed by
future taxpayers. This would keep the economy closer
to the free-market model, because there would be less
chance of state-sponsored re-distribution of income
from future workers to future pensioners.

Whether pensioners’ incomes should be
guaranteed to rise in line with incomes or in line with
prices is a political question, which must be left to the
electorate rather than to economists. It is the question
of relative versus absolute poverty. Most people would agree that poverty should be eliminated, but which sort of poverty is the greater concern? The choice need not be as stark as this. One possibility, for example, is that pensioners’ guaranteed basic incomes should rise in line with prices, plus half of the rise in real earnings. But whatever choice is made, it needs to be made now and then adhered to. Any lack of clarity about the choice will lead either to insufficient preparations being made, or to a failure to consider options which are in fact available but which appear to be ruled out by a choice which may or may not have really been made.

**Building up funded pensions**

*The justification for funded pensions*

Funded pensions are often seen as the UK’s bulwark against the pensions time bomb—the reason why the UK is much better-placed than, for example, France, Germany and Italy. On the other hand, even the Government Actuary has expressed doubts about the economic efficacy of funding, which may simply displace other saving. And in any case, the value of shares and securities in a pension fund depends almost entirely on future economic activity, which could be taxed when it happens rather than appropriated to pensioners in advance. The economic justification for funded pensions is therefore not entirely beyond question. An additional justification is that allocating wealth to a pension fund settles its current ownership, and thereby settles the ownership of a proportion of future production. What is more, these settlements are achieved through the mechanism of company law, where the state only holds the ring rather than intervening in the allocation of resources.

Settling the current ownership of the wealth concerned is important because it constrains the state. Once wealth has been allocated to a fund with the name of an individual or of a workforce on it, it is politically very difficult for the state to appropriate that wealth for other purposes. It is not impossible, but at least it is only feasible to a limited extent. For example, in 1993, 1994 and 1997, successive UK governments reduced the rate of tax credit on dividends reclaimable by pension funds, from 33% of the net dividend to 29%, 25% and finally nil. The effect was to divert a proportion of the funds’ claims on future production to the Exchequer. The amount diverted by the last change (which was by far the largest) was estimated to be £5 billion a year.

Settling the ownership of a proportion of future production usefully takes the question of its ownership out of the political arena. If future production is to be taxed when it happens, the distribution of income between those who are workers and those who are pensioners at that time will be a matter for political debate, with the outcome driven by political expediency and with knock-on effects on other state spending decisions. The legal framework of shareholders’ and employees’ rights, in contrast, gives a way of confining such debates within individual companies, where the outcomes will be regulated by the market. On the one hand, employees cannot be under-paid by reference to the market rate, or they will leave. On the other hand, the providers of capital cannot be under-rewarded by reference to the market, or they will invest elsewhere.

*Compulsion or encouragement?*

Even if pension funds are a good thing, if people are to invest in them, they may need to be encouraged or, as a last resort, compelled. The lure of current consumption is great. And even those who save may prefer forms of saving which give them free access to their capital at any time, in contrast to pension funds which mostly force them to wait until retirement and then draw steady incomes.

No UK government has yet made investment in pensions compulsory, beyond compulsory contribution to the national insurance system which pays for both the basic state pension and the state earnings-related pension scheme (SERPS) – and neither of those is a funded scheme. Indeed, the tendency has been to increase freedom, with the removal in 1988 of the right of employers to make membership of their pension schemes a condition of employment.

The current government has favoured a marketing drive, in the form of stakeholder pensions. These are essentially personal pensions, defined contribution schemes which attach to individuals and not to specific employments, which have existed since 1988 and were preceded by the broadly similar retirement annuity plans. But stakeholder pensions have been made more appealing to individuals than
personal pensions had previously been in three respects:

- Charges are limited to 1% of the fund value each year. This will, however, deter some potential providers from entering the market, because the charges in early years will be low. Only people who continue to contribute for several years, and build up substantial funds, will be commercially attractive customers. And it is not possible to require continued contributions or to penalise people who wish to move their funds to alternative providers.

- Any employer with five or more employees must allow access to a stakeholder scheme via the payroll for employees to whom the employer does not offer alternative pension arrangements. Employers do not actually have to contribute to stakeholder schemes. They merely have to make access easy, and bear the consequent administrative burdens.

- Most people do not have to worry about limits on contributions, because everyone can contribute at least £3,600 a year (gross) regardless of income.

This piece of marketing is part of a strategy to achieve an ambitious goal. The government wants more retirement provision to come from private funds, and less from the state. The objective is to reverse the current proportions, 60% state and 40% private, so that by 2050 they are 40% state and 60% private.

Recognising this difficulty, the government has a third element in its strategy: the pension credit. If a pensioner has income from private sources (whether employment or saving) in excess of the basic state retirement pension, he or she will receive an additional payment from the state. At low income levels, the credit will be 60p for each pound of private income. As income rises, the credit accrued will be clawed back. Final figures have not yet been decided, but on the illustrative figures supplied by the government, someone with a state pension income of £77 a week and £23 a week of private income would receive £23 \times 0.6 = £13.80 a week additional payment. Thereafter each pound of income would reduce the additional payment by 40p. Someone with £24 a week of private income would get only £13.40, and someone with £58 or more a week of private income would get nothing.

We do not yet know what the take-up of stakeholder pensions will be, given the tension between the minimum income guarantee and the pension credit, but early indications are not promising. If take-up is not high, compulsory contributions to pension schemes would have to be considered. But we should also review other measures which could be taken to make investment in pension funds more attractive.

Making pension funds more attractive

The traditional UK approach to the use of pension funds has been quite restrictive. If a fund has had tax privileges (broadly, tax-deductibility for contributions and no tax on income and gains within the fund), then it must be used to provide a taxable income for life, starting at an age between 50 and 75. In a defined contribution arrangement, a certain proportion of a fund, typically 25%, may be allowed, depending on the scheme rules, and an income related to salary while in work is then paid for life.

This restriction of choice may well deter people from putting their money into pension funds. Only two tax-related features of the system make it rational to prefer pension funds to other savings vehicles which also offer tax-free income and gains within the fund, but which do not restrict the use of the fund. (Such a vehicle exists in the UK in the form of the
individual savings account, which does not offer tax-deductions for contributions but does not tax withdrawals either.)

- The first feature is the option to take a tax-free lump sum out of a fund created with tax-deductible contributions.
- The second feature is that some taxpayers obtain tax deductions for contributions at the higher rate of income tax, 40%, but by reason of diminished income are only taxed on their pensions at the basic rate, 22%. However, only about 12% of the workforce at any one time pay tax at the higher rate. Even allowing for the fact that more senior workers are more likely to be higher rate taxpayers, it is most unlikely that the proportion of people who pay tax at the higher rate at some stage in their careers would be much higher. So only a small minority benefit from this effect.

Given that rational preference for pension funds is based only on these features, it is worth looking at ways to allow greater freedom in the use of funds. There are, however, three concerns about doing so:

- If the whole of an individual’s pension fund were made available for unrestricted use, he or she might spend it quickly and then rely on taxpayers in later life.
- A pension fund is built up using tax-deductible contributions. Enjoyment of the fund would have to be taxed in some way, because the state could (for the time being at least) ill-afford to have the tax deferral given by the deductibility of contributions become a tax exemption. And ending the tax-deductibility of contributions would not be an option because it would do enormous damage to the perceived desirability of pension funds.
- The tax regime for pension arrangements is viewed in government circles as setting up a contract between the state and the citizen. The state offers tax privileges and in return the citizen agrees to use the fund to provide an income for life. There is no reason to allow the citizen to renege on his or her side of the bargain.

The third concern is easily dismissed. It is open to the government to change its view of the rationale for tax reliefs. The first concern could be dealt with by requiring people always to buy annuities sufficient to keep them ineligible for state benefits, and only allowing freedom in the use of the funds remaining after buying such annuities.

The second concern could be dealt with in various ways.

- One possibility would be to make all withdrawals from the fund, during life or on death, taxable (apart from the existing tax-free lump sum or, as a replacement for that sum, 25% of each withdrawal). However, that would arguably be too severe because withdrawals might themselves be invested, yielding income which would be taxable, while an insurance company’s fund to pay annuities is not itself taxed except to the extent that a profit is made for the company. Taxing all withdrawals in full would also lead to a large proportion of any substantial withdrawal becoming subject to income tax at the higher rate of 40%, rather than at the basic rate of 22%, simply because a substantial withdrawal would create a peak in the pensioner’s income.

- It would therefore be better to work out, on an actuarial basis, the amounts of tax which would be paid if a pensioner were to buy an annuity with 75% of the fund (75% being the fund less the tax-free lump sum). Those amounts of tax could be discounted back to the date of retirement, creating a tax debt. This debt would be compounded forward until paid. On a withdrawal from the fund, a proportionate part of the tax debt would have to be paid and only the remaining debt would continue to be compounded. If there were a requirement to use part of the fund to buy an annuity to keep the pensioner off state benefits, this part of the fund would be deducted first, before the other computations were made.

One possible side-effect of relaxing the requirement to use funds to buy annuities would be to improve the annuity rates available. The current requirement to buy annuities creates a large artificial demand for annuities, at a time when fewer whole-life policies are being sold. Insurance companies are feeling more and
more exposed to the risk of longer lives (which make annuities more expensive and whole-life policies cheaper), and are therefore being conservative in setting annuity rates.

Transforming the tax-funded state pension
If funded pensions are better than unfunded ones, then it is natural to ask whether the basic state pension, which is unfunded and paid to current pensioners out of national insurance contributions raised from current workers and their employers, should also be replaced by a funded pension.

One proposal to do so, devised by David Willetts MP, has been studied by a panel of which the present author was a member. The proposal is to allow people aged up to 30 to opt out of the basic state pension. National insurance contributions would be diverted to a fund for the individual, which would be used at retirement to buy an annuity. If the annuity were to fall below the level of the basic state pension, the state would make up the difference. The pensioner might get more than the basic state pension, depending on how the fund performed, but the pensioner could not get less unless a future government changed the rules.

At present, current national insurance contributions are needed to pay current pensions. The proposal is to issue government securities in order to smooth the transition from this pay-as-you-go system to a funded system. These would of course have to be redeemed by future taxpayers, but there would be no worsening of the state’s financial position because the state is in any case liable to pay future pensions.

When the proposal was published in 2000, it looked particularly attractive because it would allow people choosing the funded replacement for the state pension to invest in equities, with their historically good rates of return. But equities have not performed well in recent months, and their future over the medium term remains uncertain.

However, the proposal has other advantages which are not purely economic. It would make it much harder for future governments to tap the wealth set aside for pensions. It would give a clearer picture of the state of the public finances by showing future liabilities as government securities. And it would give more people a sense of ownership of their pensions, which could lead them to take additional private pension provision more seriously.


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