UK PENSION POLICY

LEADER TURNING LAGGARD?

[This paper, with minor revisions, is due to be published in the December 2001 issue of Economic Affairs, the quarterly journal of the Institute of Economic Affairs]

CONTENTS

TITLE	PAGE NUMBER
Introduction	**3**
The UK Background	**4**
Pay-As-You-Go or Funding?	6
The Return of Means Testing	7
In the Face of the Evidence	9
Conclusions	11
Appendix	**13**

INTRODUCTION

In its landmark 1994 publication *Averting the Old Age Crisis*[1] the World Bank used the now familiar pension "pillars" convention to analyse the problems of ageing populations. Broadly, it recommended a modest compulsory flat rate Pillar 1 (State pay-as-you-go, either universal or means-tested) and a compulsory privately funded Pillar 2; the underlying logic was that funding provides greater security under demographic ageing and stimulates savings and growth.

In a nutshell the UK system is consistent with these recommendations; Pillar 1 is indeed "modest" compared with many other countries especially in continental Europe. So is Pillar 2, and the voluntary Pillar 3 in the shape of company or 'occupational' schemes is large and healthy. Most UK observers agree that it is exceptionally well placed to cope with the ageing phenomenon, as is illustrated by some of the numbers in the Appendix.

However, many are unfazed by a far larger Pillar 1, arguing that in practical terms there is little difference between funding and pay-as-you-go. The issue is seen to revolve round the increasing ratio of pensioners to workers and filling the gap by economic growth and deferring retirement in a combination that doesn't upset too many applecarts. This paper differs in some important respects.

In the meantime the ageing population problem has been recognised — and denied — in policy and debate for some years and activity is now strenuous. The Government has set up a "Foresight Ageing Population Panel" which has produced a Consultation Document "The Age Shift".[2] The actuarial profession is heavily involved in several initiatives, and has a Task Force investigating the major areas. Think tanks, economists, fund managers, and the pensions industry in general are heavily engaged — as are various other social research institutions inside and outside academia, along with the usual plethora of lobby groups.

THE UK BACKGROUND

Pillar 3: A long history

Employer-sponsored Defined Benefit (DB) schemes have grown consistently for well over a century and represent the vast bulk of the £1.2 bn plus of accumulated assets (see Appendix). However, exponentially increasing State regulation has created enormous problems, including the now notorious MFR (Minimum Funding Requirement) which has distorted investment strategy whilst contributing nothing except false hopes to the security of scheme benefits. In contrast Defined Contribution (DC) schemes, in which individual accounts are built up during a working career, enjoy far less State regulation and this, plus the risks for employers in guaranteeing benefits related to final earnings, has led to a reversal of the growth of DB schemes.

Pillars 1 and 2 — shorter and more chequered

Although the first State *pension*, a means-tested benefit at subsistence level from age 70, arrived in 1908 and the contributory National Insurance principle was first applied in 1925, many commentators rank the next major National Insurance Act (1946) which followed the proposals of Lord Beveridge (1942) as the foundation of the modern Welfare State. In fact little now remains of Beveridge's two most fundamental principles — a 'contributory' or 'insurance' principle linking benefits and contributions, and a universal Basic State Pension (BSP) sufficient for subsistence.

Today (January 2001) the full Pillar 1 BSP for a single person stands at £67.50* per week which is around 16% of average earnings. State Pension Age is 65 for males and 60 for females, to be fully equalised at 65 by 2020.

Pillar 2 is SERPS (State-Earnings-Related-Pension Scheme) which permits "Contracting Out" using actuarially-based rebates, in favour of an approved employer-based scheme. SERPS, designed to produce a pension of 25% of a wide earnings band on top of the BSP, was implemented in 1978 but has suffered cutbacks alongside the erosion of the BSP and like several predecessors is to be abolished. Its replacement[3], the State Second Pension (S2P), is an altogether less grand, although far more complicated, affair with distorted contracting-out rebates and a fundamental change in mid-stream. The overall result is that by 2050, State Pensions (BSP and S2P) are projected to total around 20% of average earnings, compared with close to double this figure anticipated at the outset of SERPS two decades ago.

Accrual — what's that?

A cardinal principle of company schemes, endorsed and enforced by Government, is that benefits accrue uniformly throughout membership; at a time of change accrued benefits are sacrosanct. Over the last two decades of State benefit erosion, this principle has been routinely ignored. The situation is immensely complicated but as a rough estimate those who retired two decades ago have already lost a third of their benefits, with more to come; for those retiring now the picture is only marginally better and sometimes worse. These losses *exclude* reductions applied in line with the accrual principle. This, rather than reductions per se, is the genuine scandal.

* 60% higher for married couples

With such a history realists have been forced to conclude that it is fruitless to speculate about Pillars 1 and 2 a generation ahead. Indeed last November, the UK Chancellor suddenly added 5% to all the baseline numbers. Next year, a substantial pensioners' Minimum Income Guarantee (MIG) will be in place — *at a level higher than the BSP*, and set to rise further.

Such an environment has a deleterious spillover effect on Pillar 3. It is becoming increasingly clear that many of the less well-off would be *ill-advised* to save for retirement. Moreover, the Government's "Stakeholder" initiative (a regulated pension product for the private sector) is far more suitable for the better-off than the worse-off for whom it is intended. A large Pillar 2, in the shape of more compulsion, cannot be far away.

PAY-AS-YOU-GO OR FUNDING?

"Payment of pensions to the elderly involves a transfer of resources from those parts of the economy where wealth is being created. This is so whether it is done through [direct] transfer payments ...... or through a funded system involving the private sector". [4]

Equity release schemes and Robinson Crusoe

The above quotation represents an article of faith for many leaders of the pensions industry and the actuarial profession, yet it is demonstrably false. A simple illumination for what is perhaps the greatest retirement provision controversy of the UK lies in "equity release schemes", also a hot topic. The basic principle is that the value of a home is available to be capitalised or drawn down over the period of retirement, subject only to accommodation costs in the meantime. There are numerous methods of release, including outright sale and leaseback, "trading down" to a cheaper home, and borrowing to buy an annuity. As a rough indication, a typical retiree could add over 25% to retirement income from this means alone. Not bad; and all that is required is an asset with clear title of ownership.

Let us now allow ourselves to be spirited away in both time and place to a remote island fishing community. In his heyday, Robinson Crusoe* had the bright idea that a boat would be far better for catching fish than his rather small fishing net. Steeling himself, he cut in half the time he spent fishing (and eating!) for a year and used the time saved to build a magnificent boat. Thereafter, he could catch three times as much in half the time, and lived a life of plenty,
maintaining his boat in beautiful condition, until he felt secure enough to seek more rest and leisure. Then he hired out his boat to a strapping youth (who multiplied his previous 'net-catch' by a factor of six), on terms that left plenty for *both* to be far more comfortable than anyone else on the island; and which included a gradual transfer of ownership of the boat. This too is an "equity release scheme". Again, not bad. And again, all that is required is an asset with clear title of ownership by the retiree.

In a modern economy, houses and boats are indeed examples of assets with clear title of ownership. So are shares in companies that build houses and boats. So is an interest in a scheme or fund owning such shares — or any other shares. Yet a suggestion made in all seriousness on more than one occasion in recent actuarial literature is that secure title for the necessities of life in retirement is available only if the *actual consumer goods themselves* are acquired whilst working and hoarded away! This is indeed economic illiteracy; houses, daily necessities, shares in productive assets, and cash are all interchangeable, subject only to clear title of ownership.

In short the establishment view (depicted in Figure1) is unsustainable; such transfers take place only under pay-as-you-go. By virtue of the part ownership of productive assets, the pensioner in a funded scheme is *participating directly* in "those parts of the economy where wealth is being created", and no direct relevance attaches to the pensioner/worker ratio.

* With apologies to Daniel Defoe

THE RETURN OF MEANS TESTING

According to the Department of Social Security[5], "the UK is unique amongst comparable countries in having a single comprehensive Social Security scheme for the entire population". It is also Byzantine in its complexity, containing perhaps fifty separate means-tested benefits in a jungle incomprehensible to all but a handful of expert officials, with a surprisingly large chunk relating to the elderly. Today, a typical State pensioner has several other benefits both as-of-right and means-tested, which add perhaps as much as 25% to the Basic State Pension — itself still surprisingly patchy two and more generations after Beveridge [6]

Under the Government's proposals described earlier means-testing is set to increase with a vengeance. There are several problems of incentives with means-testing, especially under the proposed high-level Minimum Income Guarantee for pensioners. High marginal tax rates — often 100%— apply to private income as the MIG top-up falls away. Accordingly the private income — and the effort expended to attain it — is of little or no value. A high pensioner MIG, correctly anticipated, often means that saving for retirement is reduced or even eliminated.

These arguments are correct, but proponents of universality tend to forget its own enormous disadvantages. The big problem with universality is that Peter is robbed to pay an equally well heeled Paul (see the concluding section). Such a transfer is indeed robbery, comparable in net loss of utility to robbery in the private sector[7].

Disincentives

The effect of universal State pensions is easily seen by the *reductio ad absurdum* argument. Poverty has a multitude of causes, not all predictable. But no fundamental principle makes poverty a function of age; this can be dealt with by arranging a suitable pattern of saving and consumption over a lifetime. So why not extend the BSP of £67.50 per week to every man, woman, and child? The answer is that the cost equates to an income tax rate of 85% on its own. The current BSP alone equates to an income tax rate of over 12%— clearly a severe disincentive.

In fact this 'absurdum' argument is anything but absurd. All tax is levied on exchanges of one form or another (including the employer/employee relationship). The greater the tax the lower are the benefits of the exchange and thus the lower is the likelihood of it taking place. Instead it will be reduced or eliminated altogether (or conducted by barter or in the black economy) with lower living standards the inevitable consequence.

The idea that under higher taxes people will "work harder" to compensate is not only unappealing; it is wrong as conventionally understood. What happens is that highly taxed exchanges give way to untaxed DIY (Do It Yourself) which (net of tax) is more efficient than the naturally superior division of labour involved in exchange and trade.

In other words tax per se is bad, not neutral. Every tax increment is a reduction in the division of labour. It is for this reason that some economists argue that the disincentive effects on work and saving are best measured by *total* taxes or *total* Government expenditure, which is over 40% of GDP and rising (there is evidence that saving is hit especially hard)[8].

Whatever happened to consumer surplus?

Economically, at least some of this loss is easily shown, as in Figure 2 which sets out a simplified version of the usual supply and demand curves. Prior to the entry of the tax man, the whole coloured area represents consumer and producer surplus — the amounts they would respectively buy and sell at prices less favourable to them than the actual market price they achieve. The tax wedge creates two prices — the gross price to the buyer and the net price to the seller. Naturally the surpluses reduce but the important point is that the reduction is *more than* the tax take — the red triangle literally vanishes and cannot be recreated. This is the "deadweight" or "excess burden" effect of tax[9].

IN THE FACE OF THE EVIDENCE

"I don't suppose anyone checked it out, but we may as well accept it as a fact"
Harold Wilson, UK Prime Minister 1964 - 70 (attrib.)

Despite the arguments of the two preceding sections, most UK commentators appear to support the principle of a substantial Basic State Pension for all, financed on pay-as-you-go lines. This "mainstream" position accepts the thesis that funding still relies on future "transfers" from workers, believes that the universal system provides "solidarity" and helps the poor, and sees means-testing as a dubious activity.

Ideological battles
Yet there is little or no theory or evidence supporting these claims. As far as I am aware, there is no evidence that the "solidarity" or contract between generations argument has ever been borne out in practice. Generational *conflict* is much more likely[10] and testament to it are the startlingly frequent changes made to all such "contracts" around the world.

The economist Phil Mullan[11] manages to write a whole book, The Imaginary Time Bomb (favourably reviewed in The Actuary, the UK profession's magazine), replete with references yet without any analysis of the simplest and surest means of avoiding the Time Bomb (private funding). He accuses funding proponents of the crime of having "an ideological commitment to greater individual responsibility". Yet the whole transfer from workers argument is redolent of Marx.

To the influential author Will Hutton[12] the only merit of private funding is that it has "safeguarded the national finances" while State pay-as-you-go offers (real chutzpah, this) "predictability".

Never mind the poor
It is inevitable that PAYG is redistributive since (despite Beveridge) there is not *and cannot be* a "contributory principle" under any kind of demographic change. But both theory and practice suggest that redistribution will be haphazard or capricious and, if anything, from the poor to the rich, where the poor contribute for more years and survive for fewer[13]. In the UK, the Fabian Society argues that the whole tax system is regressive[14]. Thomson[15] sees a Welfare State as a Tragedy of the Commons and suggests that in New Zealand (a Welfare State similar to the UK) those born in the 1920s and 1930s have gained some 18 years of pay from their children's generation.

To be helped, the poor must first be found. That means-testing carries disincentives is self-evident, but tapering reduces the worst effects and in any case the income tax necessary for universality itself requires a massive means-test.

Market Reforms —distinctly sluggish
If, as Mullan suggests, dogma is getting in the way, then it seems to be coming from those advocating a major role for the State. The intellectual lead towards market-based reforms has a handful of UK adherents in the vanguard but much is from the USA and other primarily overseas institutions[16]. The rebirth of study concerning the merits of private property and the

economic approach to law[17] has also largely by-passed the UK, even though Bethell in particular provides ample evidence that the UK's Industrial Revolution and its subsequent wealth was due in no small measure to its system of common law, property rights, and freedom of contract.

CONCLUSIONS

"In fact, until the Second World War, the idea of mass retirement at a (fixed) age was almost historically unknown".
Dr S Harper, Director of Centre on Ageing, University of Oxford

This paper does not argue that an ageing population is problem-free; it does argue that private assets of secure title are the best route to financial independence in retirement. The main problem is State pay-as-you-go, a euphemism for pray-as-you-pay.

More commitments
In the UK Pillar 1 and the pay-as-you-go element of Pillar 2 are "modest" but this in itself is not enough. What counts is *total* government expenditure, for which there is never a shortage of claims. For example, the UK may have to share the far higher unfunded burdens of many other European countries. At home, it now has a third world health service[18], a crisis in education, and creaking infrastructures — all of which affect the vulnerability of pay-as-you-go. Economic growth is not a cure-all, or even directly relevant. Hence the professional activity and the search for solutions, all of which involve reductions in Pillar 1, albeit sometimes dressed up as something else such as the deferral of State retirement age. Any other official solution involves directly influencing demographic change (fraught with difficulty!)

Private assets are not an absolute guarantee. Investment returns may fall then rise, inversely with savings. Returns can be volatile, and savings can be reduced or lost. Some form of continued Defined Benefit arrangements (not necessarily 'final salary' based) would help reduce risks. And in the extreme, a preponderance of very elderly people, largely incapable and requiring care using enormous resources, would inevitably reduce *overall* living standards (in isolation of compensating factors such as more capital) though not necessarily the *relative* standards of pensioners.

However, markets specialise in anticipating and managing changes of this nature. A fixed retirement age is rapidly becoming passé except in State schemes. Global trade and migration permit co-operation between young and old around the world. Under hardship economic forces naturally lengthen periods of economic activity — as well as encourage a revival in birth rates. Enhanced savings provide more productive capital, designed for different tasks. And so on.

Phase out the State
The way to solve a universal pay-as-you-go problem is to phase it out, *in line with the accrual principle*. No age group, least of all the elderly, should be forced *en masse* to depend upon the undependable. Nothing in the income distribution of pensioners supports the continuation of the unique and wasteful universal feature; indeed they are bunched towards the middle, with relatively few in the poorest or richest groups [19]. And this conclusion is reinforced by the still rising income from company schemes and the potential from untapped home equity.

Phasing out solves not one problem but four; it solves the pay-as-you-go ageing problem, it reduces public expenditure, it increase economic growth, and it retires Government from the retirement business — a goods and services business which can easily and productively be privatised. Whilst supporters of this view would not have started from here, phasing out should not be all that difficult; the current Government proposals unwittingly provide a (rather badly shaped) platform, with the transition spread over two generations.

Unfortunately it will not happen. With time horizons like this, one does not need Public Choice Theory [20] to predict more fudge, vacillation, reversals and betrayal.

APPENDIX: some useful numbers

	2001/2	(2050/1)
Population m	58	(59)
Support ratio*	1.8	(1.3)
GDP £ billion	900	
per head £'000	15.5	
Pension assets % GDP	135**	
State Pension expenditure % GDP	5.4	(4.2)***
Social Security expenditure % GDP	11.7	
Total public expenditure % GDP	42	
per head £	6000	
Income tax % GDP	11	
per head £	1700	

* State Pension: contributors per pensioner
** 105% for company schemes only
*** Pension increases price related; 7.8% if earnings related

Sources: Government Actuary's Department, H M Treasury, DSS, UK Actuaries' Task Force

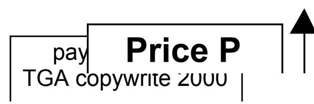

Fig 1

Fig.2

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[2][2] Department of Trade and Industry, Ageing Population Panel (2000), "The Age Shift".

[3][3] Department of Social Security (DSS) (1998), "A new contract for welfare: Partnership in Pensions" Cm 4179, *The Stationery Office, London*.

[4][4] Cited in Daykin, CD and Lewis, D (1998), "A crisis of longer life: reforming Pension Systems", *British Actuarial Journal* Vol 5 Pt II.

[5][5] DSS (1999), *Memorandum CP24*

[6][6] The Government Actuary's Department (GAD) has estimated that new retirees receive an average of less than 85% of the Basic State Pension.

[7][7] *See, for example* Friedman, D (1996), "Hidden Order", *Harper Collins, New York*.

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[12][10] Kessler, D (1996), "Preventing Conflicts between the Generations", *20th Annual Lecture of the Geneva Association, Geneva.*

[13][11] Mullan, P (2000), "The Imaginary Time Bomb", *I B Tauris, London*.

[14][12] Hutton, W and Charlotte Thorne (2001), "An inequitable pensions policy", *The Financial Times 10th January 2000 (*Will Hutton, eponymous author of "The State We're In", is CEO of The Industrial Society and until recently Editor of The Observer.)

[15][13] *See* Benjamin B, and Pollard, JH (1980), "The Analysis of Mortality and Other Actuarial Statistics", *Heinemann, London*

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[19][16] *For example*, the World Bank and the Geneva Association.

[20][17] *See* Bethell, T (1998), "The Noblest Triumph, Property & Prosperity Throughout the Ages", *St Martin's Press, New York*.

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[25]
[26] *and* Disney, R and Whitehouse, E (2001), "Cross country comparisons of Pensioners' incomes", *DSS In-house report series (forthcoming).*
[27][20] *See* Tullock, G, Seldon, A and Brady, G (2000), "Government: Whose Obedient Servant? A primer in Public Choice", *Institute of Economic Affairs, London.*