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Time to Discard Past Assumptions: Implications of the Economic Crisis for the UK Pension Reform Policy

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Introduction

The UK government's pension reform policy has three key features:

- Long –run improvements to the basic state pensions, returning to uprating in line with wages or prices and easing the contribution rules to benefit people whose labour market participation has been limited.
- Increases in the age at which entitlement to the basic pension will commence.
- The development of a new system of personal pension accounts.

The first of these is welcome, but too little too late and offering grounds for concern about the actual implications of the second. This paper is not about these though some comments within it may be regarded as implicitly relevant to them. It is about the third item. It will be argued that this, which is being pushed through without apparent regard to the changed economic situation, is grounded upon two flawed assumptions: that demographic change in itself is a fundamental source of problems for pension arrangements, and that one necessary policy response to that challenge must be the development of funded pensions invested in the private market. I challenged these assumptions in my book *Pensions* (2007). This paper takes that challenge further in the light of the economic crisis.

The Assumption about the Impact of Demographic Change

I do not question the evidence that the population is ageing, nor do I think that this process will be likely to be reversed either by a significant rise in the birth rate or by large scale immigration. What I do question is the terms in which this development is discussed. The expression 'time-bomb' is regularly used in this context. A very recent example is a Guardian article called 'Dependency time-bomb' published this February. Here it was argued:

These developments capture the economic essence of ageing populations, namely the sharp rise in economic dependency of older citizens on those of working age. For the UK it means that while there are now four people of working age supporting each pensioner, by 2035 it will be just two and a half and by 2050 only two. The financial and economic crisis is accentuating the urgency of addressing these demographic trends, not least because several hundred million baby boomers ... played a critical part in the economic boom of the last 20 years – and

are now spearheading the march towards an ageing society (George Magnus, in the Guardian, 4 February 2009).

This article, with its direct equation of age with economic dependency, is typical of many often written to make the case for the pensions industry, it was written by a man described as ‘senior economic adviser’ of the discredited Swiss bank UBS. However, it finds echoes in many government statements about the need for pension reform (see for example paragraphs 14 to 19 of the Pensions White Paper, DWP, 2006a).

There are several ways in which these assumptions may be challenged. The most fundamental point must be about the materialist emphasis upon *economic* dependency. However, even in these terms, the standard way in which this proposition is expressed sees dependency only in terms of labour market participation. It devalues contributions to society not measured in terms of wages earned. It also gives no attention to the evidence that across the conventional divide between adults under and over pension age there is now in most European countries a significant aggregate net transfer of both cash and services *from* the old to the young (Albertini, Kohli and Vogel, 2007; Saraceno ed., 2008). That is only reversed when the relationship between the very old and the rest of the population is examined.

However the ‘dependency time-bomb’ argument can be challenged in its own terms. I have set out this challenge in some detail elsewhere (Hill, 2006, 2007). In this paper I do not propose to set out more than the rudiments of that argument, but need to mention it as forming a context for my central theme. The argument has two elements.

First, there remains a significant proportion of the adult population below pension age who are not in employment. It may therefore be argued that the ratios set out in the quotation from Magnus above do not, and will not, bear any relation to the real ratios between those in or out of employment, and that shortfalls allegedly arising from ageing can be corrected by increased labour market participation by others. Attention can be drawn to several distinct groups here:

- People who are *de facto* ‘retired’ early
- People with disabilities and health problems
- People with caring responsibilities
- Young people not yet in the labour market, but in education or training.

I recognise that in each of these cases it may be contentious to argue that they should be active participants in the labour force. It is not my point here to argue that. Rather my case is that crude demographically derived dependency statistics, aimed at stressing the dependency of the old, gloss over the issues about labour market participation by all. Moreover the very fact that there may be good reasons why some people in these groups are not in the labour force gives added strength to my second argument.

This second argument is that labour force participation is above all influenced by levels of **demand** for labour. There has been a curious tendency, embedded in the labour market policy of the Blair and Brown governments, to suggest that it is the **supply** of labour that is the fundamental determinant of the level of employment. Efforts have therefore been made to increase individual capacity and commitment to participate in the labour force.

This has been most evident in the government's approach to labour market participation by mothers, but has also been manifested in efforts to increase labour force participation by older workers (including those with disabilities and health problems) and thus to raise *de facto* retirement ages. At the same time new EU inspired anti-discrimination measures aim to make employment participation beyond arbitrary retirement ages more possible. This issue is explored by John Macnicol in relation to the topic of the workforce participation of older men. He notes how efforts have been made to stimulate this but doubts whether it can be sustained, arguing (just before the emergence of the current recession):

We may find ourselves back in the pessimism of the early 1990s, when it seemed that the trend to male 'early' retirement was irreversible, and would inexorably continue (Laczko and Phillipson, 1991). Much depends on how far the rising employment rates have been caused by New Labour's sound economic management, or by economic forces over which individual governments have relatively little control. What we do know is that older men's employment rates are very sensitive to overall economic conditions (2008, p. 591-2).

Surely it is the case that all the effort to tackle the level of employment by measures impacting upon the supply of labour is now being undermined by the developing recession. While the fall in the employment rate has been a little less than the rise in the unemployment rate, it had by May this year, according to National Statistics (2009), fallen 0.4% over the previous quarter and 1.1% over the previous year. Already there are anxieties (as in the last part of the last century) being expressed about the difficulties faced by young people in getting into the labour force, and accordingly arguments are developing about driving older people out of it. Surely this is bringing us face to face with the reality that the fundamental determinant of labour force participation is labour demand. It is that, rather than demography, that determines the so-called 'dependency' ratio between those in and those out of employment.

Macnicol suggest that the total volume of work in the British economy has remained roughly constant since the 1950s (2006, p. 99). He also cites Middleton (2000) on this, but acknowledges that there are considerable methodological difficulties in achieving accurate calculations here given the complex mix between full and part-time work. If the supply of work is relatively constant then a changing age-ratio should be leading, subject to fluctuations caused by the economic cycle, to an increased need for younger workers. It may be argued that increased female labour market participation reflects such a trend. However, the whole picture is confused both by the increasingly late age of entry to the labour force by younger workers and by early retirement amongst older workers. It seems to me that analysis of trends of this kind could be difficult. There seem good reasons to see issues about the changing availability of different forms of employment for different categories of people as subject to economic and cultural phenomena that are difficult to analyse. Comparative analysis reinforces that view. If you look at variations across Europe in levels of employment it is certainly not possible to identify the association that might be expected if the demographic time-bomb hypothesis was correct: that higher levels of older people in the population would be accompanied by higher levels of employment amongst younger people. Table 1 suggests in fact rather the opposite, though

that implies a possibility that ageing countries have a tendency towards economic stagnation with a consequent impact on the availability of jobs for all. But that gets us into quite a different issue to the alleged dependency one.

Table 2

A comparison of the size of the older population in western and southern European countries with employment levels

Percentages of total population over 65				
Share of persons age 15-64 in employment	19%	17%	16%	15% and below
70 +		Sweden	Switzerland UK	Denmark Norway Netherlands
65-69	Germany	Portugal	Austria Finland	Ireland
60-64	Greece	France Belgium		
55-59	Italy			

Source: OECD, 2009

The funding assumption

The second assumption behind government policy is that a response to demographic change requires the funding of savings to reduce the burden on future workers. While this has at its heart a fallacy that has been effectively refuted by various economic analyses, this has not prevented the deployment of arguments for pension funding. The Pensions Commission provides the following authoritative statement on funding (I have elsewhere derived similar statements from OECD documents):

All pension schemes, PAYG or funded, entail a transfer of resources from future workers to future pensioners (2005, p. 164).

Barr puts the point more succinctly ‘individuals must exchange current production for a claim on future production’ hence ‘both funded and pay-as-you-go plans are claims on future output, and they are of no use to retirees if the country is not producing enough goods and services to meet those claims’ (Barr, 2002, p. 4). There ought not therefore to be a need to refute the crude argument still so regularly found in the media that nations can only face demographic change with equanimity if they have strong funded pension schemes.

However, the Pensions Commission advances four arguments for funding:

1. ‘People may be more willing to accept ...savings into an account which is legally theirs, and the value of which is defined in clear capital terms, than to accept taxation to support a PAYG system’.

2. The existence of funds imposes a measure of discipline on governments otherwise inclined to spend PAYG receipts now and leave others to worry about future obligations.
3. Individual funding increases private choice for savers.
4. 'Explicit funding, if invested in part overseas, can enable a society in aggregate to build up pension claims on other countries, providing some escape from the otherwise unavoidable challenge of a rising dependency ratio (Op. cit., p. 166).

Addressing these arguments not from the point of view of governments but from the point of view of those who are looking for protection in later life arguments 1 and 4 seem to have some cogency. However, a realistic evaluation of what they offer must involve attention to the relationship between the sacrifices required and the returns that will be achieved. To be fair both the Pensions Commission and the government addressed this issue in one important respect. They recognised that a significant disadvantage of many of the pension saving vehicles is the high administrative costs. This is a topic that has been made particularly salient by the evidence of the high rewards secured by those who claim to be able to look after our money. Obviously the efforts to ensure that administrative costs are minimised in the new personal account scheme should be welcomed, particularly as administrative costs tend to impact most severely upon more modest investments.

However, there are two more important inter-related issues that, in my view the government seems to have 'skated over', which are made more salient by the economic crisis:

- Whether in fact the market will generate returns for pension contributors that are superior to other forms of saving.
- The difficulties those who enter the personal account scheme may have in securing adequate pots of money for ultimate translation into pension annuities.

In trying to challenge these two assumptions I am taking on the orthodox 'taken for granted' view of the pension market with a contention that the future may not be like the past. To do that all I can draw upon is evidence from the recent past which seems to support that contention.

As far as the first of the arguments is concerned the standard line adopted by those who try to sell us funded pensions and other market based savings vehicles (ISAs for example) is that, whilst there may be a short run problem the long run evidence favours their product. The kind of evidence produced for this is some version of the FTSE graph reproduced as table 2.

Table 2



But what that suggests to me is that there was a golden age for the selling of products of this kind between 1984 and 1998, but that then came to an end. It is appropriate given Blair and Brown's espousal of 'asset based welfare' to use the election month (May 1997) as a starting point. At the end of that month the index stood at 4621. It is, of course, well below that now. However, to choose the very low point of the current time as the point of comparison could be said to be applying a particularly hard test. Let me instead look at a date very favourable to the pro-market investment case, the end of May 2008. The FTSE index then stood at 6304, representing approximately a 36% growth over those 11 years. But even that growth is less than a sum of money invested at 3% would have achieved over those 11 years, which would have been a growth of 38%. These are of course fairly simple comparisons. A real return on savings will not necessarily be simply what is implied by the movement of the FTSE index. On the one hand the index reflects share growth and disregards dividends. On the other hand the FTSE100 index uses the 100 best shares at each point in time, hence there is actually a substantial movement of items in and out of the index as companies rise and fall. However, FTSE 100 linking has been seen as a positive selling point for some recent investment schemes.

It may be noted that the government has also encouraged so called asset based welfare through the child trust funds. On these we may note a recent newspaper report that suggests that a £250 payment in April 2005 will now worth £232, whereas if it had been put in building society account it would be worth about £310 (Guardian Money, 2009).

However, I should not digress here. There is in fact an important difference between a one-off investment and an input into a pension fund. If we look at a real pensions

investment example are looking at returns on money going in at regular dates across a long period. Contributors' fund managers will be buying into the market not just at the low points in the cycle described in table 2 but also at the high points! I will return to this issue.

It may be argued that good pension fund management involves seeking to have a substantial body of investments that are not 'high risk' in the sense that standard stock-market investments are. Yet if the avoidance of exposure to market risks is to be a central aspect of personal accounts it may be questioned whether privatised investment management is required at all. That proposition is reinforced in noting that one way pension funds minimise risk is to have a substantial amount of their funds in government stocks. A recent OECD paper reports 'In December 2007, in 13 out of 22 countries for which information was available, over 50% of assets were invested in bonds, and around 60% of these investments were in government bonds' (OECD, 2008, p. 3). They go on to note that the impact of the economic crisis has been greatest in countries where these protective measures have been least evident, particularly Eire but also the UK, USA and Australia (Ibid., p. 4).

The OECD report from which that evidence is drawn also reiterates the standard line in favour of market investment that a long-run rather than a short run view should be taken. This leads them on to the proposition that whilst the recession may be particularly problematic for older workers 'a major drop in asset values may not matter much to younger workers who can expect the markets to recover overall in the long term' (ibid., p. 5). The head of the OECD division that produced that report makes the observation in his cover note that these younger workers 'may benefit... as future pension contributions will be invested at much lower prices'. But such a statement seems to disregard the fact, noted above, that individual contributions go into funds in small amounts over a long period. Across economic cycles a combination of investments at good times and ones at bad times will be inevitable.

Who will benefit from Personal Savings Account

The arguments in favour of asset based welfare have something of the flavour of the earlier arguments about the sale of council houses. That is that 'ordinary' people should be able to enjoy the gains that have been available to the better off (Paxton, 2003). The problem is the zero-sum nature of economic gains: that they are likely to be at the expense of somewhat else. Something is then likely to go wrong when the ranks of those who seek to benefit is expanded, since we cannot all be gainers. Growth in investments is a combination of compensation for the impact of inflation and a share in general economic growth *plus perhaps* what commentators on the Left were once uninhibited about describing as 'profits'. This third element is implicitly if not obvious and explicitly at the expense of someone else. If there is low inflation and low growth then returns to investments will be low unless there is a profit element that is added. That is a fact that the growing chorus of people who bemoan the current low returns on investments ('poor old pensioners on fixed incomes') conveniently disregard. If therefore the combination of

low growth and low inflation is likely to be with us for some time returns on 'mass' investments are bound to be low.

There are however positive aspects to the personal savings account proposal. Let me first set out the government's description of the scheme. In the White Paper they say this will:

- introduce a new pension saving scheme of low-cost, portable personal accounts, making private saving truly accessible for all;
 - introduce automatic enrolment into a private pension for all employees, to maximise coverage and combat savings inertia;
 - set a national minimum employer contribution of 3 per cent, between earnings of around £5,000 and £33,000 a year; and
 - set a minimum overall level of contribution of 8 per cent for the personal accounts of employees and encourage additional contributions from employees.
- (DWP, 2006a, p. 29).

They are now moving towards the operationalisation of this. The legislation is in the 2008 Pensions Act, but translation of that into action has not yet occurred. The government have not shifted from the commitment to this as a 'privatised' system, but as already noted they are seeking to keep administrative costs low. The most positive aspect of the scheme is that in return for employee contribution of 4% of earnings there is to be an employer's contribution of 3% and a government contribution of 1%. We should not get too excited about the latter, which is little more than the government already gives as basic tax relief to private pensions (and less than the benefit it gives to higher rate tax payers, though we may note that the recent budget proposes a marginal shift away from that). On the other hand from the employee's point of view the employer's contribution has to be a very positive point.

What then are the negative issues? One that seems to have been given very little attention is the extent to which, with an automatic enrolment system with the possibility of opting out by employees, employers will encourage opting out. A commentary by ACCA (the Association of Chartered and Certified Accountants) refrains from making a blunt comment like that but wraps it up in economic analysis saying that 'workers... could suffer adverse financial consequences in terms of wage and recruitment freezes as a consequence of the employer having to fund contributions...' (ACCA, 2009)

Aside from that, the important issue is then the extent to which even with a contribution from employers the net effect of the new proposal for many contributors will be to generate a modest private pension which simply replaces the means-tested pension credit. In other words, to put it bluntly again, low income workers will have to forego 4% of their wages during their working life in order to subsidise the government in their retirement. To quote ACCA again: 'If means-tested state benefits are to continue to be available to those in retirement, savings through personal accounts may not be a sensible financial option for the low paid, women who have taken career breaks and those at a late stage of their working lives' (Ibid.).

We then get into some complicated futurology. As far as the government's pension reforms are concerned there is no attempt to buy out the pension credit in any direct way. Better increases in the basic pension will be accompanied by comparable increases in the credit. The latter will continue to be much larger than the former. The only mitigating factor will be increases in the numbers securing reasonable amounts from the state second pension. Much then hinges on the levels achieved by personal savings accounts, and crucial to this may be the amount of growth they achieve. The general argument about savings growth set out above suggests this will be limited. It may be noted that in its paper on personal accounts DWP offers an example to illustrate in impact of management charges that assumes a nominal pension fund growth of 6.47%, described as a 3.5% growth in 'real' terms (DWP, 2006b, p. 93). That is a substantially larger growth than the share value growth between 1997 and 2008 quoted above. Beyond that are questions about the annuity market as the population ages, where ACCA notes potential problems ahead.

Then the other issue in respect of any predictions concerns the likelihood of long-run secure employment for those people who the new scheme aims to assist. The portability of pension accounts deals with problems about temporary breaks in employment but as the quote from ACCA above suggests there must be doubts about the viability of the scheme for those whose labour market participation is intermittent over a long period (or starts late and/or ends early). I am not going to engage in any futurology on this theme, I only remark that a period in which the labour market is in severe difficulties does not seem to be a good time to launch the new scheme.

Conclusions

I remain one of those who are disappointed that the government's pension reform proposals do not embody improvement of the basic pension, along citizens' pension lines. However that is not my theme here. Rather it is to question whether this is the right time to be pushing ahead with personal savings accounts, an approach to pension provision that adopts market principles and uses the private sector to facilitate limited self-funded arrangements for relatively low income people.

The arguments used here have focused upon two aspects of the conventional case for reform: the alleged 'dependency time bomb' and the desirability of funding to protect against its effects. The 'time bomb' proposition has some validity only if there is a likelihood of an excess of jobs over workers, and even then there are several solutions available should such a problem arise. The popular argument for funding rests upon an assumption that the saving of money is like the squirreling away of nuts in advance of bad weather. But saved money, unlike nuts, cannot be directly consumed. It has to be recovered from wherever it was stored/ invested to be used for consumption. Individuals may safeguard their future consumption in this way, generally speaking collectivities cannot. However, there is one other argument in favour of the investment of savings not so far explored: this is that it will strengthen the economy so that increased transfers from

those in work to those out of work can be more easily afforded. But this depends upon how saving is channelled into investment. At the present time – when there is a great deal of evidence that past savings have not led to productive investments – there is a need for a pause for thought about that. Attention needs to be paid to the mechanisms that translate individual savings into productive investments, mechanisms that we have been shown to be very much global in nature. At the very least we should surely be questioning at this time why it is the case that the government takes it for granted that the management of personal savings accounts should be in the hands of the private sector. At the very least savers might be given the option to put money into building societies or indeed into public sector investments.

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