

Pension Reform in Response to the Demographic Challenge

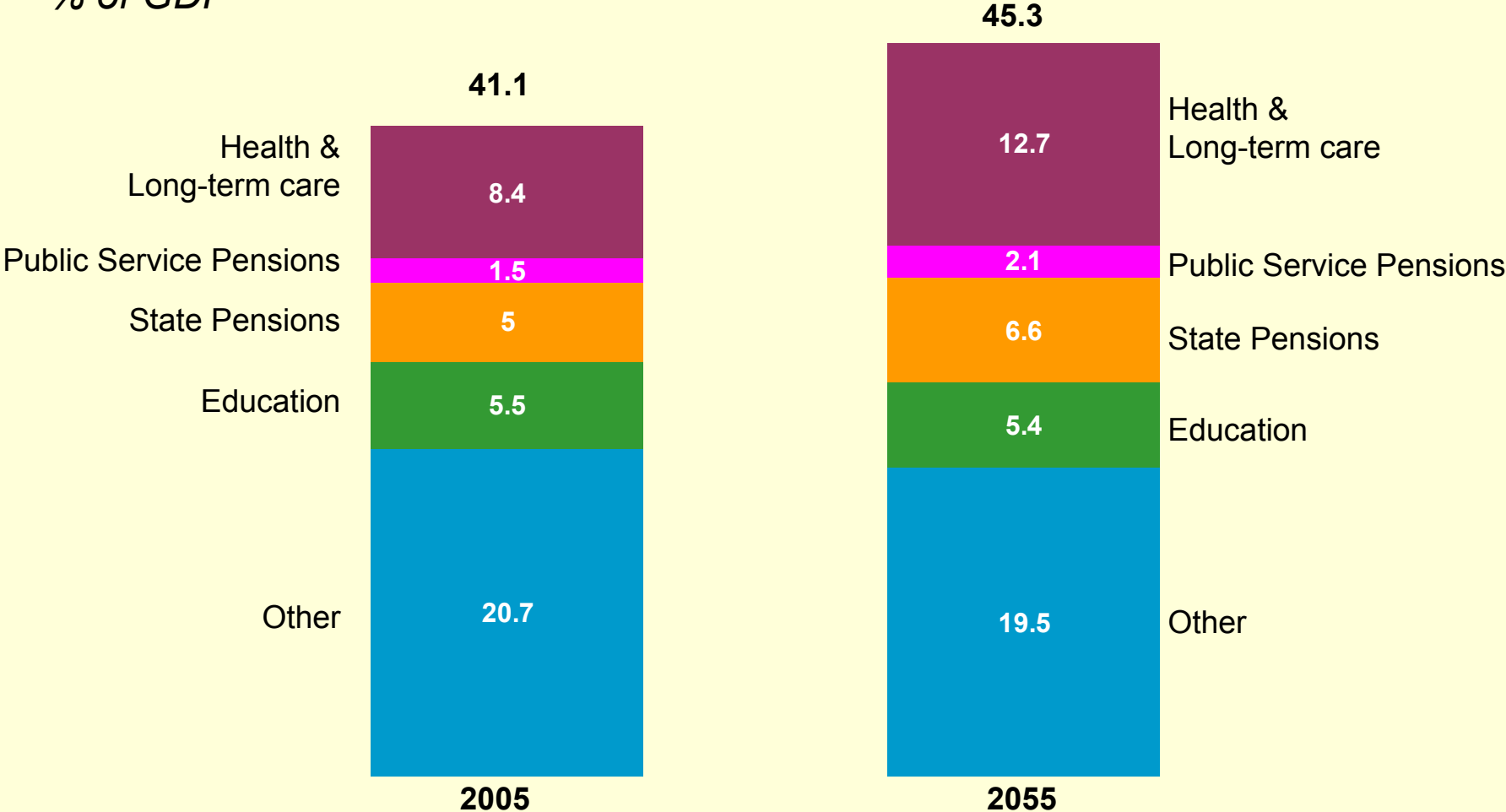
Deciding the appropriate role of Government

Adair Turner

The David Hume Institute
Edinburgh, 9th February 2006

UK Public Expenditure Projections: 2005 – 2055

% of GDP



Source: Long-term public finance report: HM Treasury, December 2005

“British tax levels must come down if we are to have a fighting change”
[Sunday Times editorial]

“It will be harder now than it was then [i.e. in the late nineteenth century] to moderate the social costs of free markets. The leverage of national governments over their economies is much weaker” *[John Gray, “False Dawn”]*

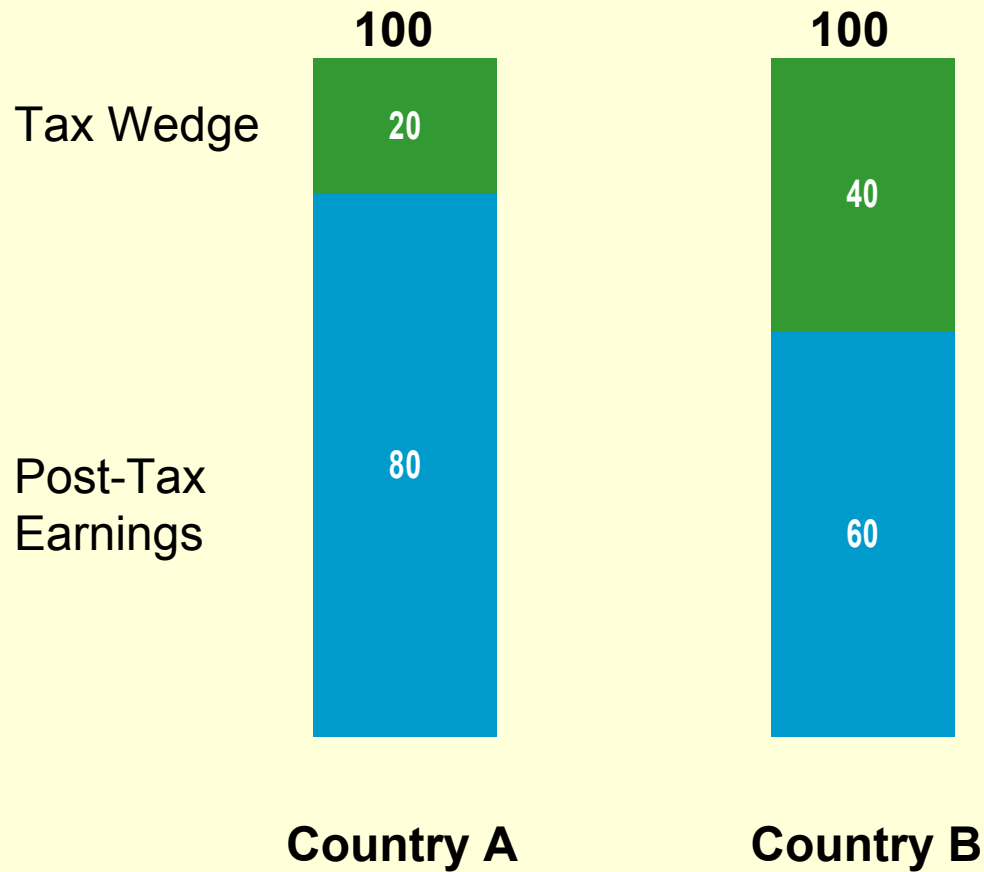
“If business taxes are not harmonised, competition for inward investment will mean competition to bring rates down to the extent that even a modernised welfare state could prove unsustainable” *[Donald McIntyre, Independent]*

Four Constraints:

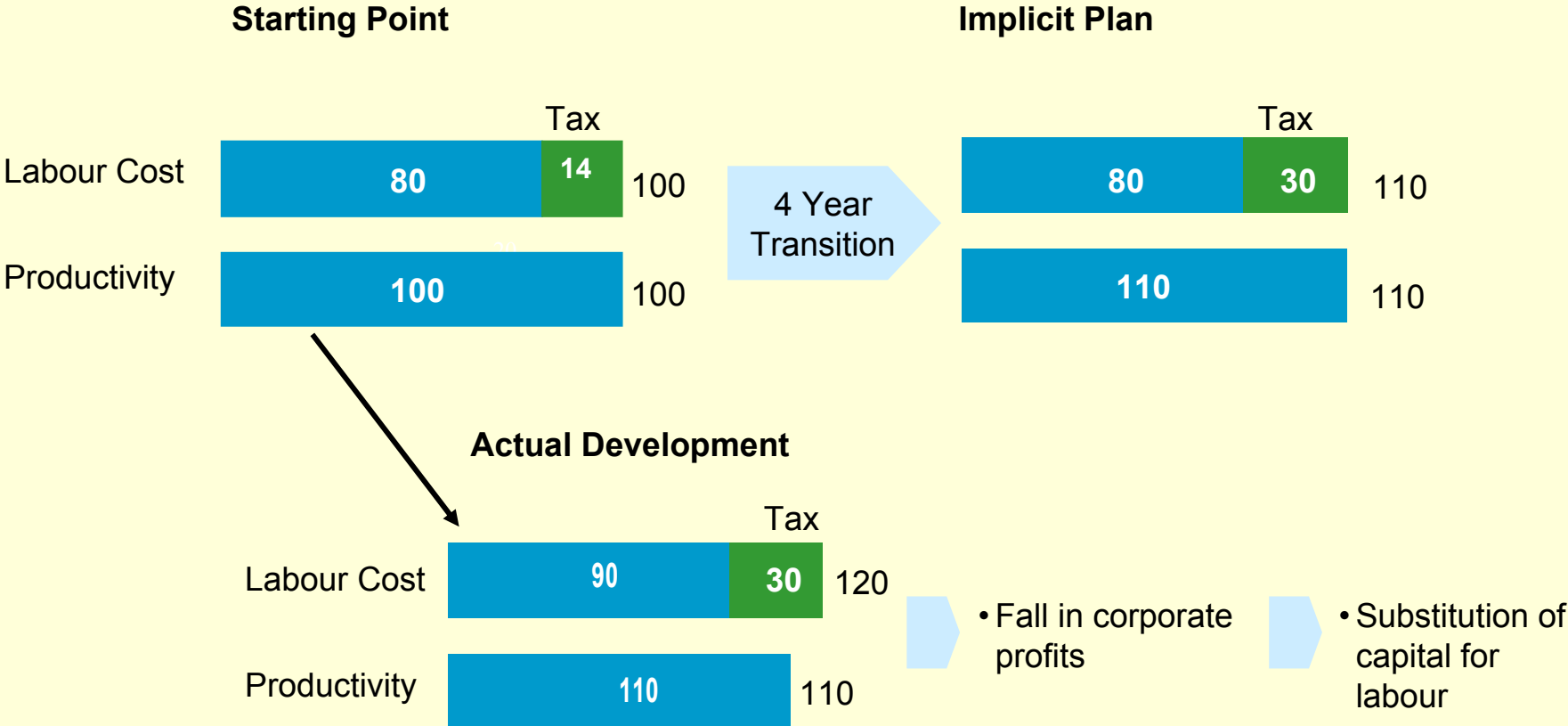
- ❖ Global capital markets
- ❖ Competitiveness
- ❖ Disincentives to work and save
- ❖ Migration of tax bases - globalisation and the internet

Tax and Competitiveness

Total cost of labour



Special Case 1: Real Wage Resistance



Special Case 1: Characteristics

- ❖ Not a competitiveness problem
 - could occur in a closed economy
- ❖ Not a problem in an efficient labour market
- ❖ Essential problem is lack of consent/agreement
 - made worse by lack of honesty?
- ❖ Problem of changing level not absolute level?

Four Constraints:

- ❖ Global capital markets
- ❖ Competitiveness
- ❖ Disincentives to work and save
- ❖ Migration of tax bases - globalisation and the internet

Assessment of Arguments

Global Capital Markets	X
Competitiveness	X
Real wage resistance	Sometimes
Disincentive to Work/Save	Important at High Marginal Rates
Migration + Avoidance	Up to a Point

Common Arguments

The Real Issues

Capital Markets X

Popular Support

Competitiveness X

Real Wage Resistance

Disincentives ?

Old-fashioned Avoidance

Migration,
Avoidance + Internet ?

Empowering Popular Will/
Honesty in Tax Debates



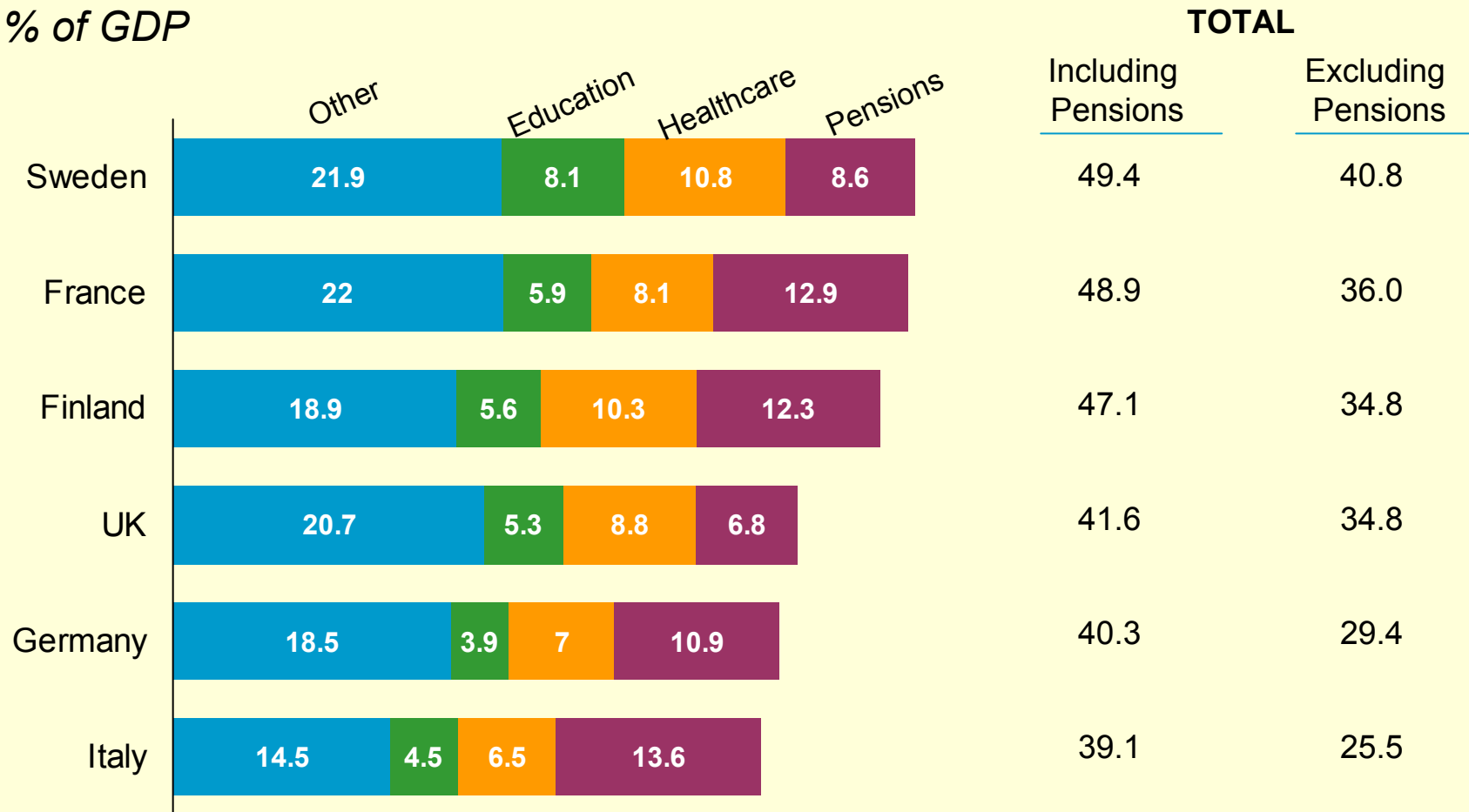
External
Economic Constraints



Internal
Political Choice

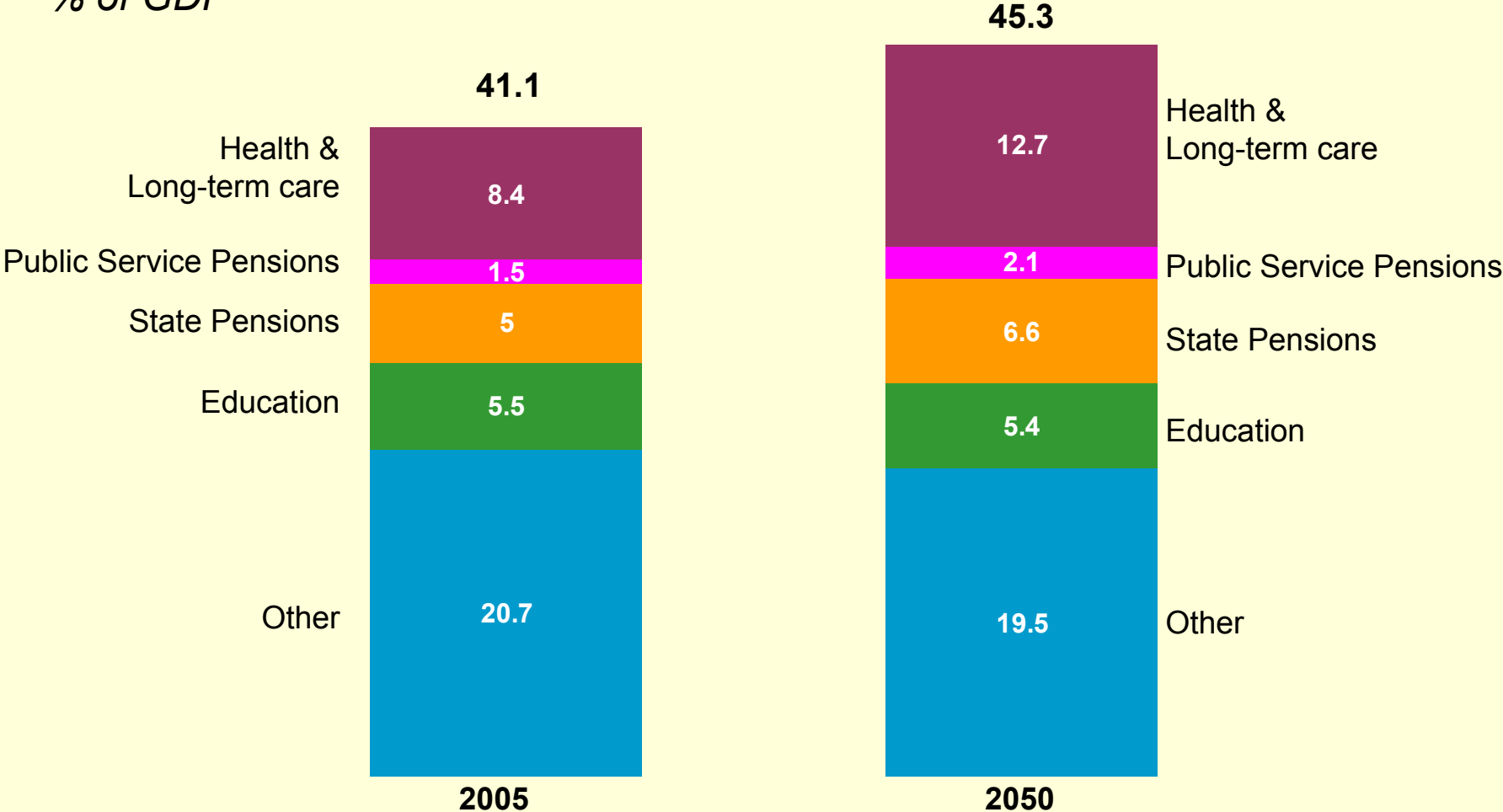
Public Expenditure in Selected Countries: 2009 Forecast

% of GDP



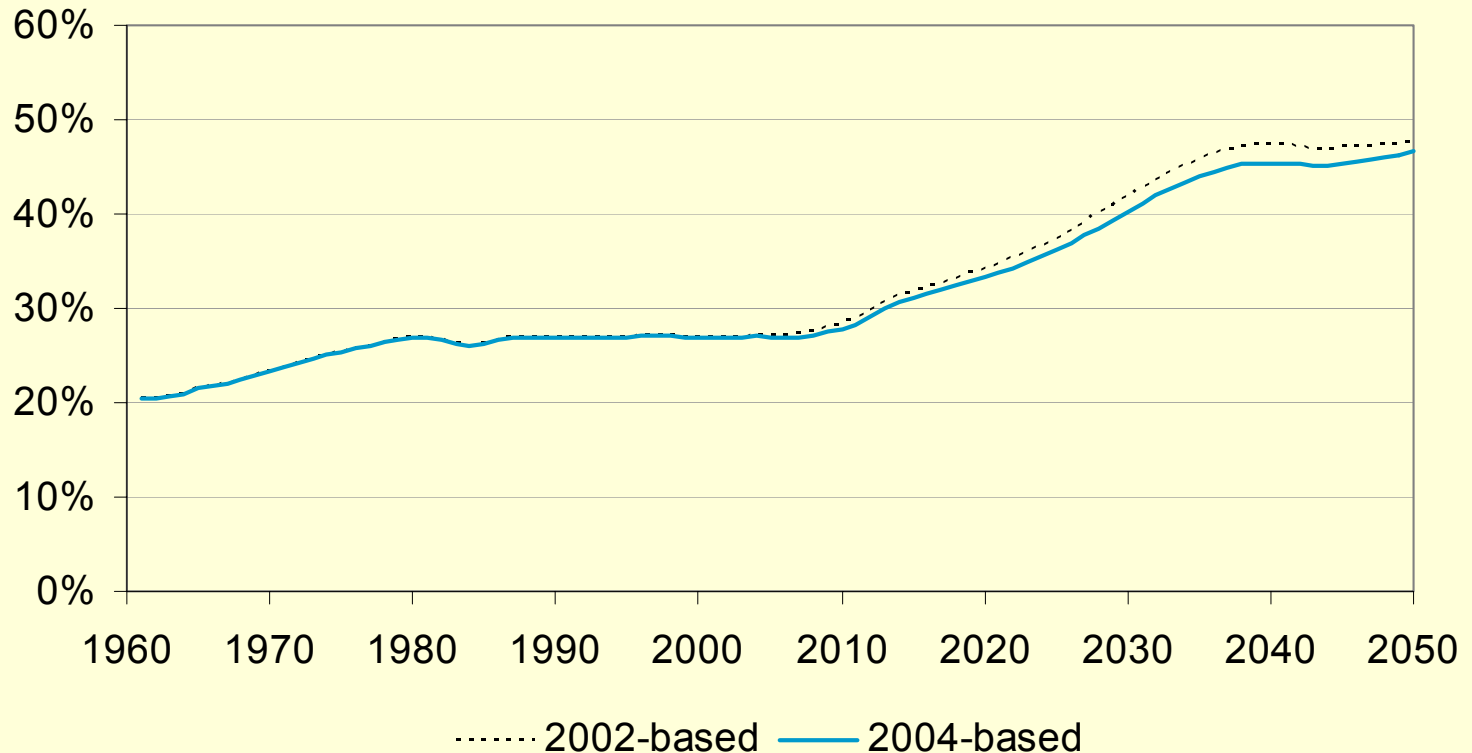
UK Public Expenditure Projections: 2005 – 2055

% of GDP



Source: Long-term public finance report: HM Treasury, December 2005

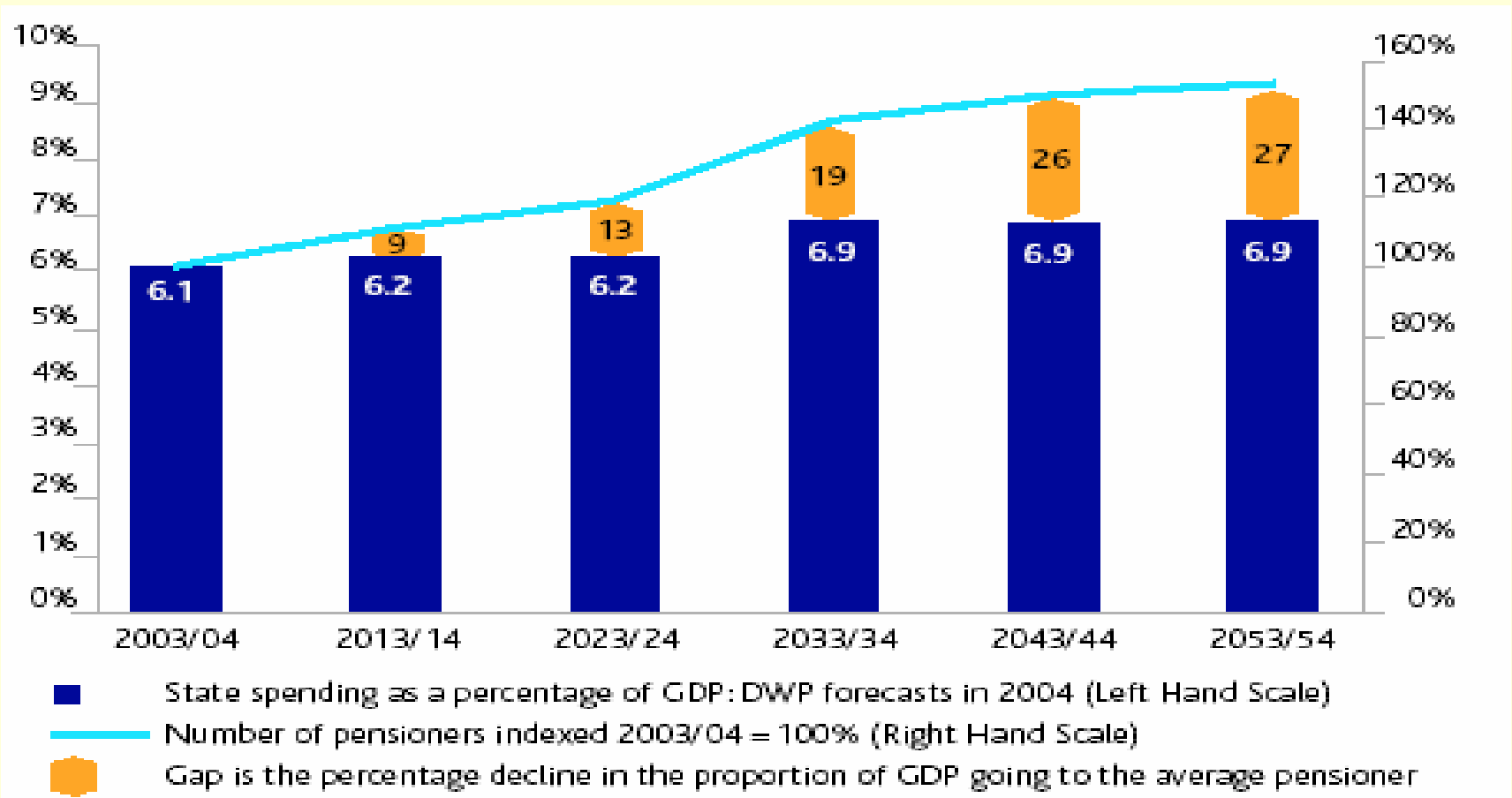
Old-age Dependency Ratio: All 65+ : UK 20 – 64



Source: GAD 2002 & 2004-based principal population projection, UK / ONS Population estimates unit, UK

Projected State Spending per Pensioner Indexed in Constant 2003/04 Price Terms

2004 Projections



Implicit Philosophy in Existing Plans

Health

Universal Public
Provision

Universally available with minimal means-testing.

Expenditure must rise with demography and high income elasticity of demand.

Redistributive since proportional/progressive taxes pay for flat rate benefits

Pensions

“Progressive
Universalism”

State pension benefits partially (and increasingly) means-tested.

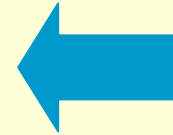
Expenditure can rise less than proportionally with demographic pressures.

Redistributive through both

- ❖ Proportional contributions
- ❖ Means-testing

Options in State Pension Provision

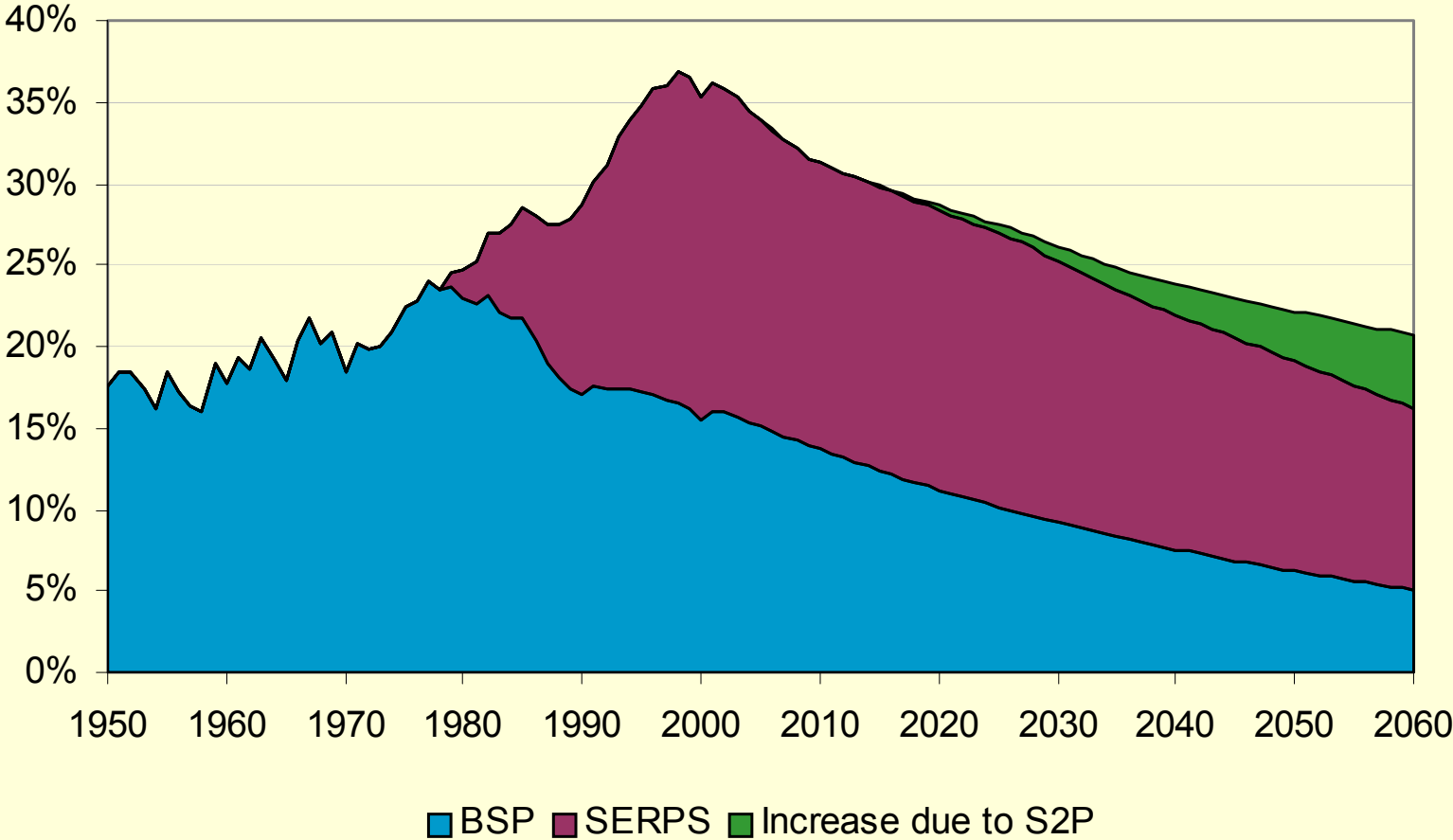
❖ **Flat rate only** Keeping people out of poverty in retirement



Means-tested or universal

❖ **Earnings Related** Pensions rising with earnings in return for contributions rising with earnings

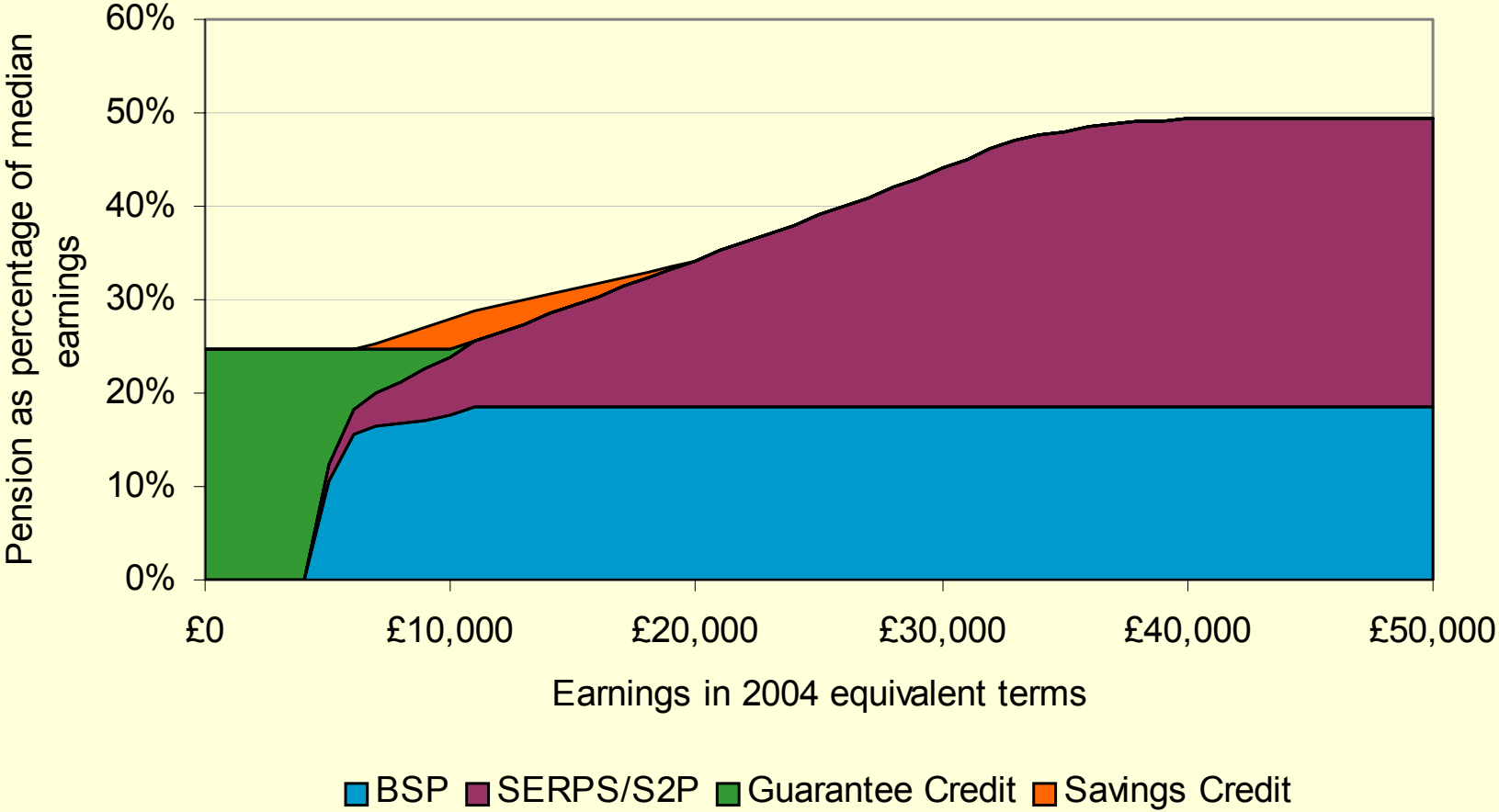
State Pension at Point of Retirement*



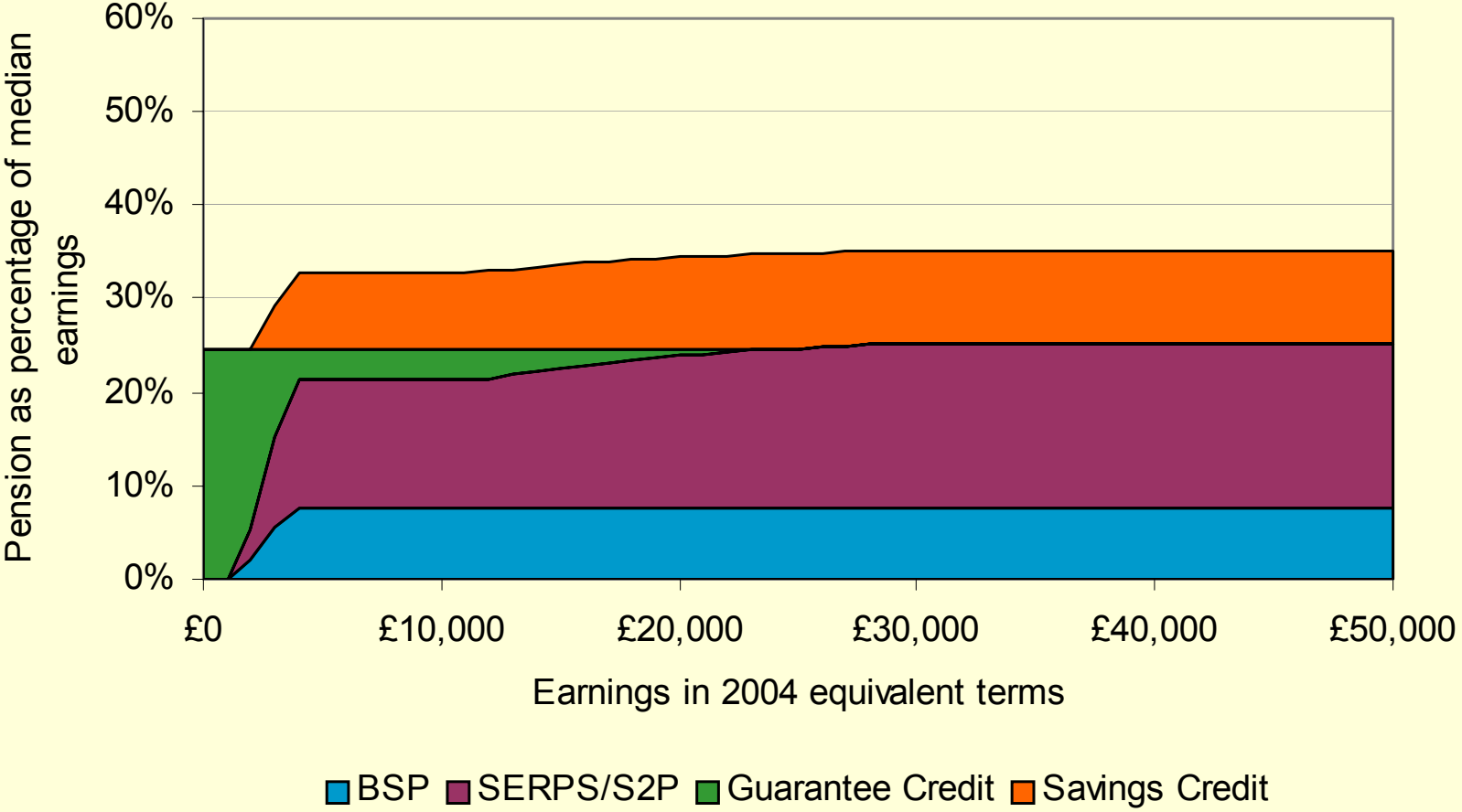
*Note: assuming a full contribution record for a person who has been on average full-time earnings throughout their working life: percentage of average earnings

Source: Pensions Commission analysis and IFS, 2005

State Pension Income at Retirement Assuming no Private Saving – 2005



State Pension Income at Retirement Assuming no Private Saving – 2050



The Case for Purely Flat Rate Provision

- ❖ State should concentrate limited tax/contribution resources on the role which only it can play
 - Redistributive poverty prevention
 - And on making this as un-means-tested as possible?
- ❖ Individuals can and should make their own private decisions on additional provision
 - Via personal savings or choice of employment
 - In light of diverse preferences on inter-temporal consumption allocation, age of retirement, risk/return trade-off
 - With benefits of competition in provision

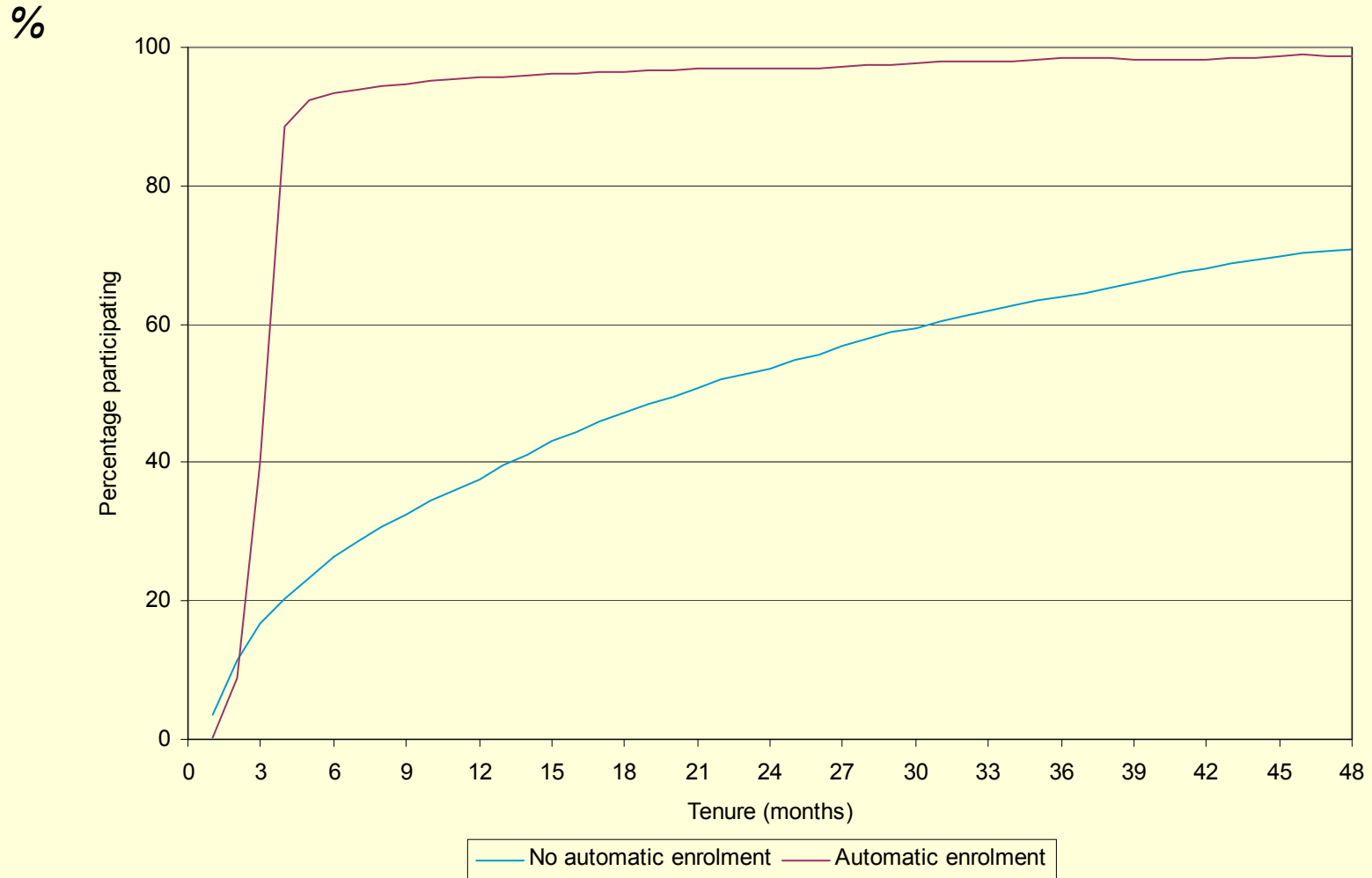
Reasons Why Not That Simple

- ❖ Irrational individual decision-making
 - Findings of behavioural economics

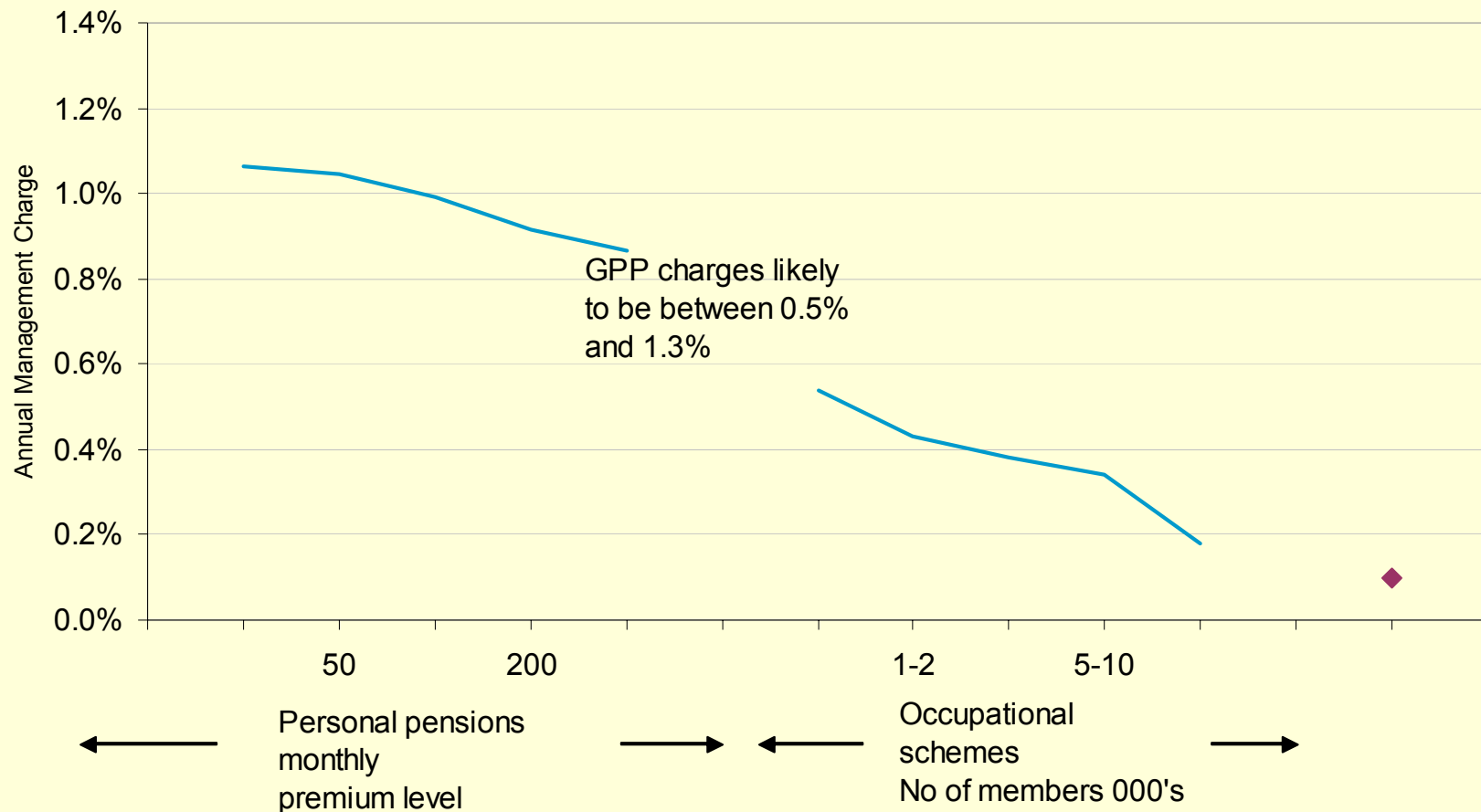
- ❖ Moral hazard
 - Individual
 - Political

- ❖ Cost efficiency

Employees Participating in a 401(k) Pension Scheme with and without Automatic Enrolment



Typical Annual Management Charge in alternative forms of pension provision



Advantages of Funded Approaches vs PAYG?

- ❖ Enables “pre-funding” of pension liability
 - Increasing national savings rate
 - Smoothing tax burden over time
- ❖ Shifts pre-retirement longevity risk to the individual
- ❖ Shifts falling fertility risk to individual
- ❖ Can be achieved within PAYG system via
 - Pay-down of government debt
 - National pension reserve fund (e.g. France, Ireland, Norway, Sweden)
- ❖ Can be achieved by moving PAYG system onto an NDC basis (e.g. Sweden)
- ❖ Can be achieved within NDC system by linking rate of return to GDP and/or by “Automatic Balance Mechanism” (e.g. Sweden)

Funded and PAYG Equivalence

- ❖ If the rate of return on government bonds is equal to rate of growth of economy

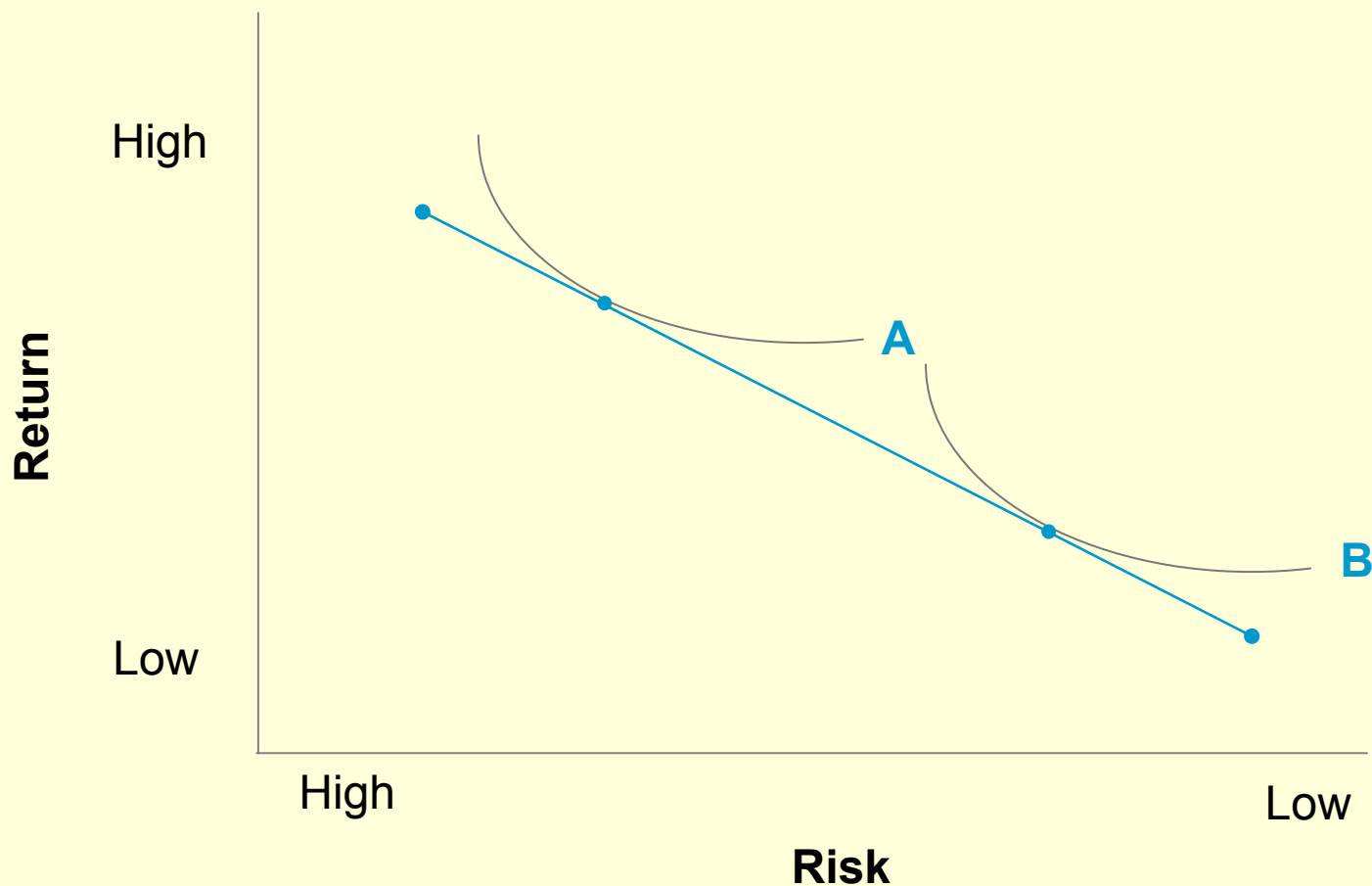
- ❖ Then

Compulsory funded
system invested in
government bonds

=

PAYG notional DC
system

Welfare Maximisation through Liberating Risk-Return Preferences



Likely Utility Preference Patterns?

Hypotheses

Declining marginal happiness from rising absolute income (within any given society even if not necessarily over time)

Strong aversion to declines in relative position once attained: strong desire to maintain in retirement relative position of working life

Illustration

In Britain today an income fall in retirement from £5,000 to £4,500 creates more unhappiness than £50,000 to £45,000.

“I want to be absolutely certain of a 50% replacement rate – above that I am willing to speculate”

Implications

Risk aversion declines as relative position in income distribution increases

Risk aversion declines as the replacement rate already secured increases

Advantages of Funded Approaches vs PAYG

1. Inherent: Enables different people to express different preferences for different combinations of risk and return – in particular higher risk / higher return preference than government bonds
2. Political: May be more political acceptable way to shift risk from state to individual.
May be more politically acceptable way to pre-fund (funded contributions more acceptable than taxes)
3. Work incentives: If 1 or 2 apply

Pensions Commission Proposals for UK

Given a political economy which will not support Scandinavian levels of taxation

And in which the introduction of SERPS squeezed out an adequate non-means-tested BSP

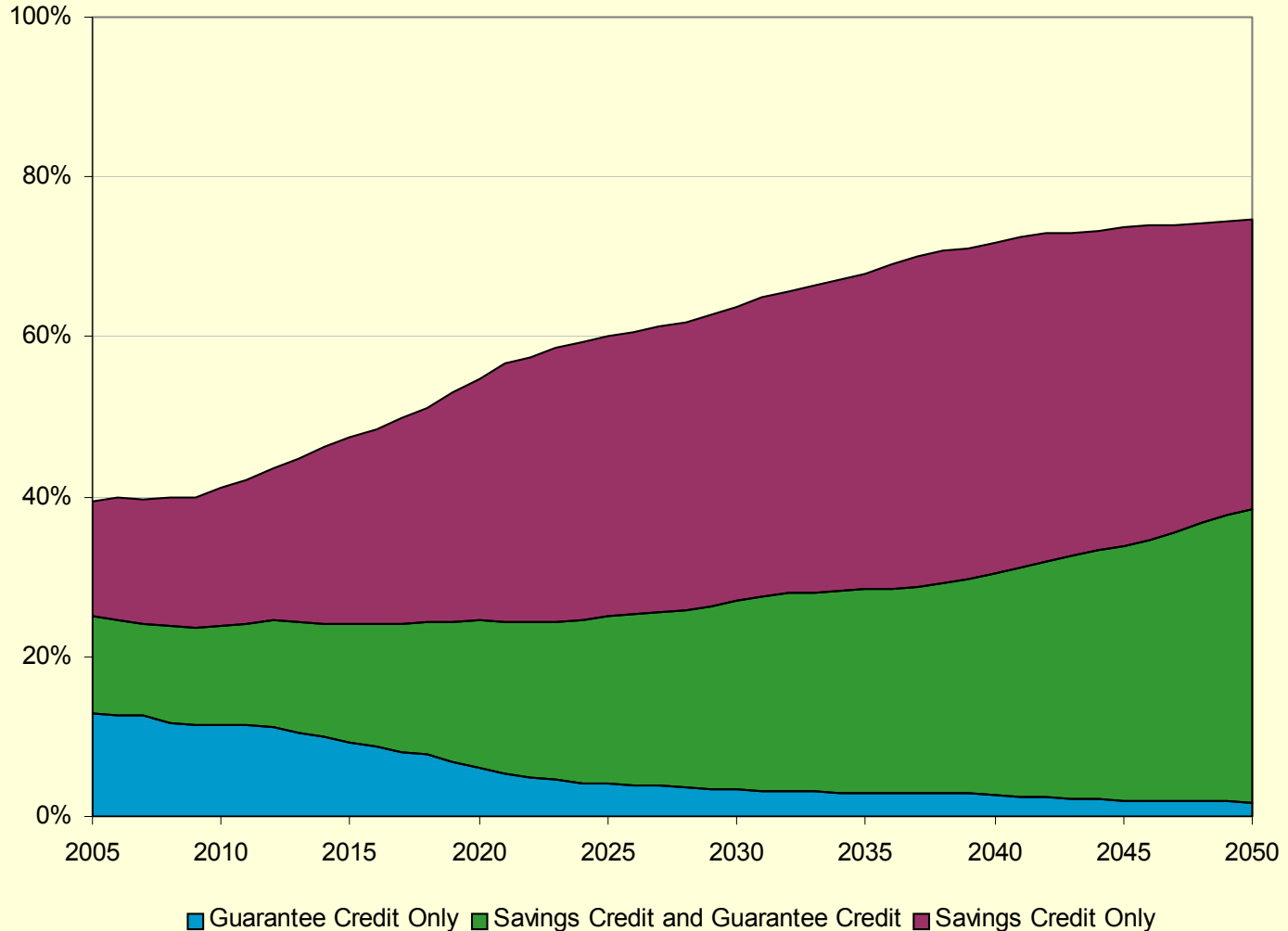


- Focus state PAYG expenditure on adequate and less means-tested flat rate pension provision

...accelerating the evolution of S2P to a flat rate pension
- Strongly encourage funded earnings-related pension saving via auto-enrolment
- Enable low cost saving for all

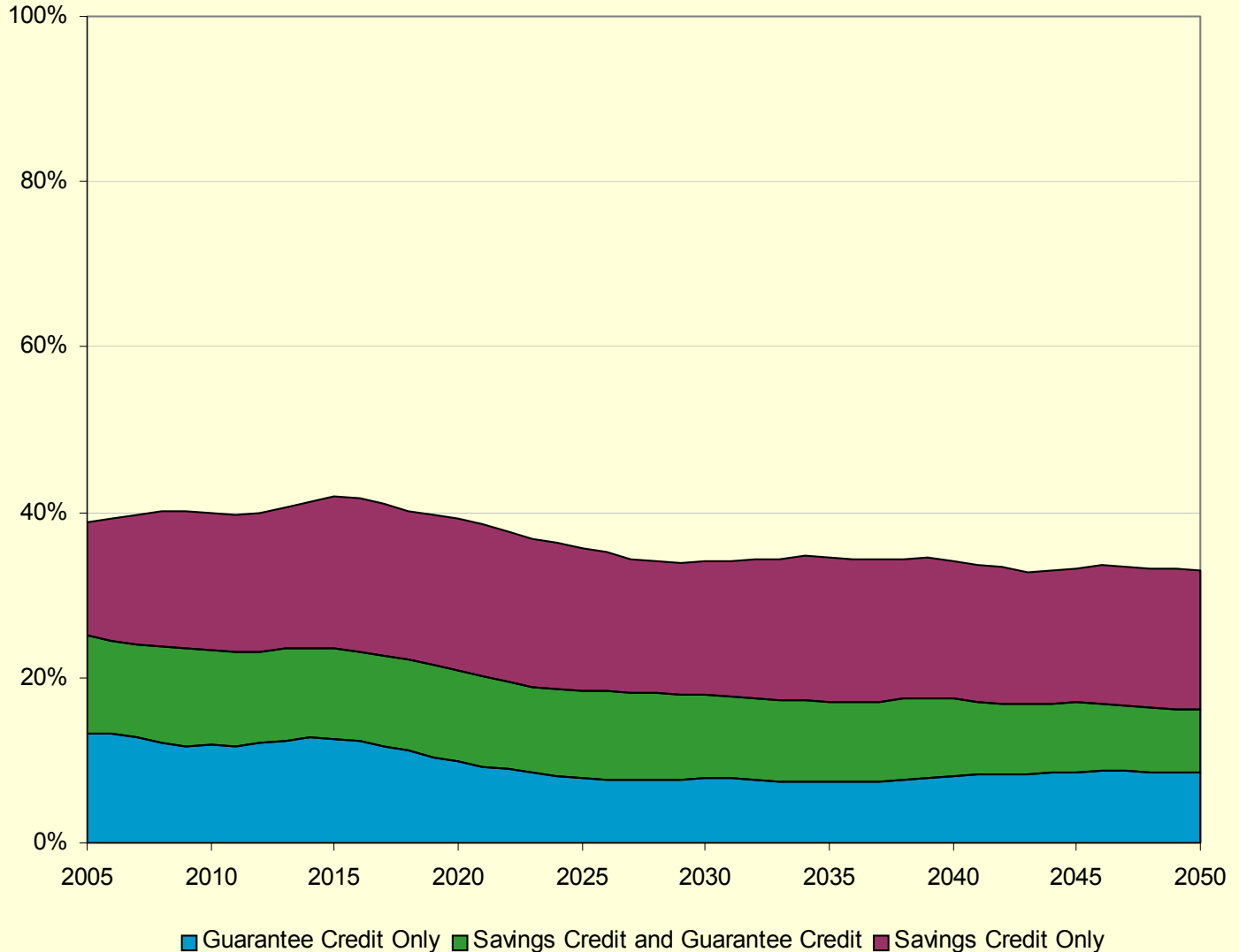
Proportion of Pensioner Benefit Units on Pension Credit

Assuming present indexation approaches continue indefinitely: 2005-2050

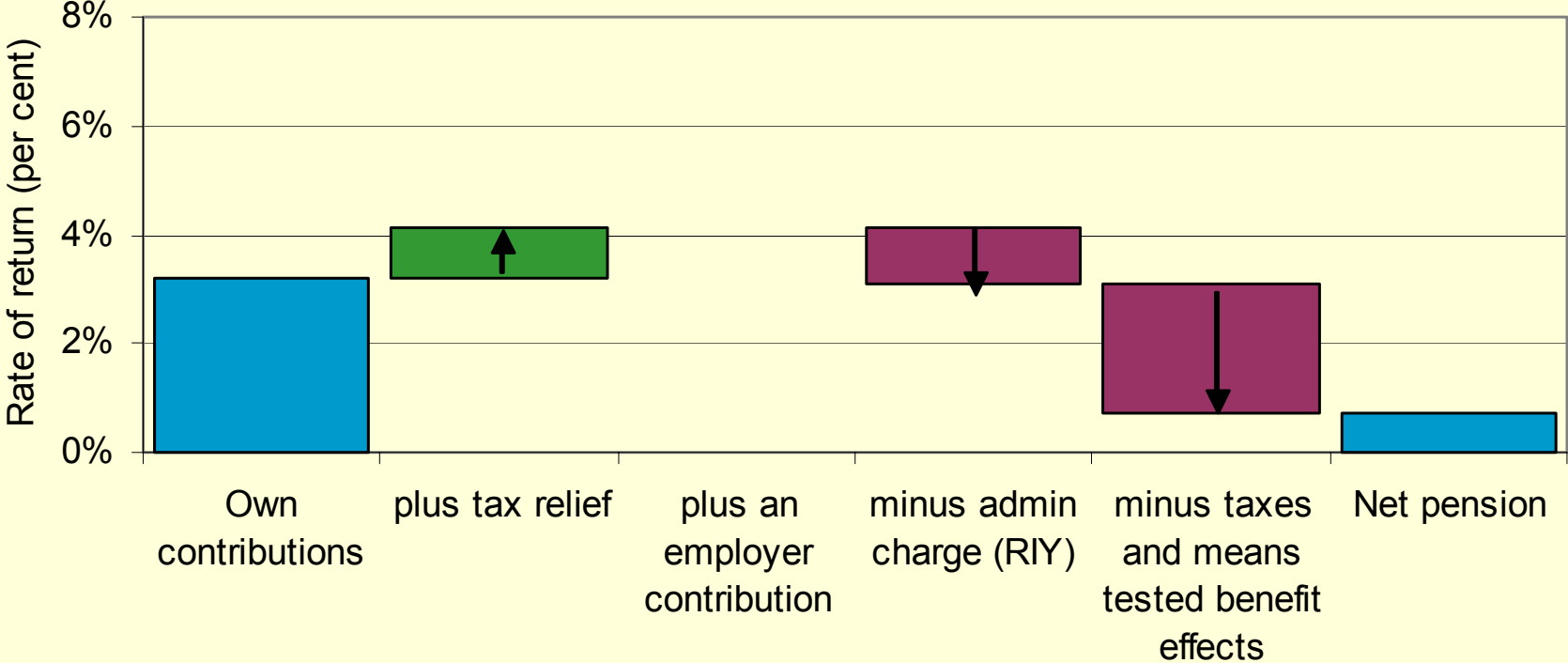


Proportion of Pensioner Benefit Units on Pension Credit

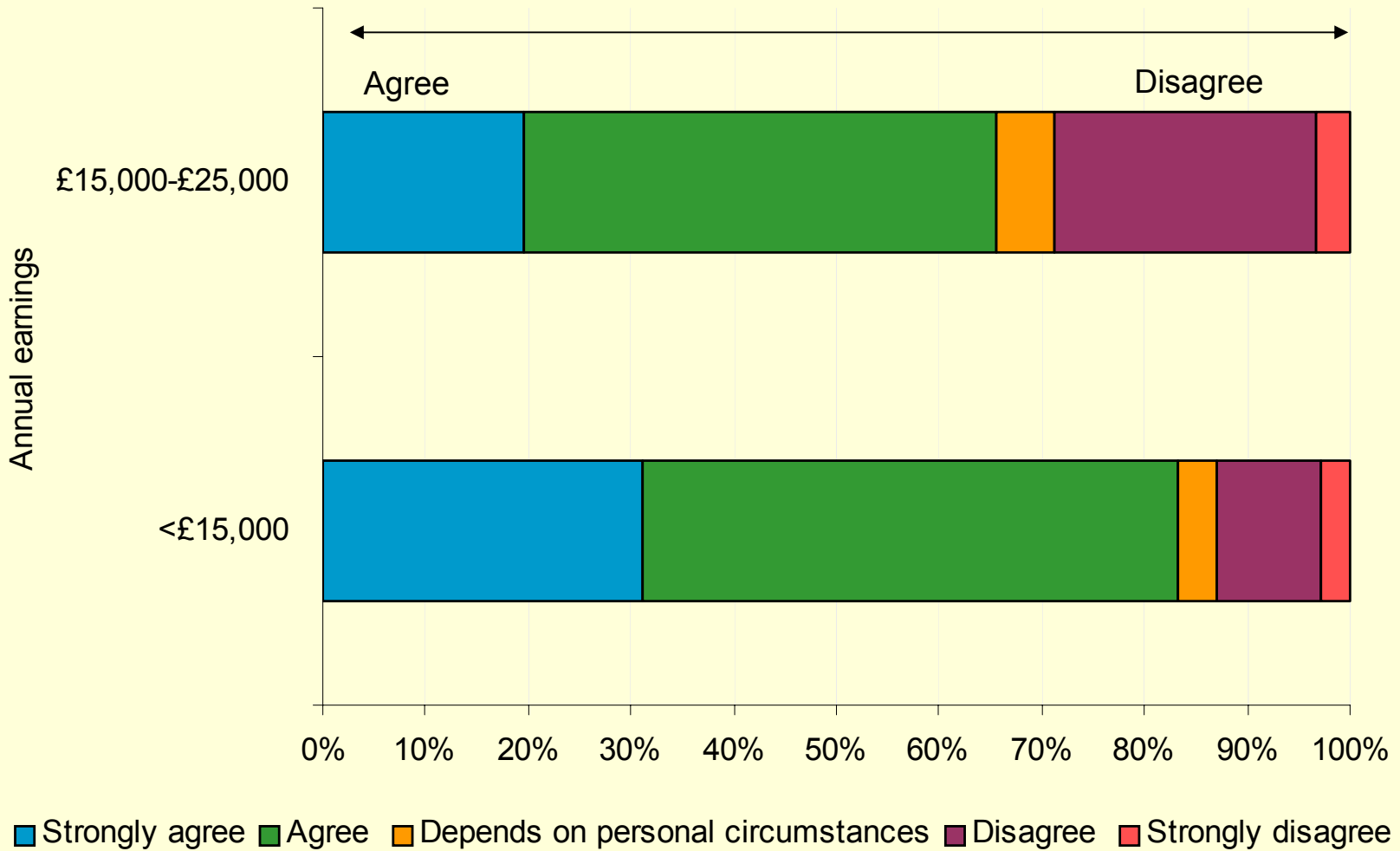
With proposed state system reforms and introduction of the NPSS



Effective Rate of Return for Stylised Individual Who Pays Basic Rate Tax in Working Life and Receives Means-tested Benefits in Retirement

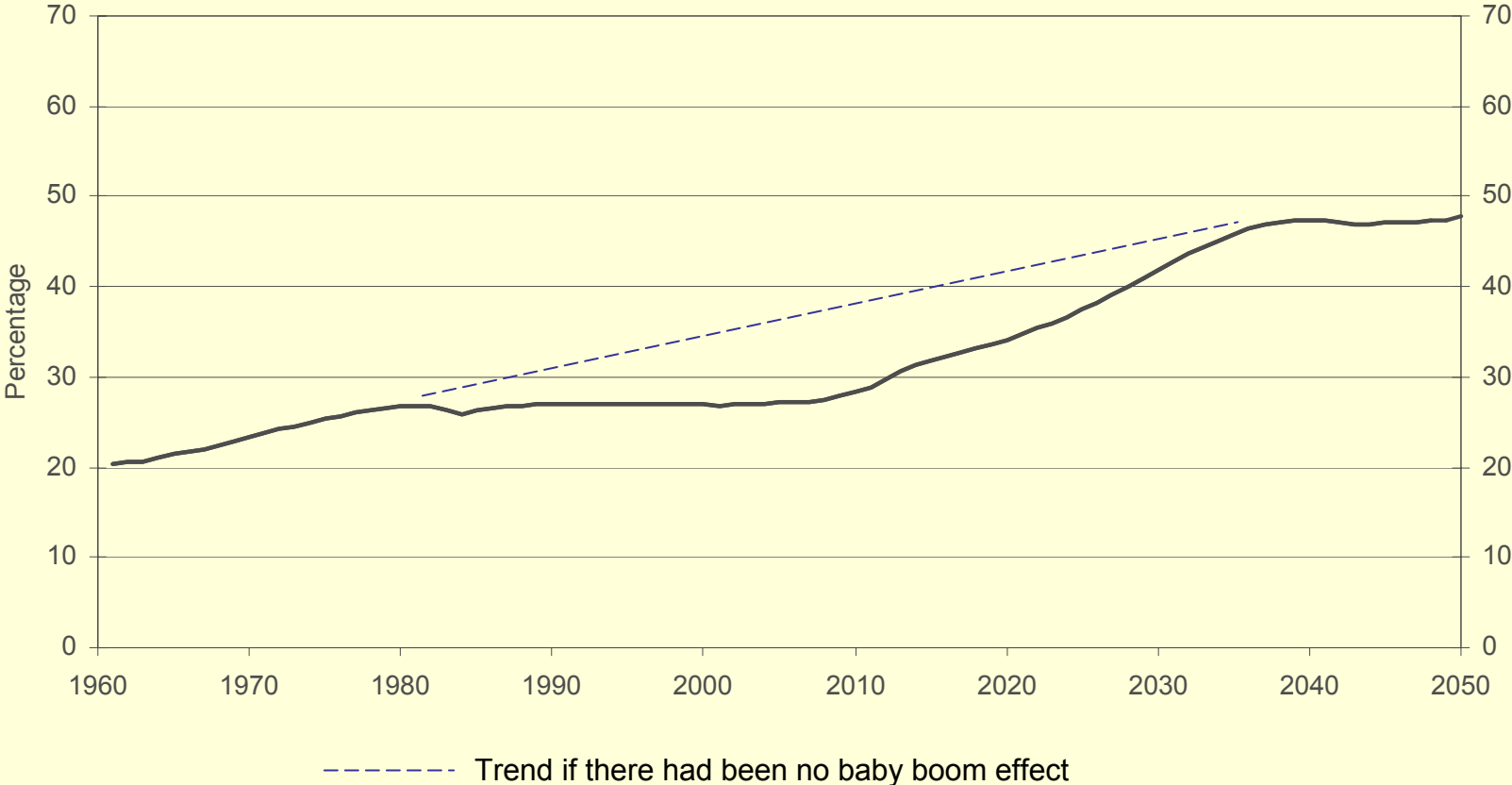


IFA Responses to the Question “If I advise people in this group to save, and means-testing reduces their entitlement to future state benefits, I could be accused of misselling

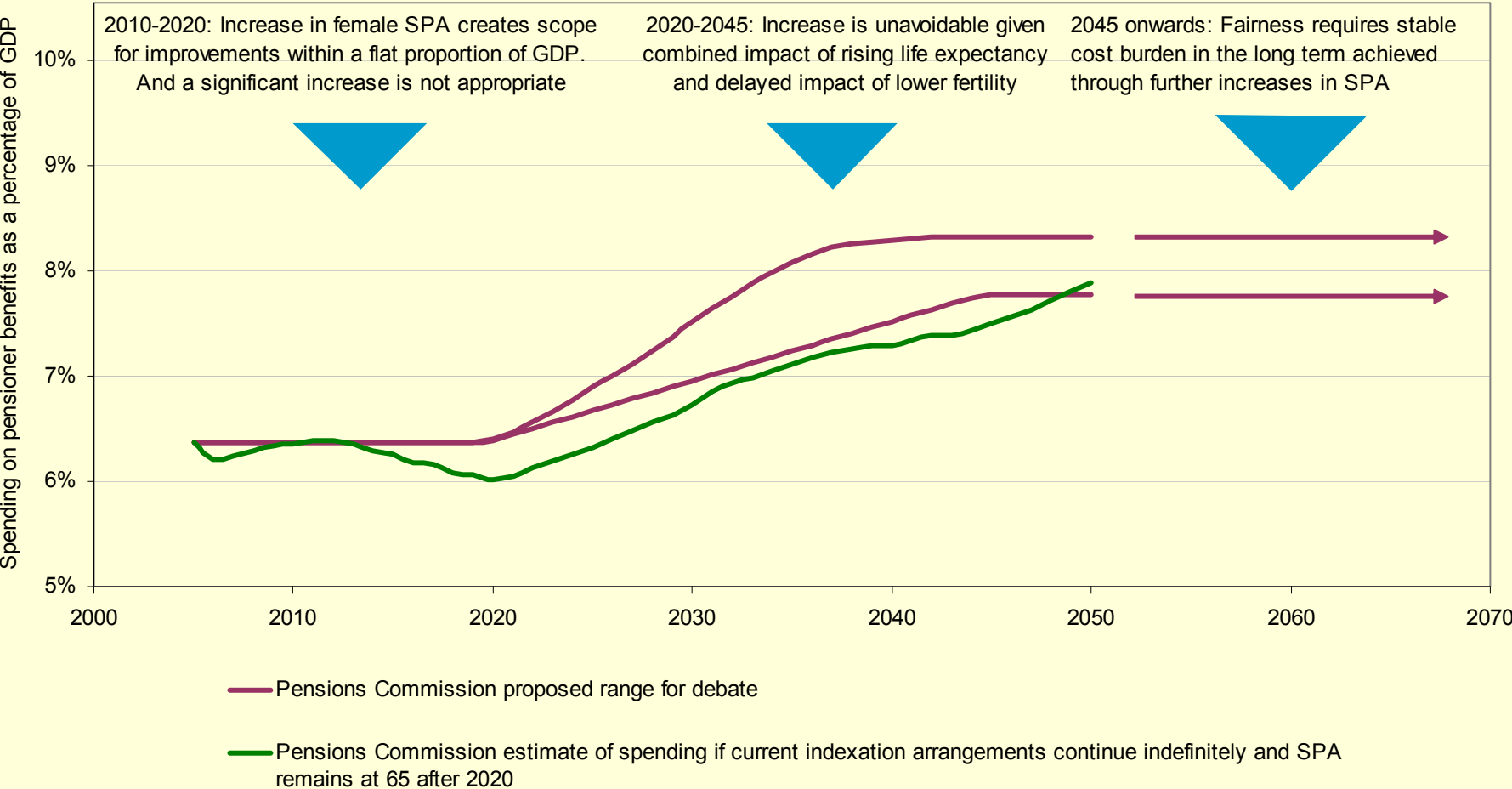


Source: Pensions Commission IFA Survey

Old-age Dependency Ratio: All 65+ : 20-64 – UK

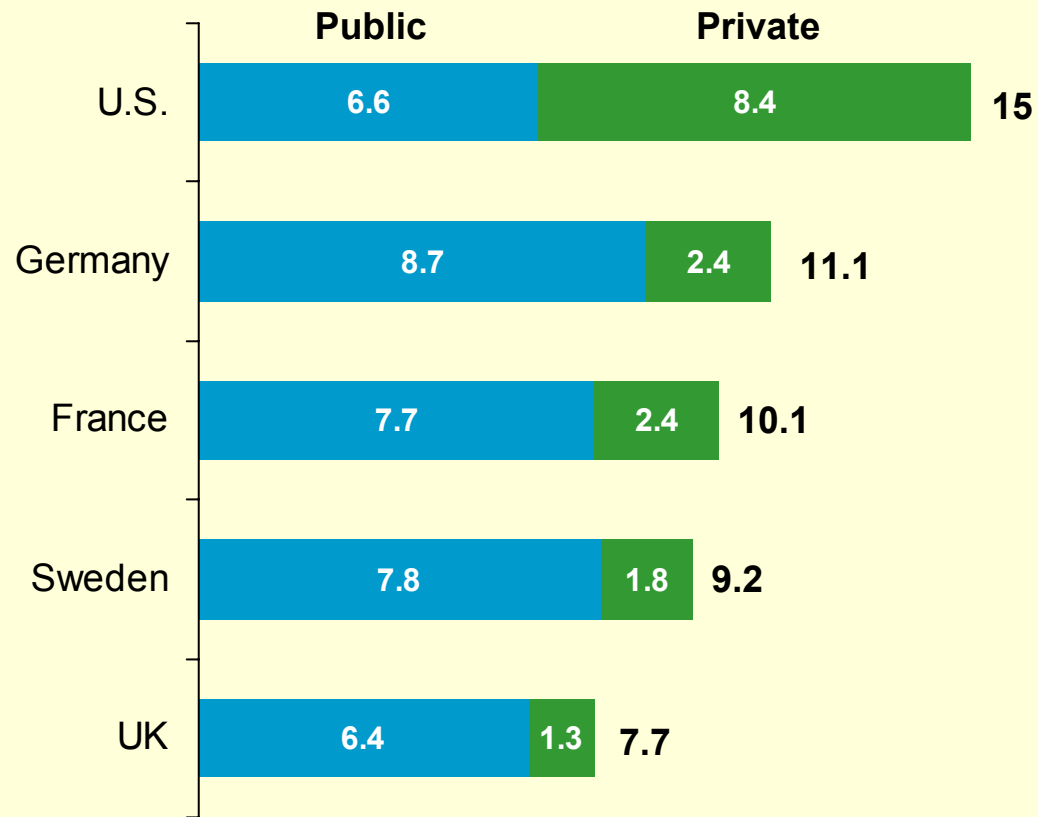


Public Expenditure on State Pensions and Pensioner Benefits: Range Proposed for Debate



Expenditure on Health 2003

% of GDP



Market Failures in Health ... and Pensions

❖ Asymmetry of information and knowledge between producer and consumer

❖ Limited value in price signals to consumers given

- Inability to assess quality
- High anxiety



Inefficiencies in free market healthcare

❖ Asymmetry of information and knowledge between e.g. financial adviser and consumer



❖ Imperfect information in “price” signals, e.g. unclear relationship between past achieved return and future prospective return

❖ High confusion → prevarication



Regulation and high costs in personal pension market

Distinctions between Health and Pensions?

	<u>Health</u>	<u>Pensions</u>	
Consumer Demand Differentiation	<p>Derives from income level rather than inherent differing preferences</p> <p>And ethical arguments for close to equal access</p>	<p>Derives from differing preferences.</p> <ul style="list-style-type: none"> • Retirement age/saving/income trade-off • Risk-return preference <p>... as well as from different income level</p> <p>... and no argument for provision to be more equal than income in general</p>	 <p>Socially provided minimum should be closer to the average desired level in health than in pensions</p>
Appropriateness of means-testing	<p>I.e. income dependent payments for prescriptions, GP visits or non-emergency operations (up to a maximum)</p> <p>Disincentives to seek treatment</p> <p>Disincentives to work?</p> <p>Administrative complexities</p>	<p>I.e. means-tested withdrawal of state pension entitlement as private (or public earnings related) pension rises</p> <p>Disincentives to private saving</p> <p>Problems of non-claiming</p>	 <p>Disadvantages of means-testing in both health and pensions</p>

Total Expenditure on Health (Public + Private)

1993 – 2003

% of GDP

	1993	2003
U.S.	13.2	15.0
France	9.4	10.1
Germany	9.9	11.1
Sweden	8.6	9.2
UK	6.9	7.7