

## Pensions: Challenges and Choices: What next?

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1. The analysis in the Report of the Pensions Commission (UK Pensions Commission 2004, henceforth referred to as the Report), is sound, the data a wonderful treasure trove, the presentation particularly clear, and the diagnosis correct. This comment takes the Report's analysis as given, and sets out what I regard as essential elements in the prescription which is the remit of the Second Report.

2. The core of any solution will involve:

- Considerable public education (section 1);
- A higher effective retirement age (section 2);
- A higher state pension with little or no means test (section 3);
- Simple, reliable savings products and annuities (section 4).

### 1 Public education

3. The fact of more older people and fewer younger workers creates costs that must inevitably fall somewhere: on workers through higher contributions; on pensioners through reduced pensions or a reduced period of retirement; or on workers and pensioners through higher general taxation. Thus the politics of reform matters, suggesting an early start to educating people about the realities. It is a mistake to think that pensions are complicated and people will not understand; the basics can readily be explained and should be explained. It is important that people understand the problems and the range of policy options. Such public education should make four points.

4. THE OBJECTIVES OF THE WELFARE STATE HAVE NOT CHANGED. In the case of pensions, the objective of the founders of the welfare state was security during working life about security in old age. That aim has not changed.

5. PEOPLE ARE LIVING LONGER – A GOOD NEWS STORY. In 1950 the life expectancy of a man aged 65 was 12 years; today it is over 16 years; the analogous figures for women are 14 years and 19 years. On average, therefore, today's older people get at least four years of extra life; and on average they are healthier years than in the past. This is terrific; more should be made of the fact, not only for political reasons but because it is a genuine gain, and one which will make people feel better.

6. WORKING LIVES ARE SHORTER.<sup>2</sup> In 1950, a typical person left school at 15 and started work – a 50-year working life for a man, given pensionable age of 65. Today most people do not start work till 18, and many not till 21, and many retire earlier than 65. On any reckoning, the average working life is shorter.

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<sup>2</sup> I am grateful to Ann Glennerster for reminding me of this point.

7. In contrast to the previous two points, public discussion focuses on state pensionable age. This focus is mistaken because it concentrates on costs (later retirement) while ignoring benefits (longer life). Discussion should start from three variables, (a) the duration of working life, (b) the duration of retirement, and (c) living standards in retirement. It is correct to say that people should retire later; but, depending on the details of reform, it may also be correct to say that they will work for fewer years than their grandparents, be retired for longer, and will have a more generous pension.

8. WHAT MATTERS IS NOT MONEY BUT OUTPUT. Pensioners are not interested in money (coloured bits of paper with a picture of the Queen on it) but in consumption – food, clothing, DVD recorders, medical services. At a macro level, pensions are about the division of output between workers and pensioners. Printing more money does not affect the size of the output pile, and hence does nothing to solve the problem; on the other hand, producing a larger pile of output obviously helps.

9. It would be easy to put together a persuasive visual display:

- One element would show how, with output and real pensions fixed, an increase in the number of pensioners leaves a declining share for workers (and for investment).
- If the maximum share of output has been extracted from workers, the remaining choices are a lower monthly pension or a shorter duration of retirement.
- A bar chart showing a typical life span (education, working years, retired years) in 1950 and 2000.

Such explanation should come from a range of authoritative sources, for example, Age Concern, the Association of British Insurers, etc.

10. Given the increase in life expectancy of 4-5 years mentioned earlier, raising state pensionable age to 68 simply splits the difference, *but* with the crucial proviso that real pensions today are more generous than in 1950.

## **2 A higher effective retirement age**

11. A core element in any solution is an increase in the effective retirement age.

### **2.1 Why?**

12. LATER RETIREMENT TO CONTAIN THE AGGREGATE COST OF PENSIONS. Pensions today cost more than in 1948 for three sets of reasons. Each person's pension costs more because (a) the weekly real pension is 2.6 times as high as in 1948, and (b) retirement lasts for longer because of increased longevity. In addition, (c) there are more pensioners, because of declining fertility. On its own, element (a) requires no change in contribution rates, since earnings have risen more than pensions, and (b) could be accommodated without increasing contributions by raising pensionable age. The problem facing pension policy is that (a) and (b) are combined with (c), so that maintaining a given real pension requires an increase in contribution rates or a larger-than-proportional increase in working life, or a mix of the two.

13. The fact that extending working life is only part of the solution rather than a complete solution in many ways strengthens the argument for later retirement. As noted, the fact that people live longer is wonderful. To talk about the ‘ageing problem’ is grotesquely to miss the point. The problem is not that people are living longer but that they retire too early. If we were designing a pension system for a new planet whose native life form was living longer and longer, we would not choose a retirement age fixed in nominal terms for all time at 65.

14. The connection between the length of retirement and the cost of pensions is obvious in economic terms. But because of its equally obvious political difficulties, past governments have ducked the issue – contributing to the downward pressure on the basic state pension over the past 20 years. An obvious way to increase pensions cost-effectively is to offer a larger pension but at a later age.<sup>3</sup>

15. VARIABLE RETIREMENT AGE AS A RESPONSE TO UNCERTAINTY. A second line of argument is less well-understood. As well as being higher, to contain costs, retirement age should also be variable, as a response to uncertainty. As discussed in section 4, below, annuities offer an efficient response to risk (where insurers have a good idea of the relevant probability distribution) but not to uncertainty (where they do not). In a world where life expectancy is broadly static, variations in age-at-death is a risk which insurance can address. Increasingly, however, longevity has assumed some of the characteristics of uncertainty, creating problems in annuities markets. If people on average live longer than expected, pensions become more expensive than expected. If the costs of uncertainty fall in their entirety on the annuity provider, the terms of annuities will become less attractive and/or the market for annuities will become thinner. Alternatively, some of the costs of uncertainty could be imposed on the buyer of the annuity by relating retirement age to life expectancy. Thus pension providers could make promises about *how much* members would receive, leaving members to face some uncertainty about *when* they receive it.

16. Specifically, if the default retirement age is linked to life expectancy (with people facing actuarial tradeoffs for retirement earlier or later than the default age), the finance of pensions is largely insulated from increases in longevity. Put another way, the accuracy of projections of the cost of pensions would be less critical, since one of the key elements of uncertainty is taken out of the equation. Pension finance would adapt automatically as uncertain outcomes eventuate but – of central importance – without compromising living standards in old age.

## 2.2 How to bring about later retirement

17. The objective is to increase labour force participation at all ages, but most particularly among older workers. While regulation (e.g. raising state pensionable age) may be necessary, it is desirable to use incentives where possible. The latter involves choice over at least two dimensions: the age at which a person first receives pension, and the trajectory between full-time work and full retirement.

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<sup>3</sup> To reduce cost pressures, careful design would be needed to make sure that the offer was (a) attractive but (b) gave less than actuarial adjustment for later retirement.

### *Later retirement*

18. PHASING IN. Change should not be sudden, but phased on the basis of three principles.<sup>4</sup> First, rules should relate to date of birth not to the date of retirement (otherwise there will be a wave of retirement just before any increase in pensionable age). Second, changes should be made annually to avoid large changes, which are problematical in political terms, and also create inequity, since benefits would otherwise differ significantly between people born in successive years, sometimes born only days apart. Third, explicit rules have advantages; ad hoc changes face exactly the sort of political pressures which have prevented action on men's retirement age until now. The existence of rules does not rule out the option to deviate from them through subsequent legislation. The increase in women's retirement age in the UK has been peaceful precisely because it conforms with these three principles.

19. HIGHER AND RISING PENSIONABLE AGE. It is not sufficient to have a one-off increase. In the long-run, state pensionable age should be variable, rising in some transparent way with life expectancy, otherwise the present problems will recur.<sup>5</sup> People should expect state pensionable age to rise over time. It causes political problems if a 60-year old is told he will have to work to age 70; the problem is minimal if today's 20-year old knows that, by the time he gets there, pensionable age will be 70 or higher.

20. SPECIFIC APPROACHES. How could pensionable age be increased?

- There could be an explicit increase in state pensionable age, as with women's retirement age.
- Along the lines of the Pensions Bill, people could be encouraged to defer pension, either through a larger pension if taken later and/or by offering a lump sum, the full lump sum being paid at 70, and a partial amount for a shorter period of deferral.
- There could be two pensionable ages. At the higher age (e.g. 75) there could be a generous addition to the state pension; the pension at the lower age, 65, would not be discontinued, but might not be increased.

21. ADDRESSING DISTRIBUTIONAL EFFECTS. People from poorer backgrounds tend to start work earlier and to have lower life expectancy than people from better-off backgrounds. On average, therefore, they contribute for more years and receive a pension for fewer years. If this makes an across-the-board increase in pensionable age unacceptable, the wrong answer is to refuse to act on pensionable age, the right answer to determine pensionable age differently. Instead of being based on reaching a fixed age (e.g. 70), eligibility for a full pension could be based on  $N$  years of contributions, where  $N$  is connected to the life expectancy of the cohort as a whole. Thus, other things equal, someone who starts work at 16 is eligible for a full state pension five years earlier than someone who starts at 21.

22. THE POLITICS OF CHANGE. The way to address the politics of such changes is twofold:

- By explaining the simple economics of pensions.
- By stressing that the package gives people additional choices, to wit:

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<sup>4</sup> I am grateful to Peter Diamond for articulating these principles.

<sup>5</sup> In Sweden, cohort life expectancy affects the level of the pension but not the earliest age at which it can be claimed. The two are equivalent under the assumption of rationality. That, however, is a bad guide to policy. Many people have a discount rate higher than the rate of actuarial adjustment, hence will retire at the earliest age permitted; as life expectancy increases, pension levels at that age will be increasingly inadequate.

### *Flexible choices between work and retirement*

23. Rising pensionable age needs to be supported by flexibility of two sorts: the pension system should allow flexible choice between work and retirement; and labour markets need to support such choice.

24. It is bad economic policy and bad social policy to force people to step over a cliff when they retire, i.e. to move instantly from full-time work to zero work. The system should allow the following range of options.

- Choice 1: full retirement on full pension at state pensionable age.
- Choice 2: full deferral: continued full-time or part-time work, not drawing pension.
- Choice 3: partial deferral, i.e. combining part-time work with partial pension. In this option a person could (say) work half time and claim half his pension; the remaining half would continue to grow. It is this option which allows people to choose a phased approach to retirement. Interestingly, Sweden has just such a system. Workers can claim full or partial benefits (one-quarter, one half or three-quarters) from their social security pensions. They can continue working while they draw benefits, in which case they continue contributing to the system.

25. Such choices need to be reinforced by labour market institutions. The following are no more than examples of the sort of actions that are necessary, all requiring further study:

- Abolishing mandatory retirement, or at least raising the age at which retirement can be unilaterally imposed by employers.
- Facilitating part-time work by a range of policies, including (a) giving workers stronger rights to work part-time if they wish, while simultaneously (b) adopting policies which minimise incentives against part-time work facing workers or employers. The latter is facilitated where costs (e.g. national insurance contributions), to the extent possible, rise proportionately with earnings or hours worked for both the worker and the employer.
- Pension formulae that do not militate against part-time work. Thus, for example, workers in final salary schemes should be able to nominate a year, or period of years (e.g. their salary at the time that they end full-time work and move to part-time), as the benchmark for calculating their eventual pension.

### **3 A higher state pension with no means test**

26. A further essential element is a higher state pension with no (or little) means test.

#### **3.1 Why?**

27. The present state pension is (a) below the poverty line, (b) supplemented by means-tested benefits, and (c) complex. All three elements are politically unpopular. And though the means-tested element has the short-run benefit of targeting scarce fiscal resources, it has significant costs.

- In the short run, means testing leads to incomplete coverage, high compliance costs and administrative costs, and stigma;
- It creates labour-supply disincentives which increasingly cut against the policy drive to raise participation by older workers.
- It creates a serious and continuing disincentive against saving, cutting against the policy drive to increase saving.

28. These, and earlier arguments, point towards a state pension which is (a) higher, (b) simpler, perhaps flat rate, and (c) payable at a later age.

### 3.2 How

29. One way to implement that change is to adjust existing institutions, keeping the contribution rules broadly unchanged, raising the basic state pension, but paying it at a later age. A more radical approach could phase out national insurance pensions and replace them with a generous non-contributory citizen's pension at age (say) 70. The Netherlands has a citizen's pension of €15,000 per year; and New Zealand has one set at about 40 per cent of the average net of tax wage for a single person and 65 per cent for a married couple.<sup>6</sup>

## 4 Simple savings products and annuities

30. The final core element in any solution is simple, reliable instruments for savings and annuities.

31. SAVINGS. The besetting problems are complexity and risk. Though the basic economics of pensions is simple, specific pension products are highly complex, creating a series of problems.

- Poor consumer information: many people do not have a good understanding of what they are doing. In the UK, only 12 per cent of people regard themselves as having 'good knowledge' of pensions, and a further 32 per cent as having 'reasonable basic knowledge' (UK Pensions Commission, 2004, Figure 6.7). In the USA, Orszag and Stiglitz (2001, p. 37) quote the Chairman of the US Securities and Exchange Commission as stating that over 50 per cent of Americans do not know the difference between a bond and an equity.
- High administrative costs: these are well documented by the Report (see, for example, Table 6.9), which points out that administrative costs are a key barrier to voluntarism. Administrative costs are central: under plausible assumptions, an annual administrative charge of 1 per cent of a person's pension accumulation reduces the person's accumulation at retirement by 20 per cent, i.e. each 1 per cent of charge reduces the pension a person gets by 20 per cent.
- Exposure to stock-market turbulence can create a further impediment to saving.

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<sup>6</sup> Under the New Zealand Superannuation Act 2001, the pension for a married couple is set within a band between 65 per cent and 72.5 per cent of average net of tax earnings. In practice the rate is kept at the lower end of the band. The rate for a single person 60-65 per cent of that for a married couple. The Act can be found on [http://www.legislation.govt.nz/browse\\_vw.asp?content-set=pal\\_statutes](http://www.legislation.govt.nz/browse_vw.asp?content-set=pal_statutes)

As a result, people's response to the need to provide for their old age has been more like a rabbit in a car headlight than a rational economic agent.

32. What is needed is a savings instrument which is (a) simple, so that people understand it, and to keep administrative costs low, and (b) safe, so that people trust it over the long term. Both feature are essential preconditions if incentives to increase saving are to work. They are probably essential for also for mandatory savings, to reduce savings offsets.<sup>7</sup>

33. ANNUITIES are a separate part of the jigsaw. The annuities market in the UK is becoming thin because longevity increasingly creates not only risk but also uncertainty. The distinction is important: actuarial insurance can address risk (where the relevant probability distribution is known), but not uncertainty (where it is not). As the Report points out, there are different elements in the longevity risk:

- Specific longevity is the probability distribution of age-at-death of a given person at age 65; this is the risk which an annuity is designed to cover. It is a genuine risk.
- Cohort longevity, relating to the life expectancy of men born in a given year, has a larger variance than specific longevity. We know that life expectancy is increasing, but there is uncertainty about how much, i.e. there is a 'funnel of doubt', which has widened as the duration of retirement has increased. Official projections have been on the low side: they correctly identified a slow-down in the rate of increase of life expectancy in the second half of the twentieth century, but mistakenly attributed this to a 'maximum duration of life' theory, rather than to the cumulative impact of smoking (an effect that has now been absorbed and, if anything, is being reversed). The practical question is whether annuity providers have the capital to address the variance in longevity; the more fundamental question is whether longevity is better regarded as risk or as uncertainty.
- Longevity over the longer term, i.e. over all cohorts, creates uncertainty rather than risk. If the costs of that uncertainty fall on the annuity provider, there will tend to be two effects: either the terms on which the annuity is offered become increasingly parsimonious, as the annuity provider protects shareholder interest by pricing policies on the basis of pessimistic assumptions,<sup>8</sup> or the annuity provider pulls out of the market – a trend already noted.

34. Policy must therefore address the facts (a) that the underlying problem is uncertainty, and (b) that uncertainty creates uninsurable costs. Those costs have to fall somewhere.

- They can fall on the annuitant if annuities are (i) missing or (ii) offer poor value, or (iii) if retirement age rises alongside rising life expectancy. As discussed earlier, option (iii) is properly part of the solution.
- Or costs can be shared more broadly, e.g. with the taxpayer. This could be another part of the solution. In this case, the state could provide the annuity – either the whole

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<sup>7</sup> If mandatory increases in pension savings are fully offset by a reduction in voluntary saving, the net increase is zero. The less people trust savings instruments, the greater the incentive to offset mandatory saving by reducing their voluntary saving.

<sup>8</sup> The same problem arises for other long-term uncertainties, notably the high price and loosely-specified contracts offered by insurance policies covering the costs of long-term care (see Barr, 2001, Ch. 5).

annuity (as in Sweden) or that element which addresses rising life expectancy (i.e. not the risk element but the uncertainty element).<sup>9</sup>

35. **DEFINED-BENEFIT PENSIONS.** Uncertainty is highly relevant also for defined-benefit schemes. As the Report points out, a range of factors have made such schemes more expensive for employers, thus facing them with more uncertainty: rising life expectancy, mandatory cover of spouses, mandatory limited price indexation, and mandatory protection of the rights of people who leave the scheme (i.e. it is no longer permitted to cross-subsidise from leavers to stayers). These factors were masked in the 1990s by the stock market boom. Today a typical defined-benefit scheme costs 20-25% of salary, defined-contribution schemes only about half of that.

36. Employers have responded to these pressures by phasing out many defined-benefit schemes. This is regrettable, since such schemes offer workers a fair measure of certainty (a key ingredient in consumption smoothing). An alternative to phasing out such programmes would be to shift to a less generous offer: a full pension based on a longer career; a retirement age that rose with life expectancy; and perhaps also taxpayer assistance in connection with uncertainty about life expectancy. Instead of imposing all the uncertainty on the employer, as at present, such policies would share uncertainty between employer, pensioner and taxpayer in a more rational way, enhancing both efficiency and equity. A return to slimmed-down, better-designed defined-benefit schemes is desirable, but easier said than done. The design of policies to encourage such a move should be a major agenda item for researchers and policy makers over the coming year.

## 5 Conclusion

37. The elements in the previous four sections are mutually reinforcing and desirable in their own right in terms of promoting old age security. They also contribute to wider policy objectives. They:

38. Assist the macro agenda. Later and more flexible retirement:

- Helps to contain fiscal costs.
- Assists UK plc by keeping productive people working.

39. Assist the social policy agenda, by:

- Giving people greater choice over retirement in an area where tastes and constraints differ widely.
- Increasing old age security: a person may actively prefer to work longer; and a person whose pension is on the low side has the option of increasing it by working longer, either full time or combining part-time work with a partial pension

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<sup>9</sup> An analogue with current institutions would be if private pensions provided limited price indexation, with the state taking on the risk of inflation above the limit.



## References

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