

UK state pensions (2)

*Should the UK switch from a pay-as-you-go to a funded pension scheme? Continuing her discussion of this subject, **Sarah Smith**, of the Institute for Fiscal Studies investigates the pros and cons*

Falling birth rates and longer life expectancies mean that many OECD countries are experiencing ageing populations. For some, this is putting their pension systems under pressure and causing governments, most recently in the US, Germany and Italy, to grasp what had become known as the “third rail of politics” – pension reform. As with the railways, the third rail of politics is not something that is to be grasped lightly and can leave the unwary politician with burnt fingers.

Most public pension systems operate on a *pay-as-you-go* basis. This means that pensions paid to current pensioners are financed from contributions paid by current workers. This creates potential problems when the number of pensioners rises relative to the numbers of workers. To remain in balance the pension system has to raise more contributions from current workers, or pay less to pensioners. In the US, the social security (pension) trust fund, which has recently been running annual surpluses, will run an annual deficit from 2015 (i.e. annual tax revenues will fall short of annual pension spending) and will have exhausted all its assets by 2037.

One proposed solution to this problem is to change from a pay-as-you-go system (also known as an unfunded system) to a *funded* pension system. In the US, for example, Governor/ President-elect Bush has proposed introducing funded, individual pension accounts. The UK already has a large element of funding with occupational pensions, personal pensions and – from April 2001 – stakeholder pensions. Funded pensions are financed out of the contributions that pensioners themselves made when they were working. Workers pay into a pension pot which, at any one time, has enough money in it to finance their future pensions. Whether the system stays in balance is therefore not affected by a decline in the workforce relative to the pensioner population.

But funded pension systems may be affected in other ways by demographic trends. In order to finance their retirement pensioners have to be able to sell the assets in their pension pot. If there is a smaller workforce demanding less capital and a larger number of pensioners with more capital to sell, the price of capital will tend to fall, reducing the value of what pensioners have saved. Also, any pensioner looking to buy an annuity (a guaranteed stream of income

until death) with the money in their pension pot will find that, with longer life expectancy, the annual income they can buy for a given level of savings will fall.

In a funded pension system, the rate of return – how much people get back from a pension compared to the contributions they put in – is determined by asset returns. In a pay-as-you-go pension system where today's workers finance today's pensioners, a positive return is generated by real economic growth. If both contributions and pensions are linked to what people earn, and if today's workers have higher real earnings than today's pensioners did when they were young, then on average pensioners will get more out of the pension system than they put in. The rate of return will be broadly equivalent to the growth rate of earnings and, indeed, in most European countries, pensions are annually updated in line with earnings. In the UK, however, the earnings link in the state pension was replaced in 1981 with a link to prices.

In recent years, asset returns have exceeded the growth in earnings. This implies that, for a given level of contributions, someone would have got a bigger pension from a funded system than from an unfunded system. For many this has been a key attraction of switching to a funded pension systems appear relatively attractive. But, the fact that asset returns have been higher than earnings growth in the past, does not necessarily mean that this will continue to be the case in the future. In particular, demographic trends might tend to raise future earnings as the number of working age people falls, and tend to reduce asset prices as a larger number of pensioners try to sell their assets to a smaller workforce.

This analysis is based on a closed economy. When capital is mobile between countries, then a single price of capital is determined internationally. If pension funds can invest in countries with growing labour forces, i.e. rising investment needs, asset returns could be preserved. However, the investment of pension funds abroad may entail different economic and political risks.

More generally, pay-as-you-go and funded systems entail very different risks. A key risk in a funded system is of a sudden fall in asset returns – although people can adjust their portfolios to reduce this risk as they approach retirement, by switching to safer assets such as Government bonds. But essentially with any scheme of individual pension accounts, individuals bear any risk themselves. With a pay-as-you-go scheme there is a far greater degree of risk-sharing across generations of workers.

If, after a careful weighing up these different factors, politicians decide that a switch from a pay-as-you-go to a funded system is desirable, a crucial issue is how to deal with the transition from one system to the other. The main problem is that it means one generation of workers paying twice. When a pay-as-you-go system was introduced, the first generation received a pension without making any contributions. They were the winners from the system. The losers are the generation of workers who must finance the pensions of current pensioners and must also pay into their own pension pots for when they retire. Politicians may try to spread the burden by reducing the generosity of the pension system to current pensioners – reducing the burden on current workers – at the same time as encouraging workers to make their own contributions. In the US, Bush is proposing to use some of the money from the existing federal budget surplus to kick-start a funded pension system. But, typically, pension reform will involve fairly unpopular measures for current workers and pensioners often in the interests of long-term gain, a combination that very few politicians find attractive.