Overview: Rising longevity is likely to strengthen the recent trend toward later retirement, as well as encouraging the development of new-style company and occupational pension schemes, according to James Banks and Richard Blundell, researchers at the ESRC Research Centre, the Institute for Fiscal Studies. Workers and firms may both favour schemes more friendly to job mobility in later life - in which retirement incomes are less linked to final salaries than in most existing defined benefit schemes, but which offer employees greater protection against unfavourable movements in financial markets than most existing defined contribution schemes.

This presentation at the festival of science from researchers at the ESRC Centre at IFS documents the pressures for change on retirement and pensioner income in Britain and examines their implications for future generations of pensioners.

The main pressure on pension systems in the western hemisphere has been the sizable and largely unexpected increases in longevity. The trends for men and women have resulted in a four year increase in life expectancy for men and women in Britain since the 1960s. With a more rapid increase for men in recent years. Actuarial forecasts have systematically underestimated longevity. For example in 2000 the Government’s actuarial department predicted that there would be 16.1 million people aged 65 and over in 2051. Just two years later it revised this prediction up to 16.8 million. With health improvements likely through the dramatic drop in smoking this may well continue.

Unexpected increases in longevity put pressure on all pension systems. The rate of benefit calculated for a given level of pension savings will be too high and even fully-funded systems come under severe pressure. Even though these pressures were evident during the 1980s the exceptional rise in equity prices over the 1990s managed to cloud this problem. The recent fall in equity prices has brought it home in a rather dramatic fashion.

The unique form of pension arrangements in Britain mean that these upward revisions in longevity play out in a relatively complex way. In Britain over 70% of pension scheme members are contracted out of the state earnings related scheme. An unusually high proportion, by international standards. In contrast in the US and in continental Europe, the majority of pension saving is in ‘pay as you go’ government funded social security schemes. Until 1988 this private pension saving in Britain was mainly held in employer based final-salary schemes or public sector final-salary schemes. Since 1988 individuals have been able to contract out into private ‘defined contribution’ pension schemes and now more than one third of this group are in such schemes.

What does this mean for pension incomes and retirement decisions? While returns on the stock market were unusually healthy, company based schemes and private defined contribution schemes displayed unprecedented growth. Quite generous retirement incomes were afforded despite the increased longevity. Around the same time the state earnings related system (SERPS) reached full maturity (in 1998). This resulted in a ‘golden generation’ of retirees, at the end of the last century, who retried on relatively generous pensions despite their increased longevity.
The stock market crash put an end to that. At the same time the state system was redesigned to make it less generous, especially to those on relatively higher levels of earned income. Moreover there was a squeeze on long-term bond rates and resulting annuity rates at the end of the 1990s. This clearly spelled an end to the trend toward early retirement and employment rates among older men haven rise by more than 5 percentage points.

For those individuals in final salary employer pensions the pressure on the fund meant that firms were unwilling to offer generous early retirement windows. New entrants to firms were typically offered a private defined contribution scheme rather than the company’s final salary scheme. Given the commitment to those already retired this put increased pressure on those workers remaining in the company scheme. Those individuals with defined contribution schemes, whose fund was still in the stock market, felt the full impact of the increased individual risk of a DC scheme. In addition falling annuity rates made the income stream, from a now less valuable fund, even less generous. In both cases these pressures created an increased inducement not to retire early. This is theoretically strongest in those individuals with mainly DC based pensions. The recent results from the English Longitudinal Study of Aging confirm that this much stronger incentive to work longer in defined contribution schemes has a noticeable impact on actual retirement decisions. It shows that those aged 50-54 in (predominantly final salary) employer DB plans report on average 10 percentage points lower chances of working at age 60 that those with DC arrangements.

What of the future? Will we see further increases in longevity? The evidence suggests we will. Will there continue to be unexpected increases in longevity? Perhaps the actuaries could learn from their mistakes. In any case it is unlikely that the equity prices will rebound sufficiently to cover this secular rise in longevity and there is no economic reason why they should. In general individuals should expect to work longer or consume less. The move to defined contribution schemes looks set to continue and it is possible that individual’s, thinking of longer working lives with possible moves across occupations, will benefit from this flexibility. However, pension income becomes more risky in such schemes and, with little pension income from the first tier level of support, this could shoulder some individuals with more risk than they feel is acceptable. As a consequence company and occupational based defined benefit schemes will surely evolve. Less related to final salary and with more flexibility on the labour supply margin. They could allow individuals to draw their pension income early, and while working in the same or another occupation. Therefore enjoying some insurance against annuity and financial market risk that a defined benefit scheme offers while removing some of the restrictions on mobility.

Notes to Editors:

1. Press copies of this presentation are available from the Institute for Fiscal Studies. Please contact Emma Hyman on 07730 667013 or emma_h@ifs.org.uk
2. This presentation took place as part of the British Association Festival of Science 2004. For further information on the Festival, please visit www.the-ba.net/festivalofscience or contact the Press Office at press@the-ba.net