

Pensions: Some thoughts

1 Introduction

In recent years there has been much discussion on pensions. How much should individuals contribute to their pension schemes? How much should the state contribute? Is the state the long stop for those on low incomes and for those whose pensions are small?

A lot of the argument has been based on how much pensions cost and whether the “taxpayer” can afford the system as the population grows older. Some of the arguments revolve around the question of choice. During the Thatchers era there was a government view that people should be encouraged to participate in personal pension schemes.

An individual’s attitude might well depend on their age and their political beliefs. Those on the left might believe that everyone is entitled to a decent pension irrespective of their behaviour in their working years and others might think that if you have misspent your earlier years then why should the taxpayer pick up the problems.

One of the difficulties is that many of the problems are long-term, when you are thirty, what is going to happen to you when you are eighty is a long way away and you might never get there. Also we have a hang-up about the present generation of pensioners who suffered in the last war and deserve better treatment now, however in the long term this is not going to be an ongoing problem. There is also a problem of partners, mainly women, whose pension depend on the contributions of their partner, especially in the situation where the significant other has become the ex-partner.

2 Some of the problems

At one point there were quite a lot of company pension schemes and they were very often good schemes, especially those attached to the nationalised industries. However in the days of financial licence these were seen to be very restrictive as the pension was attached to the job and this was a disincentive to job mobility. There was also the Robert Maxwell scandal in the early 90’s where he used the company pension scheme to support his failing businesses. He was not the only person or company to misuse pension funds. The prob-

lem was that the pension fund was perceived to belong to the company and not to the pensioners and workers, so they had no rights in how the money was invested and when companies went bankrupt very often the pensions went with them.

There was a big campaign by the government to persuade people to take out private pension schemes and this led to much misselling of pensions, much of it by so-called large respectable companies. One of the big problems of personal pension schemes is that the value of your pension pot is dependent on the state of the economy at the point of retirement. So there can be no guarantee of how much your pension pot might be at this point.

One way to avoid some of these problems is to be part of a bigger scheme and many people were in company schemes which offered a pension which was based on final salary and the number of years which had been worked. The government scheme SERPS was based on this principle. It was attacked by both the left for freezing the inequalities of working life into retirement and by the right for being too expensive. It was finally closed during Mrs Thatcher's period in office. The costs of final salary schemes become too much for many companies and they have closed the schemes, normally only for new employees but not for the directors and top level management. The question is why did they become too expensive, some of this will be illustrated in an example but when companies are cutting staff the burden of the financing becomes too great when the contributing members are small compared to those drawing pensions. So the contribution to the pension fund becomes more and more expensive. This effect can be exacerbated when the company has invested much of the pension fund in the company so as the company declines the value of the pension fund declines and the problem spirals out of control.

3 An Example

It might help to use an example to illustrate some of the problems that individuals might have. This is a very simplified example, it will ignore the effects of inflation and changing circumstances of the individual.

We consider an individual who earns the same for the whole of their working life. The first scenario assumes that the person wishes to save so that they have a final sum which would provide 50% of their salary for life. Making the assumption that they can get a safe 4% on their capital they

would need to save 31.25% of their salary. This is clearly impractical.

Let us make a slightly different assumption, this time we assume that the person is willing to run down the fund so will take the pension as interest and capital. They decide they are going to die by the age of 85 so if they retire at 65 they will have 20 years to run down the fund. On this basis they would need to save only 17% of their salary, which if split between the person and their employer becomes affordable for those above the lowest levels of income.

It is important to note that these figures are very sensitive to the assumed interest rates but these are very hard to predict reliably. Also the number of years assumed about the life expectancy makes a significant difference as might be expected.

4 Some Conclusions

The example gives some idea of the proportion of salary which has to be saved over someone's lifetime to create a viable pension pot to enable someone to enjoy a salary during retirement of half of their previous earnings. That ratio can be challenged, those arguing it isn't sufficient and those arguing it is too much but the main point is how can people afford to do this and even if they do what are the consequences.

As an individual you will be dependent on the investment decisions taken during the 40 years your pension has been building up, note I have not taken account of the earning that will have accrued to the pot during those years. It might be that all the decisions will have been wise but some might not have been. Then the actual value might well depend on the state of the economy at the point of retirement. Whether the money was in shares, bonds or properties you as one individual are very exposed to the random effects of the financial markets. Again how much you need to save depends on how long you live and how do you protect against that. The idea of many pension funds is that by contributing your funds to a company they will make collective decisions and that this will protect you. However they charge for this and when the time comes the pension will still be dependent on the financial situation when you retire.

The question that we need to address first is what do people want from a pension scheme. There are two major wants, an income which enables a reasonable life style and a guarantee that it will be secure. What we have

seen is that an individual pension scheme cannot meet these aspirations.

Those pensioners who are now comfortably off largely come from the public sector with pensions paid out of taxation or those who worked for large companies which had terminal salary schemes, many of which were contributory but not all of which have automatic inflation linking.

The conclusion is that there is protection in collective action. That means that your pension is merged with lots of others and then there can be a guarantee because if there are enough people involved in the scheme there will always be people retiring so some will retire when things are good and some when things are bad. Some will live longer and some will live shorter but when the sample is large then averages tend to be true.

The only way to achieve this satisfactorily will be by government action. As we see in the present situation, the government, in the form of “taxpayers” is expected to pick up the bill when things go wrong. So my view is that they should take the responsibility at the beginning. They would then collect pension contributions from employees and employers alike and invest the money. There are a number of technical decisions about investment and ring fencing the money. One thing that must not be allowed is to just use the money as tax income and hope to pay pensions out of tax in the coming years as this will lead to horrendous tax bills in the future.

5 SERPS revisited

To provide for a satisfactory pension scheme for all needs government support. To try to rely on the private sector is almost certainly doomed to failure as they would not be able to offer the necessary guarantees. So the government sets up a pension scheme, which would be compulsory, to which all employees and employers have to contribute. The money in this fund would be widely invested, probably by a different number of separate, but publicly owned, investment funds. This would give guaranteed pensions and given the numbers most actuarial estimates would be reliable and over the years the system should be stable. Thus the system would provide the benefits of a good company scheme whilst giving total transferability. This would give to the public at large the security in old age that the public sector enjoy.

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