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Shaping a stable pensions solution: What should be the balance between state and private pensions?

On Wednesday 6 April 2005 the PPI and the Nuffield Foundation held the first seminar in the *Shaping a stable pensions solution* series at the Nuffield Foundation.

Around 40 people attended the seminar, which was chaired by Tom Ross (Aon Consulting and Chairman, PPI).

Chris Curry (Research Director, PPI) presented key findings from the background paper *What should be the balance between state and private pensions?* This showed that government's long-term target of switching the proportion of pension income from 60% state and 40% private to 40% state and 60% private does not look likely to be achieved based on either macro-economic or micro-economic analysis. It also suggested that the balance between state and private pensions should be as much as a social policy decision as an economic one.

Chris Dobson (Pensions Commission Secretariat) summarised findings from macro-economic modelling in the Pensions Commission's First Report. In particular, he showed the reduction in the 'savings gap' if people worked to older ages than currently.

Four discussants gave contributions to the debate before questions and contributions were taken from the floor.

Please note that the PPI has not checked any facts referred to in the following, and we may not agree with the opinions expressed.

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Professor Nicholas Barr (Professor of Public Economics, London School of Economics) argued that the key driver of the real incomes of future pensioners is growth in economic output and not the extent to which pensions are funded. The evidence suggests that funding can have a beneficial effect on output, but that effect should not simply be assumed and may not be very large. What is more important is to set State Pension Age at a level that makes is possible to provide an adequate state pension, and for that age (and people's expectations) to rise as longevity increases. The choice and flexibility of private pensions are advantages only if the resulting welfare gains exceed the costs of regulating private pensions and informing consumers.

Adrian Boulding (Pensions Strategy Director, Legal & General) said that private provision had the advantages of flexibility and ownership. Employer pension provision is also an important part of labour market competition. Private pensions redistribute over time, rather than from rich to poor.

Professor Paul Johnson (Professor of Economic History and Deputy Director, London School of Economics) said that the state pension system should be equitable to parents who forgo earnings to pay for bringing up the next generation. The state pension should be related to the number of children parents have had, with non-parents relying more on private provision. Greater pension provision for parents would help women and could encourage fertility, which could improve the demographic situation.

Peter Lilley MP said that extra savings into private pensions can improve future pension provision by increasing output. He argued that private pensions encourage a feeling of ownership, provide an incentive to work longer (especially Defined Contribution pensions) and help each generation pay for itself. He was concerned that abolishing contracting-out would have a detrimental effect on savings.

The following points were raised in discussion.

1. Addressing the balance between state and private pensions is not the right place to start the debate. Only when state provision is designed to adequately prevent poverty can we start addressing who should provide higher levels of pensions. The "40:60" target is not very helpful and the balance should be more of an indicator of where we are than a target.

2. It is right that tax relief and pensions accrued by contracted-out rebates are counted as private pension income in the government target. The analysis shows that in order to get to the 40:60 target (which this contributor felt was the right target) we need not only contracting-out but also compulsion.

3. The appropriate balance of state and private pensions varies from person to person depending on earnings. It is not feasible for those on low incomes to have 60% of their pension from private sources. People have other priorities for their income other than saving in pensions.

4. Private pensions differ from state pensions in two fundamental ways: they tend to be funded rather than pay as you go (PAYG) and voluntary rather than involuntary. In macro-economic terms it matters little whether pensions are funded or PAYG so there seems to be little rationale for a target unless it is a target for voluntary savings.

5. Rather than try to reduce future expenditure on pensions by funding the pensions system, we could reduce the future costs for pensioners by investing in healthcare and care homes.

6. Funding encourages equitability between generations by ensuring that the current generation pays for its own choice in having fewer children and for its own longevity.

7. There are a variety of other ways to increase economic output, including increased labour market participation and an increased retirement age.

8. More workers than expected (80% was quoted from a survey) would like to continue working past their retirement age. Further, they would work past State Pension Age provided they can work part-time and have flexibility.

9. Final salary pension schemes penalise people who choose to work for longer by working part-time or in a less well paid position. Employers could help encourage longer working lives by switching to career average pension schemes or by indexing their retirement ages to life expectancy.

10. In order to prevent carers being penalised, the state pension should be made more generous for carers in particular. Carers cannot save in a private pension so only crediting carers to the state pension which everyone receives is not enough. There is an issue with how to define a target replacement ratio for carers.

11. One reason successive governments have imposed more regulations on private pensions is because they expect them to be "quasi-state pensions" and make up for low state pension provision. Increasing the level of the state pension may allow the government to loosen regulations surrounding private pensions.

12. Any funded system of compulsory contributions would need a government guarantee if it comes on top of a weak or inadequate foundation tier. However, the opposite opinion was also voiced: the Australian system has compulsory contributions without a government guarantee.

Much of the discussion focused on the relative strengths and weaknesses of state and private pensions:

Strengths of state pensions:

1. State pensions have lower expenses than private pensions. The expenses of private pensions can be very significant, particularly for those on low incomes. The administration costs of means-tested benefits such as Pension Credit are very high but these are not borne only by those who claim them.

2. State pensions are not subject to investment risk and longevity risk is not borne by the individual as much as under Defined Contribution schemes. This is especially important for those on low-mid incomes who cannot bear much risk.

3. State pensions can be redistributive towards those on low incomes and carers in a way that private pensions cannot.

4. State pensions do not require individuals to make a choice about a system they do not understand. Such choices in private pensions have an administration and legislative cost.

Strengths of private pensions:
1. Private pension schemes allow more flexibility and choice, both in when contributions are made and what pension is provided.

2. Private pensions encourage a sense of ownership. This leads to better understanding of their pension provision and encourages people to make more pension contributions. Ownership means that people have more of a stake in the economy working well.

3. Private pensions are an important part of labour market competition. Employers use private pensions to attract new staff and employees use them to discriminate between employers.

4. Private pensions are easier and quicker to change and reform.

Apparent conclusions (synthesised by the PPI after the event)
1. No-one disagreed with the importance of growth in the economy for the transfer of resources to pensioners.

2. There was an implicit agreement that both state and private pensions are important, although there are different individual preferences for policy to favour more of one than the other.

3. There was no consensus for the existence of a target for the balance of state and private pensions, or that 40:60 was the right balance.

4. Working longer is likely to be an important part of resources in later life. The key is to make possible the type of working that people want.