The economics of pension arrangements

Note of a paper for the Bank's Panel of Academic Consultants

The Bank's Panel of Academic Consultants met on 4 March, and had as its theme the general issues raised by the growth of pension schemes. Two papers were prepared for the meeting and subsequently have been slightly revised. One, by Professor Harold Rose, considers occupational pension schemes and discusses the reasons for their growth, their economic effects and the issues of policy which arise; the other, by John Kay, looks at the broad considerations bearing on the appropriate method of financing public sector pension schemes. They have now been issued as Panel Paper No. 20, which also includes a background paper by Mr Kay on the State earnings related pension scheme. Copies are available from the Bank at the address given on the reverse of the contents page in this *Bulletin.*

The theme was prompted by the wide-ranging effects that pension arrangements may have on social and economic developments. The Panel did not discuss questions regarding the supervision and regulation of occupational pension schemes, but rather concentrated on the five areas noted below.

In what sense is pension provision to be considered a possible future burden?
The coverage of occupational pension schemes has quadrupled since the war and now just over half of all UK employees are members of such a scheme. Both private and State schemes have become more generous, and demographic trends have increased the proportion of pensioners to the working population. Professor Rose points out that 'in real terms, consumption by pensioners must be met out of the real resources otherwise at the disposal of their working contemporaries, in the last resort at the expense of consumption by the latter. This truism is independent of the method by which pension schemes are financed...'. On present arrangements, the proportion of total personal incomes taken by pensioners will grow, but provided that significant economic growth continues this growth should still leave room for a large increase in non-pensioners' consumption.

Do funded pension schemes encourage saving, and thus also increase economic growth?
The effect of funding on personal savings will depend on how individuals react to the saving being done for them by pension schemes. Empirical studies have not produced unequivocal results but it seems likely that in the real world, which does not have the perfect capital markets of economic textbooks, funding does increase saving — but not by the full amount of pension provision. These studies are discussed by Professor Rose and the possible effects of public sector funding are considered in Mr Kay's first paper.

Should schemes be funded or operated as pay-as-you-go?
Most private sector pension schemes are funded to protect pension rights in the event of bankruptcy. Many UK public sector schemes are also funded. Mr Kay submits that the main argument for funding (and, in the case of public sector pension schemes, notional funding) is that it provides the 'correct signals' as to the cost of pensions, and (for public sector schemes) for the future implications for taxation.

What is the rationale of the fiscal encouragement of contractual saving?
In addition to prescribing a compulsory minimum level of pensions, the State encourages higher private provision through fiscal incentives. Professor Rose gives examples of greater returns from saving through a pension fund rather than through an ordinary annuity fund. He also notes that the tax arising from pension schemes is similar to the effect of an expenditure tax (as proposed by the Meade Committee) offsetting the general bias in direct taxation now in favour of consumption and against saving.

How far are existing schemes seriously inequitable as between different groups of members?
Because of inflation it has become customary to relate pensions to the salary carried in the final years of employment with the employer. This is penalising those who change jobs in mid-career as compared with those who remain in the same employment; and the possible effects on labour mobility are considered by Professor Rose. Present arrangements also imply a bias against some other classes of contributors. As Professor Rose points out: 'The introduction of such [final salary] schemes is obviously attractive to existing senior employees and to potential high-achievers. However, the benefits which both receive are paid for partly by the younger members ... and by low achievers ...'.