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PENSIONS POLICY AND THE RECESSION

Summary

1. Retirement provision requires a balance between pensions financed by individual saving and pensions paid by the state from taxes and insurance contributions collected from people of working age. The balance to be struck has to reflect the extent to which it is fair to expect future generations to support the current population in old age as against the fact that people of modest means are likely to find saving for retirement very difficult.
2. The Government's policy approach has been based on the view that, for behavioural reasons, individual retirement saving is best facilitated through automatic enrolment into incentivised pension schemes which prevent people having access to their retirement saving until they reach retirement. The Government takes the view that, in order to maintain a fair balance, pension saving should be encouraged and enabled
3. Policy-makers are probably more concerned than households about the burden that some mechanisms for financing retirement impose on future generations. Indeed some households may not fully recognise the implications for their successors of some forms of finance.
4. This means that an overall assessment of whether the nation is saving enough for its changing population structure may give an answer different to that obtained from the question whether and how far existing households have resources adequate to finance their own old age.
5. Capital gains on housing amount to a transfer of resources to existing home-owners from future generations which do not yet own homes and some of the econometric evidence on household behaviour suggests that these gains do affect consumption; they would not do so if households wanted to take full account of the impact of them on their descendents.
6. Savings rates including capital gains have been very high recently. On the other hand savings rates excluding capital gains but taking account of saving by businesses and by the government (both of which contribute to the resources available to address an ageing population) have been low in the last twenty years, both by comparison with earlier periods and relative to other advanced countries.
7. This suggests that policies to raise savings rates are very timely.
8. However, an argument is frequently put forward that, during a recession, the economy can be supported by promoting consumption rather than saving. This raises the question whether the Government's policies of facilitating retirement saving are misplaced.
9. This study concludes that the country's long-term history of low saving makes it sensible to have improved arrangements in place to facilitate saving. It notes that consumption can nevertheless be stimulated by means of other government policies, such as fiscal expansion, which take long-term savings arrangements, along with other aspects of the structure of the economy as given.
10. A more minor point is that the Government's major pension saving reforms do not come into effect until 2012, and won't take full effect until 2015. There is a general expectation that economic recovery will be underway then. But even

if it is not, the point remains that long-term problems can be avoided only by raising the normal rate of saving in the country.

11. Separately, it is possible that pensions participation will be affected by the recession, since there is a strong link between employment and pensions participation. In addition, people's preferences during turbulent economic time may shift towards liquid savings rather than illiquid pensions, although evidence of this is yet to emerge..

Savings Policy and the Recession

Introduction

The Department of Work and Pensions' Service Objective 4 is to "promote independence and well-being in later life, continuing to tackle pensioner poverty and implementing pension reform". The concept of independence in this objective must include financial independence; pensioner poverty is in any case avoided, as a tautology, by ensuring that pensioners have incomes large enough to stop them from being poor.

It is widely but incorrectly asserted that the only way retired people can be supported is by transfers from people currently of working age. There are in fact four ways in which people can be supported and only one of them relies on transfers from younger people. The first is by relying on transfers from people who are currently earnings labour income. The second is by enjoying the income and running down the capital arising from their own past savings invested in productive capital[1]. The third is by relying on transfers paid out by the state financed its, rather than individuals' past saving. The fourth means of financing retirement is through reliance on inherited wealth

Since most people no longer expect to support their own parents in old age, transfers from younger people are managed through the tax and benefit system. The UK state pension and other social security payments are typically funded out of taxes on current income/expenditure and national insurance contributions. The importance of national insurance contributions, which fall entirely on labour income as a source of revenue means that a large part of the revenue system is specifically designed to collect resources from labour income rather than from the broader base enjoyed by income and expenditure taxation. Reliance on this mechanism inevitably means that, as the population ages and the proportion of benefit recipients relative to people of working age also rises, tax and contribution rates would have to rise, an outcome which may not be politically attractive.[2]

The Government's pensions reform programme is designed to increase individual saving, supporting the second mechanism for providing for independence later in life. The balance how far policy makers want to rely on this mechanism rather than the first is obviously a matter for political judgement. But it is adequate to say that, even if no greater reliance is to be placed on it than has been done in the past, the changing age structure of the population and its rising longevity mean that savings rates should probably be expected to rise as the baby boom generation approaches retirement. The Government's policies are designed to facilitate this.

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[1] The way in which this mechanism works can be clarified by imagining the position of someone who wants to keep a cat after retirement. They could buy tins of cat-food while they are working and use up their stock after they retire. The only conceptual difference between this and investing savings in productive capital is that the latter is, in the mean time, lent to people who are prepared to pay for access to it.

[2] An ageing population would not automatically lead to this conclusion. Working lives could extend to reduce the dependency ratio, or pensioner incomes could fall relative to younger people, however unappealing that might be.

The third mechanism is similar to the second except that, instead of people doing saving for themselves, the government does it on their behalf. Were this approach to be adopted the government would run current account surpluses ahead of demographically-related increases in benefit payments. There is little reason to doubt that this approach is possible from an economic point of view but it does not seem that it has ever received serious political consideration.

The fourth mechanism, use of inherited wealth is sometimes discussed. But two rather obvious points need to be made. First, the mechanism can be used only once. If any cohort uses an inheritance to support its retirement, that inheritance will be spent and its children will either have to rely on their own retirement or on transfers from their descendents. Even if only the income associated with inherited capital is used, this, in a growing economy, will, as time goes by, decline relative to general consumption levels and thus relative to expectations of living standards in retirement. Secondly, substantial reliance on such arrangements as a matter of policy would put people who, through no choice of their own, do not inherit any wealth, at risk of poverty in old age.

For practical purposes, then, the choice is between the first and second mechanisms, financing retirement by transfers from people of working age and financing retirement through savings that people accrue during their working lives. Or rather, since neither excludes the other, the balance to be struck between the two.

There are two powerful arguments for the first mechanism to have a substantial place. First of all, since living standards rise with the passage of time, it is reasonable to expect, at least to some extent, people to be supported by their descendents. Secondly, the fact that such arrangements are already in place means that, if reliance on them is reduced, during the transition people will both be supporting previous generations and having to make a higher than normal provision for their own retirement. It should be noted that the need to redistribute resources within generations does not, in itself, make a case for this mechanism. People with very low incomes during their working lives could be given pension saving credits during their working lives, financed by taxes on their contemporaries, rather than benefits during their retirement financed by taxes on their descendents.

There are also powerful arguments for substantial reliance on saving as a means of financing retirement. First of all, the principle that each cohort should pay its own way, or at least much of its own way, has an obvious resonance and provides the basis for the results mentioned subsequently on savings. Secondly, transfers from future generations have to be financed by means of taxation. Taxation inevitably has distortionary effects and there are costs associated with these. Thirdly, the transfer burden as it falls on people of working age inevitably depends on the size of the working population relative to the retired population. This is affected by fertility and mortality rates in a manner which is likely to make it difficult to establish any normative principle of what constitutes a “fair” transfer.

What is Saving? Normative and Positive Analysis

The question whether and how far capital gains should be regarded as saving, or equivalently how far capital gains, and particularly those on land, should be regarded as a means of financing retirement is obviously important. The key message from

Weale (2009) is that there is no correct measure of saving, but rather that policy-makers need to consider which measures of saving are relevant to which questions.

In this summary we focus on two possible questions and their relations with measures of saving.

1. How well equipped are household to fund their retirement, taking benefit arrangements as a given?

   The resources that households have to fund retirement over and above state benefit are those provided by the wealth that they own at market prices. Thus this question is addressed by marking wealth to market and including capital gains as saving. Distributional questions can be addressed only in this context. As with the analysis of any pension fund, a full answer to this question should identify key risks and, in particular, that market values of many assets owned by households are volatile. Households may appear to be well positioned but subsequent capital losses may leave them in a rather poor position. Similary one may wish to consider the question of public finance risk- that benefit rates may fall lower than those expected.

2. Is the nation doing enough to fund its retirement?

   This question is of at least equal importance to the first. If it appears, from aggregate data, that the nation is not doing enough to fund its collective old age, then a logical conclusion must be that at least some households will have difficulty. If aggregate savings are adequate distributional questions must nevertheless be addressed.

   The answer to the second question may appear to contradict the answer because a number of funding mechanisms available to households may function only by burdening future generations to an extent that policy-makers regard as excessive. Thus households' expectations of what is feasible may differ from those of policy-makers. One point is that already alluded to, that demographic change may put downward pressure on socially acceptable levels of benefits paid to retired people. Secondly, there may be other fiscal risks. If the government is running a large deficit then future tax payments will have to be increased; households which appeared to have adequate retirement finance based on current tax rates would discover that their resources were inadequate if they took due account of the fiscal position. Thirdly, and very importantly, many types of capital gain, with gains in land prices being the most obvious, are transfers of resources from future generations to current owners of land.[3] These do not enhance the ability of the economy as a whole to pay for retirement[4]. In many cases they raise the ability of

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[3] Perhaps the simplest way of seeing this is to observe that, while a rise in the price of land may be a consequence of changes to future consumption possibilities, it is hard to see that it can itself add to long-term prospects. The benefits of the gains can be realised only by selling land to people who do not yet own it. The high price results in a larger payment from the buyer to the seller than would be the case had the price of land not risen.

[4] Exceptions are those capital gains on shares which arise from the discovery of new processes or better ways of using capital equipment. Resource discoveries also lead to capital gains which are associated with increased consumption possibilities.

currently active households to pay for their retirement at the expense of future households.

These issues can be addressed in summary form by netting out the transfers which take place, whether intermediated by the government, as with taxes and benefits or through other mechanisms such as capital gains and losses on asset prices, and focusing on the saving of the country as a whole, relative to its consumption needs and plans. Essentially the argument is that, ultimately all of the country's resources accrue to households and that a broad perspective of the position can be obtained by netting out the various different actors in the economy. If this is done the variable which indicates most appropriately the extent to which the country is putting resources aside for the future is net national saving.

These two measures can give very different indications of overall saving. Over the period 2002-2006 net national saving as defined in the national accounts averaged to 3.7% of GDP. On the other hand household saving inclusive of capital gains amounted to 23.4% of GDP. Thus, while neither of these numbers indicates whether saving was adequate to meet retirement needs, the discrepancy between them means that it is more than likely that households would have taken quite a different view of the extent to which assets were being accrued from that taken by policy-makers who were concerned about the overall resources the nation had access to.

It is logically possible that households take an infinite perspective, and plan their savings behaviour in the light of the government's fiscal position and with a full awareness of the impact of rising land prices on their successors. If this were the case households would not regard their capital gains as consumable wealth. But Barrell and Liadze (2009) found quite good evidence that capital gains on housing (and to a much lesser extent on other financial assets) do raise households consumption in the short term. Simulation results on the National Institute Benefit and Tax Model (NIBAX) suggest that the response to capital gains and losses depend on whether labour supply is endogenous or exogenous. If the former labour supply is likely to adjust to offset substantially the effects of gains and losses. If not the simulation model shows impact effects on consumption somewhat larger than those estimated econometrically by Barrell and Liadze. This difference is not surprising. Barrell and Liadze's work does not make any assumption about how far people are concerned about their descendents' welfare while NIBAX assumes that they are not.

Thus the econometric evidence suggests that the way households see capital gains on assets such as housing is different from the perspective which would be taken by a policy-maker concerned about burdens on future generations as well as the welfare of those currently alive. It suggests that, at least at a time of rapidly asset prices people may feel that their retirement provision is adequate because they do not consider fully the implications of reliance on capital gains for their descendents.

Adequacy of Saving

If one starts from the perspective that each cohort should pay its own way, an assessment of the adequacy of saving has to be done on the basis of assumptions about i) future incomes, ii) future spending plans, iii) future mortality rates and iv) future rates of return. While Weale (2009) presents the results of such calculations based on plausible assumptions, it is obvious that the sensitivity of the results to

forecasts of the future means that there is unlikely ever to be a single acceptable number.

There are nevertheless three broad issues which could be monitored in order to obtain some sense of saving adequacy

1. How does national saving compare with past savings rates?
2. How does it compare with saving in other countries?
3. What is happening to the produced wealth of the nation (i.e its produced capital plus net foreign assets)?

On all of these measures the last twenty years stand out as a period in which net national saving was low relative to our own past history and the behaviour of other advanced countries. While this need not, *prima* facie indicate a problem, it should be noted that at the same time both the age structure of the population and rising survival rates of old people might have suggested that net national saving should have been increasing. The Government's policies to promote saving are a recognition of this.

Saving and the Recession

If *prima facie* there is a case that saving needs to be higher, it may reasonably be asked how this is affected by the recession. It is generally accepted that, while the overall output of the economy is in normal circumstances, constrained by available supply, during a recession it is demand rather than supply which is the constraint. A higher rate of saving inevitably reduces demand and one might therefore question whether it is sensible for the Government to be promoting saving in the current circumstances.

There are two reasons for believing that the general thrust of government policy is sensible. The first, and more important is a general strategic issue, while the second is a short-term point.

The arguments sketched out above suggest that the British economy has a long history of under-saving. This view is entirely coherent with that of the Pensions Commission (2006). While there is as yet no clear evidence that overall national saving is likely to rise if more people can be encouraged and enabled to save individually nevertheless it is a plausible assumption. Government policy to promote retirement saving focuses on the promotion of savings schemes with the property that people have no access to their savings until the age of fifty-five and, even at that point, can draw only one quarter in cash with the remainder to be annuitised.

If the view that lock-in arrangements such as pensions are the best way of encouraging people to save for retirement is correct, then it follows that such arrangements should be financially incentivised and encouraged through behavioural economic techniques. What is less clear, however, is the level of saving necessary to meet individuals' retirement needs. This can be seen as a matter of personal preference, since it is, in effect a choice about whether people consume while they are of working age or after retirement. However, the government needs to monitor the position because people may choose to save very little in the expectation that they will be supported by generous state benefits after retirement. If a large number of people reach retirement without saving enough to finance even a low level of consumption

the political pressure for higher state benefits may be very substantial. From the tax-payers' point of view it is therefore important that the government should monitor savings patterns and intervene if saving is very low. Over-saving does not pose the same risk, because it is much harder to see that people should devote very high proportions of their current income to saving for retirement in the belief that they would, at the same time, receive state benefits on a scale larger than is in fact available.

When considering the role of pensions in the macroeconomy, it is therefore essential to make a distinction between the long-term savings needs of the economy, which the government wishes to meet in this way and the short-term benefits of demand stimulus. To play down the importance of long-term saving may result in the public becoming confused over the need to provide for the long run. It is therefore better for the government[5] to provide the necessary stimulus through fiscal means such as tax rebates than for it to weaken its message on long-term saving.

The second factor is one of timing. The government's pensions reforms will not be introduced until 2012. Past periods of falling output have typically not lasted more than two years, and the 1990 recession was shorter than this. On past form, then it is quite likely that by 2012 output will be rising. There may still be spare capacity in the economy and this could be used to justify the stimulus of lower saving but if a recovery is underway the perceived need for stimulus is likely to be lower. However, it should also be stressed that the recession may not evolve as is now forecast. Even if, in 2012, there appears to be a strong case for a further demand stimulus, it will still be the case, for the first set of reasons, that it is better delivered through fiscal means than by a delay in the introduction of automatic enrolment, the minimum employer contribution and personal accounts.

While the recession then, does not have any substantial impact on either the rationale or the timetable for the introduction of the pensions reforms, it may have an adverse impact on people's willingness to save in pensions. A key feature is that savings are locked in until retirement and the Government regards this lock-in or illiquidity as an important means of ensuring that such savings and the tax relief attached to them do indeed support people in their retirement instead of being spent earlier.

Nevertheless, it is widely recognised that precautionary behaviour, as well as planned income smoothing, also motivates saving. From the perspective of a rational household which in normal circumstances would not want to spend its retirement savings early, a draw-back of pension saving is that the money is not available to meet pre-retirement needs. If, for example, people become unemployed it is perfectly rational for them to eat into their savings so as to avoid an excessive reduction in their

[5] The nub of this question is whether it is easier for the government or for households to handle the consequences of high borrowing or low saving. The difficulties that the government faces are, in the short term the risk that high borrowing may push interest rates up and that, in the long term it is politically difficult to bring deficits under control. The problem that households face is that they may well not understand the need to save more in the future to make up for providing a financial stimulus to the economy today. Should they not make up for low saving it is in any case possible that political pressure from pensioners will oblige the government to provide extra state benefits to make good the savings shortfall at some time in the future. On these grounds we think it is better for the government to provide the stimulus taking long-term saving as a given rather than to discourage household from adequate saving with the risk that that might lead to strong political pressure for spending in the future.

spending during the period of unemployment. This desire is catered for by other savings products, such as ISAs, and is entirely consistent with the idea of consumption smoothing, that, taking the resources available to people over their life-times, they prefer slowly changing consumption levels to the alternative of high spending in one year and much lower spending in the next year.

This factor has always been relevant as a deterrent to investment in pensions. But the higher is the risk of unemployment, the greater is the deterrent. The experience of the three previous recessions since the Second World War has been that the unemployment rate has reached its peak at around the time when output has recovered to its value at the start of the recession. This is likely to be in 2011 or 2012. Beyond that it is hard to say how fast unemployment is likely to fall.

Pensions may be more attractive if some way could be found for allowing people some access to their savings during periods of unemployment (and particularly if this did not affect their entitlement to means-tested benefits). Balanced against this must be the implications for the cost of running pension schemes if interim withdrawals[6] are to be permitted.

Conclusions

If people are to have acceptable levels of retirement income and excessive burdens on future generations are to be avoided, then saving out of current income has to play an important role in financing retirement. The current recession does not affect the need for such arrangements in promoting retirement arrangements which do not impose excessive burdens on future generations.

There is a risk of confusion to the public if either the form or the timing of the policy were changed in order to promote consumption and provide a short-term stimulus to the economy. In any case a consumption stimulus can be provided in other ways, for example through fiscal means. The government should recognise, however, that the prospect of higher unemployment may make pension saving less attractive than they would be at a time of low unemployment. Arrangements which allowed people to draw on their accounts in the event of unemployment or financial hardship could mitigate this problem.

References

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[6] There might also be a case for permitting withdrawals to finance training, but the issues surrounding this are beyond the scope of this paper.

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