

Europe Economics Newsletter

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Regulating long-term savings: Pensions in Crisis?

It is a commonplace of British political debate that the pensions system is “in crisis”. All that the main political parties disagree about is how to address this “crisis”. However, “crises” are not always crises; we sometimes misdiagnose a crisis even when there is one; and our solutions even to well-specified crises can often have unexpected effects.

In December 2002 the government established a Pensions Commission, under the chairmanship of Adair Turner. This commission produced its First Report in October 2004, and there followed a period of consultation which closed on 31 January 2005.

The First Report argues that, given demographic

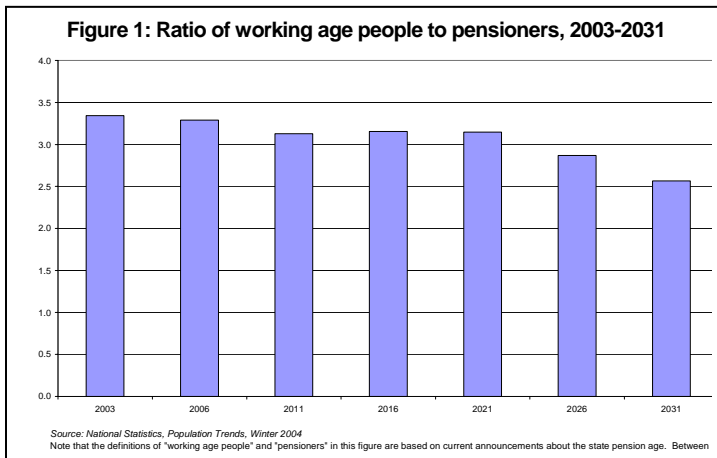
public spending;

- 3) Savings rates could increase;
- 4) Average retirement ages will have to rise.

From a market economics point of view, perhaps the most straightforward interpretation of a scenario in which savings do not appear high enough to prevent a sharp fall in incomes at retirement at or about current retirement ages is simply that people are not expecting to retire at those ages. Young people today may not expect (or even want) to retire at 55 to 65. Or, perhaps, they do intend to “retire” in the sense of not working full-time in their main life careers, but anticipate doing part-time work or consultancy, or taking up some other career (say, writing or teaching) that would bring in enough money to fill the gap they are creating by their savings decisions.

The First Report considers the possibility that retirement ages will rise, and it accepts that this will be part of what happens. However, it believes that the rise in retirement ages required will be too large for this to represent the whole answer. The main reason it gives for this is that the required increase in average retirement ages would be larger than the expected rise in life expectancy, with the result that the proportion of life spent working would increase, reversing the trend, seen since at least 1950, of the percentage of life spent working declining (see Table 1).

The increase required would take the average age of retirement from 63.8 for men and 61.6 for women today to 69.8 for men and 67.4 for women by 2050. This is clearly not infeasible — the evidence offered by the First Report was that greater longevity is being accompanied by extra years of active life, and indeed in 1950 the average male retirement age was 67.2, with some 48 per cent of men aged 65-69 in work (compared with only 21 per cent in work at 66 today). However, the Commission states that its “current judgement...is that it is unlikely that society or individuals in aggregate will wish to choose an increase in retirement ages which is greatly more than proportional to future increases in life expectancy”, and



trends including in particular greater life expectancy, there are significant problems with saving for pensions, with 11.3 million people not making any private pension contributions. It foresees a 30 per cent decline in the relative incomes of pensioners between now and 2035, and suggests there are just four possible ways forward from here:

- 1) Future pensioners could be poorer, relative to workers, than is the case today;
- 2) State pensions could rise, implying either higher taxes/NI contributions or less of other

Interest rates to stay on hold again: The Bank of England Monetary Policy Committee meets on February 9th and 10th. M4 continues to grow at 8-9% on an annual basis, with M0 at 5-6%. Though mortgage approvals are decisively down, house prices appear to have experienced a new year bounce, possibly associated with some catch-up of lending delayed because of the introduction of FSA regulation of mortgage intermediation. CPI inflation rose to 1.6% in December, Average Earnings by 4.4% in the year to November, the claimant unemployment count was down to 826 thousand in December, GDP grew by 0.7% in Q3 2004, but retail sales grew just 0.3% in the three months to December (though 4.7% on the same three months a year earlier).

Matters again appear balanced. House price falls are not well established and gloom about consumption seems premature, while inflation is rising as should be expected from recent strong monetary growth. Interest rates will surely stay on hold.

hence suggests that increased retirement ages will have to be accompanied by increases in state support and/or private savings.

Table 1: Percentage of adult male life spent in retirement

	Average age of exit from workforce	Life expectancy at age of exit from workforce	Percentage of adult life spent in retirement
1950	67.2	10.8	18.0
1960	66.2	11.5	19.3
1970	65.4	12.5	20.9
1980	64.6	14.2	23.4
1990	63.5	17.2	27.4
1995	63.1	18.7	29.4
2000	63.3	19.8	30.5
2004	63.8	20.1	30.5

Source: First Report, Figure 2.8

At first sight, the Commission's judgement here looks rather odd, since as we have suggested the savings behaviour of people today is most naturally interpreted in orthodox economics terms as implying precisely that "individuals in aggregate" are choosing to have such an increase in their retirement ages. The alternatives would seem to be either

- that they are happy to be poor (implausible);
- that they believe that future taxpayers will fund higher state support (surely naïve);
- that they intend to save more later in life; or
- that they are making some kind of mistake.

It is not entirely implausible that the lifetime profile of savings is changing. This might be the case if, for example, people believed that in the future their wages will be considerably higher than they are today. Such a possibility may have been partly involved in stock market valuations of the late 1990s and in the house price boom of the early 2000s. Intending to save more later might also be justified if it is believed that regulations or taxes will change in the future so as to favour pensions compared with those regimes today.

The First Report prefers an interpretation somewhere between the idea that regulations might change in the future to favour savings and the idea that people are presently making mistakes. In particular, it contends that research in behavioural economics illustrates that people are not fully rational, in the economists' sense, but instead take short-cuts and are influenced in many ways by how choices are presented. A combination of such bounded rationality and various asymmetric

information issues arising in the selling process led the Commission to conclude that there are "big barriers" to a "free market voluntarist" solution and that pension saving is likely to be inadequate and remain so without government involvement.

There is a danger that we make mistakes in trying to construct intuitive interpretations of the consequences of bounded rationality. It is very tempting to look at the results of some psychological survey, come to the conclusion that economic agents are less-than-fully rational in some way, and think that we know what implications that will have for how markets function. But the economic intuitions of regulators and commentators have been trained to guide policy in rational settings. In models where economic agents are boundedly rational many unexpected things happen and our normal intuitions are a poor guide. For example, the Europe Economics Staff Working Paper "Regulating markets with Short-sighted Decision-makers" sets out explicit models of the behaviour of short-sighted agents in which, contrary to natural intuitions, short-sighted decision-making creates more problems for short-term decisions than long-term ones, and in fact under some conditions short-sightedness can lead people to make ideal long-term decisions.

The significance of this for pensions policy is that policy-makers might easily make mistakes in considering new regulations for forced savings or new state pension arrangements if they devise these schemes on the basis of intuitive interpretations of the implications of bounded rationality. Bounded rationality may well have significant implications for savings decisions, but policy should be guided by insights derived from explicit models.

If government policy did make pensions saving more attractive, that could have significant unexpected effects on other markets. House price rises of recent years may have partially reflected problems with pensions. Assuming that the Commission is right to believe that falls in pensions saving reflect rising problems in understanding pensions or falling confidence in pension funds, or other similar effects, it seems likely that housing would represent an alternative destination for savings funds. This extra money entering the housing market would surely have been a factor in the house price boom since 1998. If the government succeeds in making pensions saving more attractive, or if the job is done by improving equity markets, these investment funds are likely to shift back out of housing and into pensions, with profound implications for house prices.

Other news: Jan 14:Europe Economics publishes comment on new water mergers regime...Jan 25:Windfall tax on oil companies debated by Trade and Industry Select Committee, but rejected by government..Jan 25:CPRE publishes Europe Economics report on the Taxation of Property...Feb 2: Fed raises US interest rates to 2.5%