DOES IT MATTER WHAT TYPE OF PENSION SCHEME YOU HAVE?

In 1990, there was one pensioner in the UK for every four workers. By 2030, it is estimated that there will be nearly two pensioners for every five workers. This so-called 'Demographic Timebomb' means that the way in which people provide for their retirement has to change. In a paper published in the February 2000 *Economic Journal*, **David Blake** outlines the options for reform. He argues that, in the world in which we now live, funded schemes provide greater security than PAYG (i.e. unfunded). But the choice between which type of funded scheme you choose will depend on both your behaviour and your characteristics.

There are essentially two types of funded scheme: the defined benefit (DB) scheme, where the benefits to be received by the pensioner are independent of the performance of the pension fund, and the defined contribution (DC) scheme, where the contributions are fixed but the benefits depend on the performance of the fund. In the UK most DB schemes are arranged by companies and are known as occupational final salary schemes, since the pension is some proportion of final salary, where the proportion depends on years of service in the scheme. DC schemes are better know as personal pension schemes.

DB schemes offer an assured income replacement ratio in retirement: pensioners can expect to enjoy a standard of living related to their standard of living just prior to retirement. But this is the case only for workers who remain with the same employer for their whole career. Fewer than 5% of workers in the UK do this. The average UK worker, who changes jobs about six times in a lifetime, would lose 25-30% of their full service pension compared with someone who stays with the same employer for their whole career. Even someone changing jobs once in mid-career can lose up to 16% of the full service pension.

Individual DC schemes have the advantage of complete portability when changing jobs. However, they tend to have much higher operating costs than occupational DB schemes. Individual DC schemes in the UK take around 2.5% of contributions in administration charges and up to 1.5% of the value of the accumulated assets in fund management charges. It is estimated that these costs are equivalent to a reduction in contributions of 10-20% – the equivalent costs of running an occupational scheme are 5-7%.

In addition, there are a number of problems facing both annuitants and annuity providers that are an impediment towards the provision of a successful private sector DC scheme. First, there is an adverse selection bias associated with mortality risk – i.e. only individuals who believe that they are likely to live longer than average will wish to purchase annuities. Second, mortality tends to improve over time and there can be severe consequences if insurance companies underestimate these improvements. Third, there is an inflation risk, in that unanticipated high inflation rapidly reduces the real value of pensions. Fourth, there is an interest rate risk, in that annuity rates vary substantially over the interest rate cycle.
Blake outlines a number of policy recommendations to deal with the above problems:

- If governments wish to preserve a component of the pension system that is PAYG, then they have a responsibility to ensure its long-term viability. This can only be achieved by severely constraining the real growth rate in state pensions or by systematically raising the retirement age in line with increased longevity.

- If governments want to maximise the value of pensions in the private sector, then they must provide an infrastructure that helps the private sector. The regulatory framework should be kept as simple as possible in order to minimise compliance costs, and charging structures should be made simple and transparent to enable consumers to identify the most competitive providers.

- Governments could also keep costs down by enabling economies of scale to be exploited more fully (e.g. by establishing a central clearing house to channel contributions in the case of DC schemes) or by introducing a common set of actuarial assumptions, as in the Netherlands, which would enable full service credits to be transferred between schemes when workers change jobs, thereby improving the portability of DB schemes.

- Governments could help the private sector cope with the market failures that make it difficult for individuals to hedge certain risks. For example, surplus risk could be hedged more effectively through the introduction of zero-coupon wage-indexed bonds and mortality risk could be hedged through the introduction of survivor bonds.

- If governments wish to promote the efficient management of pension assets they should encourage the introduction of appropriate incentives, such as greater transparency in published performance data and the adoption of performance-related fund management fees. This would encourage the less talented fund managers to invest in indexed funds, with consequential benefits in terms of lower fund management charges and a lower dispersion in performance.

However, the greatest impediment to having an adequate pension in retirement is inadequate pension savings made during the working lifetime. Only with sufficient mandatory minimum contributions into a funded pension scheme (with credits given to those on very low earnings) can an adequate retirement pension be achieved. But few governments seem willing to confront this issue: the UK mandatory minimum for the second-tier supplementary pension is not sufficient to build an adequate pension and the UK Government's 1998 Green Paper on Pensions explicitly rules out additional compulsory contributions. Yes, the type of pension scheme matters, but the level of pension saving matters most of all.

Note for Editors: 'Does it Matter What Type of Pension Scheme you have?' by David Blake is published in the February 2000 issue of the Economic Journal. Professor Blake is Director of the Pensions Institute, Birkbeck College, University of London.

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