Final Salary Pensions and UK Competitiveness

The Green Paper shows that State funding of pensions is well under control in the UK, especially relative to other countries in Europe. But, this is not necessarily good news! If the Exchequer will be spending much less as a proportion of GDP on pensions than other countries, with a reasonably similar demographic profile, this might mean:

1. Our corporate sector is picking up the cost of supporting pensioners which is borne by the State elsewhere – so the cost base and competitive position of corporate UK will suffer

or

2. private individuals need to save much more in the UK, to make up for less State pension support – this is not happening

or

3. UK pension levels will be much lower than in other countries, - implying lower consumer spending, more poverty and lower long term growth in the UK, as an increasing proportion of the population has low incomes.

Any of these implications is worrying from a long term perspective. Policy makers have not focussed on the longer term competitive problems facing many UK firms as a result of our pension system. We have a large pool of retirement savings, but our system relies on generous occupational pensions from mainly defined benefit schemes, which have become increasingly mature and expensive and which rely on superior equity returns to be affordable over the medium term. I believe this system cannot be relied upon to continue delivering high pensions, without damaging corporate sector financial strength and economic growth prospects.

The recent bear market in equities has made the situation worse, but there are many other reasons why final salary pension provision has become unaffordable here. The schemes have been raided by Governments and employers and ravaged by equity falls. Industrial restructuring of recent decades - hiding the costs of labour force reductions in early retirement packages funded by pension schemes, the 1997 Pensions Act with its indexation requirements, MFR, tax rules penalising surpluses, removing ACT relief, contribution holidays, optimistic investment assumptions, over-reliance on equities, incorrect longevity assumptions, FRS17 – all of these have undermined the sustainability of UK final salary schemes. The schemes have grown significantly, often dwarfing the size of their sponsoring companies and there are not enough young members to offset the increase in pensioners. This applies to the private sector – where final salary pension liabilities of maturing schemes could seriously undermine the competitive position of corporate UK – and the public sector - where the costs of funding pension promises will entail large rises in council and general taxes.

We need to ask why employers should be expected to support retiring employees (after working there for perhaps a few years) for a further 20 or 30 years? Why should the cost uncertainties of such a commitments fall on employers and shareholders? With a DC system, employer just have to provide a certain proportion of salary towards employees' pensions, a pre-determined amount, that can be planned for and negotiated upon.

The trend away from DB is inevitable. We are no longer in a paternalistic society, where individuals work loyally all their lives for one employer. Ownership of firms changes, job mobility is more common, working lives have shortened and individuals are living much longer than when our pension system was devised. The reliance on and strong performance of equity investments has masked these problems, but this cannot last.

Surely, the role of supporting the elderly should be funded collectively, by society as a whole, or individually, by people's accumulated savings or continued earnings. The role of the employer should not be as a lifelong support system but to facilitate individual savings, provide a certain level of contributions by way of salary deferral, and ideally provide a collective mechanism for investing the funds. Pooling of accounts, rather than reliance on individual provision would be much more cost effective.

Employers should also have a vested interest in enabling workers to delay drawing their pension for longer, perhaps working part time at older ages. The Green Paper proposals to encourage flexible and gradual retirement are an important part of the answer for ensuring better income and growth prospects in the UK over the longer term, but improving the workings of DC, encouraging higher contributions and better structured investment options are important too.

In summary, the Green Paper tackles the 'work' aspects of financing of our ageing population well, but the 'pensions' side less so. We are on the cusp of a major change in occupational pension provision, requiring careful management of the move to DC, to help us maintain a successful system of private pension support in future.

We can no longer pretend that companies will be able to fund pensions for the increasing numbers of older people, while State support costs stay stable. The drain on UK corporate competitiveness will pose a problem for our economy. Our firms will not be competing on level terms – past pension promises will detract from future profits, unless something changes quickly.

Perhaps we should recognise that companies paying generous pensions are taking over some of the responsibilities of the State and cut corporation taxes for those firms offering good schemes?