

WHAT TO DO ABOUT RETIREMENT AGES

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Abstract

Perceptions of a looming financial crisis in pay-as-you-go state pension schemes, especially in Europe, have led governments to search for ways to reduce the long term rate of growth of public pension liabilities. European governments have before them three possible approaches to pension reform. The first is wholesale privatisation along Latin American lines. The second is to preserve the existing PAYG schemes, but with some cost reducing parametric changes. The third approach, and the one most likely to be followed, involves partial privatisation combined with some changes to the parameters of existing public schemes. Indeed, many governments are already introducing changes to the rules of their public schemes, including reductions in scheme generosity and increased contributions. Some countries are also considering increasing the state retirement age.

Given increasing longevity, increases in state retirement ages seem entirely logical. Raising retirement ages would slow the rate at which old age dependency ratios are deteriorating and, by shortening the pensionable portion of individuals' lives, reduce future pension expenditures. There are, however, some important equity considerations associated with increasing state retirement ages. This is because increases in the official age of retirement will not affect all groups in society equally.

This paper considers the case for raising state retirement ages in the light of expected demographic trends. In exploring the various options open to governments, emphasis is given to equity between different socioeconomic groups. In particular, consideration is given to the impact upon groups with non-typical life expectancies and/or whose life time earning profiles differ markedly from the average.

Introduction

Perceptions of a looming financial crisis in pay-as-you-go state pension schemes, especially in Europe, have led governments to search for ways to reduce the long term rate of growth of public pension liabilities. European governments have before them three possible approaches to pension reform. The first is wholesale privatisation along Latin American lines. The second is to preserve the existing PAYG schemes, but with some cost reducing parametric changes. The third approach, and the one most likely to be followed, involves partial privatisation combined with some changes to the parameters of existing public schemes. Indeed, many governments are already introducing changes to the rules of their public schemes, including reductions in scheme generosity and increased contributions. Some countries are also considering increasing the state retirement age.

In Britain, the official retirement age - the age at which a person becomes eligible for a state pension - is currently 65 for men and 60 for women. It has not always been so. When public pensions were first introduced, in 1908, 70 was selected as the age at which qualifying individuals, men as well as women, could receive a retirement income from the state. In 1925, the retirement age was reduced by five years, to 65. Further change came in 1940, when the retirement age for women was reduced to 60. The justification for a lower female retirement age appears to have been the average five year age gap, at that time, between married couples. With men, on average, five years older than their wives, the change made it possible for many couples to retire together.

After more than 60 years of stability, change is set to take place once more. The Government decided, in 1993, to equalise male and female retirement ages, by raising the age at which women can receive a state pension by five years, to 65. The change will be phased-in over a 10 year period, beginning in 2010. Women born before 6 April 1950 will be unaffected. Women born between 6 April 1950 and 5 April 1955 will be able to retire between the ages of 60 and 65, depending upon their date of birth. All women born on or after 6 April 1955 must wait until they are 65 before they can receive their state pension.

With the UK's old-age dependency ratio - the ratio of retired people to those of working age - projected to worsen over the coming decades, the possibility of raising the official retirement age to 67 or 70 is now being considered. In the United States, the normal retirement age of 65 is already set to rise, under legislation introduced by Ronald Reagan in 1983. Workers born after 1943 will not become eligible to receive a full pension until the age of 66. Those born after 1959 will have to wait until they are 67. Although Americans will still be able to retire on reduced benefits at the earlier age of 62, the associated benefit reduction will be around 30 per cent compared with 20 per cent today. Among a number of suggested changes put forward by the 1997 report of the U.S Advisory Council on Social Security was a proposal to bring forward the date at which 67 will become the normal age at which all U.S workers retire - currently 2027 - and then to raise the retirement age by a further three years, to 70.

Given increasing longevity, an increase in the UK's official retirement age seems entirely logical. Raising the retirement age would slow the rate at which the old age dependency ratio will deteriorate and, by shortening the pensionable portion of individuals' lives, would reduce future pension expenditures. There are, however, some important equity considerations associated with any increase in the state retirement age. This is because an increase in the official retirement age would not affect all groups in society equally. It is the equity implications of an increase in the UK's retirement age that form the focus of this paper.

The paper is organised as follows. The next section sets out the rationale for raising the UK's retirement age from a

generational accounting perspective. The discussion then turns to a consideration of the implications of a higher retirement age for people with non-typical life expectancies and/or whose lifetime earnings profiles differ markedly from the average. It is suggested that increasing the retirement age may not be a good way to maintain the UK's generational accounting balance. The paper concludes with an examination of some possible alternatives to raising the normal age of retirement.

Retirement Ages and the Fiscal Balance

Even before state pensions were introduced, people worried about the cost of such schemes to the taxpayer. Although state pension schemes were set up to provide financial assistance for those who were too old to support themselves through work, the choice of retirement age was made principally on the basis of cost. As Thane (1978) shows, in Britain, it was generally agreed that 65 was the age at which most peoples' physical powers had declined to the point where they were no longer capable of regular work. Yet, as in Germany, where state pensions were first introduced in 1889, 70 was chosen as the official retirement age for the British scheme, established in 1908.

Under the 1908 scheme there was no automatic right to a pension. The scheme was a non-contributory one, with eligibility for a pension restricted to those aged 70 and over, whose incomes were less than 12 shillings per week. It was hardly a pension scheme at all. Rather, it was a mechanism for delivering poor relief to the destitute old provided out of the benevolence of taxpayers. The insurance principle on which the current state pension arrangements are based has its origin in the Widows', Orphans and Old Age Contributory Pensions Act of 1925. Under this Act, workers became entitled to a pension at the age of 65 in return for contributions paid during their working lives. The scheme was intergenerationally redistributive, since contributions were really a tax on workers which was used to meet the cost of providing pensions for their predecessors. This arrangement was politically acceptable because of an implicit bargain between the generations. Those currently in employment were willing to accept slightly higher taxes - sufficient to pay for the pensions of former workers - in return for having the cost of their pensions met by the next generation.

It made perfect sense, in 1925, to establish a pension scheme which redistributed income between different generations. Taxes were low, because the cost of providing pensions for a relatively small number of retired people was spread over a large working population. Moreover, as economic growth raised the incomes of workers, pension benefits could be increased without the need to increase the tax rate. Over time, then, successive generations of pensioners were able to receive more in pension benefits than they had paid out in contributions.

By the 1980s, though, serious doubts were being expressed about the long term affordability of the state pension scheme. Improvements in life expectancy, and falling fertility rates, had gradually altered the once favourable population balance between pensioners and workers. The old age dependency ratio, which stood at 0.10 in 1921, had risen to 0.13 by 1941, 0.15 by 1961, and 0.22 by 1981. What's more, this upward trend in the old age dependency ratio, which was also apparent in other developed economies, was projected to accelerate over the coming decades. As Johnson and Falkingham (1988) observe, rather than question the economic usefulness of the old age dependency ratio, its increase was widely regarded as evidence that the elderly were becoming an economic burden on society, a burden that might not be sustainable in the long run. Since then, a succession of high-profile reports (OECD, 1988; World Bank, 1994; Bank for International Settlements, 1998; OECD, 1998) have highlighted the need for urgent remedial action by national governments to counter the looming fiscal crisis implied by population ageing.

In order to measure the potential fiscal burden implied by long term population ageing, and to determine the magnitude of the necessary policy adjustments, governments around the world are nowadays making increasing use of the relatively new technique of generational accounting. This is a technique developed in the 1990s, (Auerbach, Gokhale and Kotlikoff, 1991; Kotlikoff, 1992; Auerbach, Gokhale and Kotlikoff, 1994) to describe the burden imposed by fiscal policy on different generations. It involves the calculation, and comparison, of generational accounts for different birth cohorts. Generational accounts are defined as the lifetime net taxes paid by people born at different times, expressed as a proportion of their lifetime earnings. They are calculated as the present value of the taxes paid over the lifespan of a typical member of a particular birth cohort net of any transfer payments he or she receives. Generational accounting is not without its problems. Various aspects of the generational accounting method and its practical application are analysed in Haveman (1994), Buiter (1995) and Baker and Weisbrot (1999).

Central to generational accounting is the intertemporal budget constraint. This is the requirement that the unpaid government bills of those currently alive must ultimately be paid by future generations. Because of the intertemporal budget constraint, for a given fiscal policy, any unpaid government bills run up by the current generations will raise the generational accounts of those not yet born. The way this works is summarised in the following formula.

$$\begin{array}{lclcl} \text{present value of} & \text{present value of} & \text{present value} & \text{government} \\ \text{remaining net tax +} & \text{net tax payments} & \text{of all future} & \text{net} \\ \text{payments of} & \text{of future} & \text{government} & \text{wealth} \\ \text{existing generations} & \text{generations} & \text{consumption} & \end{array} =$$

Auerbach, Gokhale and Kotlikoff (1994)

Generational accounting is a way of describing not only what those currently alive will have to pay, based on existing policy, but also what future generations must pay. (Auerbach, Gokhale and Kotlikoff 1994) If the generational accounts of future generations are greater than those faced by the current birth cohort, existing policy is unsustainable because it is generationally unbalanced. To restore generational balance, it would be necessary for those alive today to pay higher taxes and/or receive less in government transfers. The old are currently the major recipients of government expenditures on social security and healthcare in most developed countries. Indeed, as Ferguson (2001) notes, they are net beneficiaries of most First World fiscal systems. Consequently, they are an obvious target for measures aimed at reducing government spending in order to maintain long term generational balance. One such measure would be to raise the normal age at which people became eligible to receive a pension from the state.

The case for raising the retirement age to 67 or 70 is straightforward. As Table One shows, life expectancy in the UK rose significantly throughout the twentieth century. It is projected to continue rising in the coming decades. Furthermore, improvements in the health of older people mean that 65 is no longer the age at which most people's physical powers have declined to the point where they cannot work in order to support themselves. On these grounds alone there is a *prima facie* case for lengthening the working portion of people's lives. An increase in the retirement age could, moreover, significantly alter the intergenerational balance of current fiscal policy. This is because a higher retirement age would shorten the period during which people collect pension payments and, consequently, reduce the total value of the benefits they receive. Some people would not live to the new retirement age and so would not receive any pension payments at all. At the same time, by working for longer, those who do make it to retirement would end up having paid more in taxes. In other words, their generational accounts would have risen, reducing those of future generations.

Table 1
Life Expectancy at Birth

	Males	Females
1901	51	58
1921	61	68
1941	69.6	75.4
1961	73.6	79.1
1981	75.5	80.4
1999	76	80.8

Source: Thane (2000)

The generational imbalance implied by recent UK fiscal policy appears to be relatively minor, compared with Japan, the U.S

and some other industrialised countries - Cardarelli, Sefton and Kotlikoff (1999). This suggests that the need for an increase in the retirement age may be less pressing in Britain than it is in some other countries. There are three reasons for Britain's relatively good long term fiscal position. First, the rate of population ageing is projected to be lower in Britain than in some other developed countries. Second, the basic state pension in the UK is only worth around 15 per cent of average earnings, compared with more than 60 per cent in some continental countries. Finally, since 1979, a series of measures has been put in place to reduce the long term rate of growth of state pension expenditures. These include: a switch to the exclusive use of price indexation for uprating pension benefits, incentives for people to opt out of SERPS - the state earnings-related pension scheme - and the equalisation of male and female retirement ages at 65, beginning in 2010. Even if a good case could be made though, on intergenerational grounds, for raising the UK retirement age, as the following section shows, there are some important equity issues that militate against such a move.

The Differential Impact of Later Retirement

With life expectancy still rising, and the health of older workers improving, an increase in the normal retirement age seems perfectly reasonable. Raising the retirement age would cut the future cost to the exchequer of providing state pensions. It would also reduce the rate at which the old age dependency ratio deteriorates and improve the long term fiscal balance. Of course, people with private pensions would still be free to cease working before the state retirement age. Indeed, an increase in the state retirement age might be expected to lead to increased take up of private pensions. This is something successive British governments have sought to encourage. Analysis of the implications of a higher retirement age for different social groups, however, suggests that the case for such an increase is less clear-cut than it appears at first sight.

Other things being equal, raising the retirement age would affect workers in two important ways. First, by shortening the portion of their lives during which state pension payments are received, the total value of these benefits to all workers would be reduced. The exact size of the benefit reduction for any particular worker would, of course, depend upon how long he or she actually lives after retirement. Second, raising the retirement age would increase the value of private pensions. This is because income from a private pension would represent the only means by which most workers could avoid the necessity of remaining in employment beyond the age of 65. The extent to which the members of different groups in society would be affected by an increase in the state retirement age would depend, therefore, upon their particular post-retirement life expectancy and their ability to accumulate a worthwhile private pension income.

Significant disparities exist in the mortality experience of different groups in society. (Baker and Weisbrot, 1999; Weller, 2000; Attanasio and Emmerson, 2001) As table Two shows, on average, women aged 65, in the UK, can expect to live 3.5 years (23 per cent) longer than 65 year old men. Since the longer life expectancy of women is not reflected in lower weekly pension payments, Britain's state pension system is - notwithstanding the current five year lower female retirement age - considerably more generous to women than it is to men. Consequently, any increase in the retirement age would, on average, result in a proportionately larger reduction in total lifetime pension benefits for men than it would for women.

Table 2

Residual Life Expectancy at Age 45 and 65 in the UK (2000)

	years remaining at age 45	years remaining at age 65
Men	32.0	15.1
Women	36.4	18.6

Source: Government Actuary's Department

Differences in the average life expectancy of 65 year old males and females mask substantial variation in the life chances of men and women from different socioeconomic groups. As Table Three shows, a positive correlation exists between a person's socioeconomic class and their probability of survival. It can be seen, for example, that 65 year old men from classes iv and v have a 19 per cent probability of dying before reaching age 70 - three percentage points above the average for all men. Men from classes i and ii, on the other hand, have an almost 19 per cent greater than average chance of survival. Similarly, although females generally have a greater probability of survival than men at all ages, the table shows that 65 year old women from classes iv and v have an 11 per cent less than average chance of reaching age 70. This compares with a 33 per cent greater than average chance for women from classes i and ii.

Table 3

ABRIDGED LIFE TABLES BY SOCIO-ECONOMIC CLASS, ENGLAND AND WALES
1987-91

Age:	I-II	IIIM	IIIN	IV-V	All
Males					
60-64	0.08	0.1	0.08	0.13	0.1
65-69	0.13	0.16	0.15	0.19	0.16
70-74	0.2	0.25	0.23	0.29	0.25
75-79	0.29	0.36	0.33	0.38	0.35
80-84	0.41	0.48	0.45	0.52	0.47
85-89	0.64	0.62	0.56	0.62	0.61
90+	1	1	1	1	1
Females					
60-64	0.05	0.06	0.05	0.06	0.06
65-69	0.06	0.09	0.07	0.1	0.09
70-74	0.12	0.16	0.13	0.17	0.15
75-79	0.18	0.24	0.22	0.23	0.22
80-84	0.32	0.36	0.31	0.37	0.36
85-89	0.47	0.51	0.57	0.52	0.5
90+	1	1	1	1	1

Source: Murthi, Orszag and Orszag (1999)

Given the differences in the life chances of people from different socioeconomic classes in the UK, it is apparent that an increase in the state retirement age would impact more heavily on workers with below average incomes. The same is true in the U.S. As Table Four shows, low income women in America can typically expect to live 3.6 fewer years after 65 than those with incomes at or above the national average. For low income men the difference is -4.6 years.

Table 4

Life Expectancy at Age 65 in 1997 (USA)

	Remaining life expectancy at age 65 in years	Chance of reaching age 74 after reaching 65 in 1996
Total	17.7	77%
Women	19.2	82%
Men	15.9	72%
African Americans	16.1	70%
African American men	14.2	63%
Low income women	15.6	71%
Low income men	11.3	61%

Source: National Center for Health Statistics
in Weller (2000)

Reductions in total state pension payments arising from an increase in the retirement age must be analysed in the context of other forms of retirement income, principally private pensions. This is because private pensions - whether occupational or personal - constitute an important source of supplementary income in retirement, which could be used to offset any reduction in state pension payments. As noted earlier, private pensions would, following an increase in the state retirement age, also represent a means by which workers could avoid the necessity of remaining in employment beyond the age of 65. Membership of occupational pension schemes has never been much above 50 per cent of the active workforce. Today, it is around 45 per cent. Roughly two-thirds of male workers are covered by an occupational scheme, compared with only about one-third of employed women. Around 25 per cent of the workforce are currently contributing to a personal pension. More than a quarter of the employed workforce, however, are not members of any private pension arrangements.

Unfortunately, membership of a private pension scheme is not equally advantageous for all workers. Private schemes are of most benefit to workers who join at an early age and who maintain a continuous flow of contributions throughout their entire working lives. Consequently, they favour workers in secure occupations. Late starters, early leavers, low-paid workers and individuals with discontinuous employment patterns all tend to do less well out of private pensions, whether salary related occupational schemes or individual money-purchase plans. Workers with these less favourable employment characteristics tend to be concentrated in socioeconomic classes iv and v. Thus, private pensions are typically of greatest benefit to members of classes i and ii. Moreover, although the health of older workers has improved in recent years, these improvements have not been as dramatic for unskilled and semi-skilled workers as they have for those in professional and managerial occupations. As a result, the obligation to continue in employment beyond the age of 65 would be more physically onerous for workers in socioeconomic classes iv and v than for those in classes i and ii.

It is clear, then, that raising the retirement age would be particularly problematic for workers from socioeconomic classes iv and v. Not only do these workers have substantially shorter life expectancies at 65 than those in classes i and ii, but they are less well-placed to accumulate a worthwhile private pension. The case for raising the official retirement age rests on the perceived need to cut costs. Yet, as Hutton, Kenedy and Whiteford (1995) have observed, in pensions policy, cost is not the only consideration. Fairness is equally important. A policy which impacts most heavily upon those who can least afford it cannot be a good one.

Conclusion

The belief that population ageing will, in the near future, make redistributive state pension schemes unsustainable, has led governments around the world to search for ways to reduce the long term rate of growth of their public pension liabilities. Increasing life expectancy, and improvements in the health of older workers, suggest that raising state retirement ages would be a good way to achieve this objective. Indeed, some governments have already increased the age at which their citizens become eligible to receive a pension from the state. Others are likely to do the same. Raising the retirement age makes sense, from a generational accounting perspective, since it would reduce the burden imposed by current fiscal policy on future generations of taxpayers. In pensions policy, however, cost is not the only consideration. Issues of fairness are also important.

As this paper has shown, the impact of an increase in the UK's official retirement age would not be the same for everybody. Workers in socioeconomic classes iv and v would suffer much more than those in classes i and ii, because they have lower post-65 life expectancies and are less able to accumulate a worthwhile private pension. Given that the generational imbalance implied by current UK fiscal policy appears to be rather small, a case can be made, on equity grounds, for maintaining the current retirement age. In fact, there are other, more equitable, ways to ensure that Britain's long term fiscal balance does not deteriorate as the population ages.

One way to increase the generational accounts of people alive today, and thereby reduce those of future generations, would be to provide workers with incentives to postpone collecting their pension after age 65. This might be done, for example, by permanently increasing pension benefits by a given amount for each month of postponement. The option to receive enhanced benefits in return for delaying their retirement has been available to Canadians since the 1960s. The Canadian Pension Plan permits workers to receive a 0.5 per cent benefit increase for each month of postponement beyond age 65, up to age 70. An alternative approach would be to reduce the rate of income tax payable by workers who delay collecting their pensions. Policies to promote greater labour market participation by people in the decade prior to retirement would also improve Britain's long term fiscal balance. Employment rates for those aged 55 to 64 have declined significantly since the late 1960s, especially for men. The proportion of males aged 55 to 64 in employment fell from more than 90 per cent, in 1968, to less than 70 per cent, in 1996. For men aged 60 to 64, the participation rate was more than halved over this period. (Blundell and Tanner, 1999) Underlying these reductions has been a high level of redundancies amongst older male workers and a growing trend towards early retirement. Since private pension payments are taxed in the same way as earned incomes, early retirement is less problematic, from a generational accounting perspective, than older age unemployment. Not only

do unemployed workers pay little in taxes, they are, like state pensioners, substantial recipients of transfer payments.

Appendix: Socioeconomic Classifications

Classification Occupations

i	professional
ii	managerial, technical
iii	skilled
	(m) manual (n) non-manual
iv	semi-skilled
v	unskilled

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