Reforming UK pensions for today’s and tomorrow’s older people

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14 September 2005

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Reforming UK pensions

• Why is reform needed?
• What reforms should be considered?
The UK pension system

Tier 1
- State Unfunded Contributory Compulsory for workers
  - BSP: Basic State Pension

Tier 2
- State Unfunded Contributory Compulsory for employees
  - S2P: State Second Pension Previously SERPS

Tier 3
- Private Funded Incentivised Occupational and personal pension savings

State Means-tested

Pension Credit = Guarantee Credit + Savings Credit

The backdrop

- People are living longer
- The state pension is declining
- Savings are flat

If nothing else changes, tomorrow’s pensioners will be relatively poorer, on average, than today’s pensioners
The structural arguments for reform

1. Unequal outcomes
2. Complexity a barrier to action
3. Too high expectations of saving
4. State pensions unsustainable

Retirement income varies greatly
Pre-tax income of single pensioners by quintile
2003/4, £ per week
Multiple reasons for unequal outcomes

Earnings
State pension & benefits
Higher earners more likely to work
Occupational pension & personal pension
More £s saved and more tax relief per £
Contributory system: gaps for women and carers
SERPS: higher pensions for higher earners
Benefits: More saving = more Savings Credit

Outcomes vary by cohort - women
State pension income at age 65, £ per week in 2005/6 earnings terms, by earnings decile
Outcomes vary by cohort – men

State pension income at age 65, £ per week in 2005/6 earnings terms, by earnings decile

Contributionary pensions disadvantage women

Typical differences in weekly state pension income in 2005/6 earnings terms
**Around 20% of pensioners are in poverty**

<table>
<thead>
<tr>
<th>Proportion of pensioners in households with incomes below 60% of median, 2002-3</th>
<th>Before Housing Costs</th>
<th>After Housing Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single male pensioner (1.1 million)</td>
<td>17%</td>
<td>17%</td>
</tr>
<tr>
<td>Single female pensioner (3.0 million)</td>
<td>22%</td>
<td>21%</td>
</tr>
<tr>
<td>Pensioner couple (3.0 million)</td>
<td>21%</td>
<td>23%</td>
</tr>
</tbody>
</table>


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**The structural arguments for reform**

1. **Unequal outcomes**
2. **Complexity a barrier to action**
3. **Too high expectations of saving**
4. **State pensions unsustainable**
The UK pension system

Tier 1
- State
- Unfunded
- Contributory
- Compulsory for workers
  - BSP: Basic State Pension

Tier 2
- State
- Unfunded
- Contributory
- Compulsory for employees
  - S2P: State Second Pension
  - Previously SERPS

Tier 3
- Private
- Funded
- Contributory
- Incentivised
- Occupational and personal pension savings

State Means-tested

Pension Credit = Guarantee Credit + Savings Credit

More older people will be means tested

Estimated proportion of people over state pension age eligible for Pension Credit

Pension Credit take up: 50% - 80%

- 50% 52%
- 60% 64%
- 65% 71%

- DWP estimate
- IFS estimate

DWP estimate
IFS estimate
The UK state pension and benefits system is complex

• Over 100 parameters define an individual’s future state pension income
• Over a lifetime, parameters may change:
  • Individual circumstances
  • Government policy
  • Annual Budget decisions

State pension forecasts partially helpful, but potentially confusing
The structural arguments for reform

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It was hoped private pensions would grow rapidly

Projected income paid to pensioners as a percentage of GDP, 1998 Green Paper

- 1998:
  - Occupational and personal pensions: 9.0%
  - State pension & benefits: 5.4%

- 2050:
  - Occupational and personal pensions: 11.3%
  - State pension & benefits: 4.5%
State pensions will be important to most people

Number of people of working age by income group with or without a private pension, millions

Accruing occupational or personal pension?

- Yes: 15m
- No: 20m

The 40:60 shift will not happen on current trends

Projected income paid to pensioners as % GDP, 2050

- Occupational and personal pensions: 10.9%
- State pension & benefits: 6.9%

1998 Green Paper aspiration: 6.8% 4.5%
Pensions Commission central estimate: 37% 4.0%
Why is private pensions saving not growing?

- Employers limiting expenditure on employee pensions
- Means-tested state benefits a barrier to selling and buying pensions
- High living costs, especially at young ages
- Low trust in pension products
- Low interest in savings and pensions
- People prefer to spend money now!

The structural arguments for reform

1. Unequal outcomes
2. Complexity a barrier to action
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4. State pensions unsustainable
There will be many more people over SPA

There will be many more people over SPA in the UK.

State spend on pensions falls below the number of people over SPA

State spend on pensions falls below the number of people over SPA in the UK.
The UK’s spending plans look out of line

Illustrative Government spending on state pensions % GDP

The ‘reverse credibility’ problem (1)

- State expenditure on pensions is projected to grow much more slowly than the number of people over state pension age...
- ..and private pensions do not look likely to make up the balance
- So although it looks like we are fiscally prudent, political expediency is likely to mean future ad hoc increases in state benefits
A large ‘funnel of doubt’ on cost of state pensions

% of GDP

PPI estimate of cost:
Upper bound  Base case

Cost of current pension system, Government projection

The ‘reverse credibility’ problem (2)

• There is a huge funnel of doubt in the cost projections – with all the risk on the upside

• The cost projections are incomplete: there is no projection for the cost of tax relief…

• …and the state pays for public sector occupational pensions too
Reforming UK pensions

• Why is reform needed?
• What reforms should be considered?

Principles for pension reform

1. Unequal outcomes
   More equal coverage

2. Complexity a barrier to action
   Simplify so easy to understand

3. Too high expectations of saving
   Clarify role of the state vs. private saving
   vs. working longer

4. State pensions unsustainable
   Higher state pension, less Pension Credit
What should the role of the state be?

1. Alleviation of poverty
2. Prevention of poverty
3. Belonging and participation in the community
4. Continuance of economic status

Broadly accepted

Evolution of state pensions debate

1940s
- Beveridge
- ‘Adequacy for all’

1970s
- Joseph, Castle
- Accrued rights
- Reward for work

Now
- Many reform proposals
- Simplicity
- Fairness to women

Contribution
- Universal?
Many organisations want reform of the state first tier

- Indexed to earnings: 28%
- At least at level of Guarantee Credit £109 pw: 29%
- Citizenship/Universal coverage: 15%
- Scrap State Second Pension: simplify: 17%

A universal first tier at £109 costs more than the current system over time

- Universal Pension
- PPI upper bound
- PPI base case

% of GDP

2010 2020 2030 2040 2050
Keeping a second tier as well may cost too much of GDP

Universal Pension
Universal Pension plus S2P
PPI upper bound
PPI base case

...so we need to understand the cost and distributional trade-offs

Illustrative state pension income under different strategies, by annual earnings

A: Universal Pension of £90 a week
B: Earnings-related pension
Universal Pension of £109 a week at the same cost as A+B
To fill the ‘gap’ ....

• **Without better state pensions**: need to save more and work longer

• **With better state pensions**: only one of working longer or saving more could be needed

• **Working longer** may be a more natural response than saving more

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Later working seems to be increasing

Employment rates (not seasonally adjusted)

- **Men aged 50 - SPA**
- **Women aged 50 - SPA**
- **All age 50 - SPA**
Arguments for and against increasing State Pension Age

✓

• Enable a better state pension
• Strongest available signal on later working
• Consistent with healthier longer living

✗

• Should get over-50’s working first
• “I don’t want to work till I’m 70”
• Seen to disadvantage ‘manual men’

Increasing SPA enables a better state pension

% of GDP

Universal Pension
SPA to 70

Universal Pension

PPI upper bound

PPI base case

2010 2020 2030 2040 2050
More people now live beyond 70 than used to live beyond 65

Proportion of men born in certain years expected to live from age 25 beyond age 65 and beyond age 70

<table>
<thead>
<tr>
<th>Year born:</th>
<th>Age in 2004:</th>
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<tbody>
<tr>
<td>1885</td>
<td>62% 49%</td>
</tr>
<tr>
<td>1915</td>
<td>72% 60%</td>
</tr>
<tr>
<td>1940</td>
<td>83% 76%</td>
</tr>
<tr>
<td>1960</td>
<td>87% 82%</td>
</tr>
<tr>
<td>1980</td>
<td>89% 84%</td>
</tr>
</tbody>
</table>

We need the state pension to provide insurance against longevity

Age to which half and one-quarter of women reaching age 65 in year shown are expected to live

<table>
<thead>
<tr>
<th>Year</th>
<th>Half of Women</th>
<th>One-Quarter of Women</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950</td>
<td>80</td>
<td>86</td>
</tr>
<tr>
<td>1980</td>
<td>84</td>
<td>90</td>
</tr>
<tr>
<td>2005</td>
<td>88</td>
<td>94</td>
</tr>
<tr>
<td>2025</td>
<td>90</td>
<td>96</td>
</tr>
<tr>
<td>2045</td>
<td>90</td>
<td>96</td>
</tr>
</tbody>
</table>

Affected by SPA change
Better data on socio-economic longevity is needed...

Life expectancy, years

...and on future healthy life expectancy

Years expected after age 65, self-perceived as healthy or not
Conditions for raising SPA

- Packaged with a better state pension
- Clear message of ‘we are all living longer’
- Later working a reality: anti-age discrimination legislation and changes in employment practices
- Support for those unable to work before the new SPA (retain GC below SPA)
- A long lead time and political consensus

3 priorities for pension reform

1. Strengthen first tier state pension
2. Decide on second tier: state delivers or enables private provision?
3. Enable later working