

The Pension Commission Interim Report

The Pension Commission comprises Adair Turner, former Director-General of the CBI, John Hills of London School of Economics and writer on inequality and Jeannie Drake of the TUC and Communications Workers Union. They are supported by a team from the Department of Work and Pensions (DWP).

The Pension Commission's remit was to examine the case for compulsory savings. In practice, it has taken its remit much wider. The Interim Report issued in early October 2004 does not include recommendations. These will be in a Final Report in October 2005.

In the meantime, the Commission has produced an outstandingly well-written and researched analysis of the UK's pension situation. Though extensively summarised in the press, the coverage has not done justice to the mass of information in the Report's 300 pages. This *Briefing* presents TAEN's selection and interpretation from it.

Responses

The Commission is inviting contributions by the end of January 2005 on fairly specific aspects:

- whether the factual analysis is right. This includes specifically any evidence on whether extending working life has a positive or negative impact on health and life expectancy (p32);
- Whether the judgements on current trends are right;
- what the role of the state should be. This question of principle is clearly set out (p129), with a choice between the limited role of supplying a safety net for those who need it to a wider role of setting up mechanisms to ensure that the wider population do save enough for their retirement.

A 7-page Executive Summary, the full Interim Report and back-up material are available from www.pensionscommission.org.uk

Main messages

The Commission's position is that there are only four possible components to the solution:

- Pensioners becoming poorer
- More taxation to fund pensions
- Personal savings rising
- Actual retirement ages rising.

The Commission examined what would have to happen in the extreme situation of using one of these options on its own to create satisfactory resources for retirement incomes. The results are:

- a 30% decline from today in pensioners income by 2035;
- taxation rises £57 billion – equivalent to a rise from 6% to 11% of GDP;
- personal savings rising from 10% to 15% of GDP;
- retirement age rising from 64 to 70 for men and 62 to 67 for women.

It is fairly obvious that no one component is politically or economically feasible on its own. The first option is rejected in principle; so future policy has to be a combination of the remaining three and *must* include raising the average *actual* retirement age. Working past State Pension Age (SPA) should be made easier.

The extensive analysis of the UK's current voluntary systems and the barriers to saving suggest that the Commission would have voted for compulsion if it could have done. Its conclusion is very carefully worded. Other options such as relying on non-pension savings and housing stock are dismissed as partial elements for some people at the margin.

The ultimate solution involves a mix of revitalising the voluntary savings system, reform of the state pension system and a degree of compulsion.

The Commission wants ideas on how retraining can make extended working lives more attractive (p44); and views on risk management. TAEN has already raised a number of specific issues with the Commission team at DWP and our formal submission will include proposals from our six *Essential Steps Manifesto*.

Work and retirement ages

Chapter 2 of the Report deals with work and retirement ages. The focus is on the actual or 'real' average age at which people retire as opposed to Mandatory Retirement Age or State Pension Age. There is a discussion (p53) of how to measure average actual retirement age. In practice it will become increasingly hard to measure the average as retirement becomes more of a process over time and less of an event. With more part-time working it may need rethinking.

The Commission concluded that the scope to increase the employment rate of the 50-64 age group is considerable. If both men's and women's actual retirement ages rose to the level of men in 1950 it would be four years above the current level (p34).

An alternative scenario is based on the employment rate of men rising to the level in South East England and of women rising to the level in Sweden. In this case the male 50-64 employment rate would rise from 72% to 79% and women's from 55% to 72%, both similar to the current 25-49 age group rate (p40).

The Commission also concluded that there is scope for employment rates after State Pension Age to rise. While it is the job of the Commission to make recommendations on the pensions system, it is not its job to (and it does not) address how and why actual retirement ages might rise. Nor does it address the economics of retirement ages which influence the action of employers and employees. Will a rise in average actual employment age happen through market forces and economic circumstances? To what extent does the State need to intervene to accelerate the process (apart from the fact that it employs 25% of the workforce who on average retire several years earlier than the rest of the workforce)?

Findings

We summarise below a number of the findings in the 300 page report (plus a 200 page appendix) which seem to us particularly striking.

Increasing life expectancy

- **... has been consistently underestimated:**

In 1950 life expectancy of a 65 year-old male was 12 years. The 1981 forecast of life expectancy of a male who would be 65 year old in 2004 was 14.8 years. In the event, in 2004, it is now calculated at 19 years.

- **... is the largest influence on pension economics:**

Those under-estimated extra 4 years are the major cause of the change in pension economics, more significant than falls in financial markets (p2) or the actions of employers or governments. The baby boomers moving through mid-life have disguised the trends in the period 1980 to 2000 but will accentuate them as they retire between 2005 and 2020.

- **... continues to be forecast cautiously:**

The Governments figure for life expectancy after 65 in 2050 is 21.7 years. The Pension Commission indicate that if the rate of increase in life expectancy in the last 15 years is extrapolated to 2050 the range could be 24.4 to 27.7 years (p2). This pushes up dependency ratios further, unless it is offset by a sustained high level of net immigration.

- **... may or may not be healthy:**

The data on healthy life expectancy is inconclusive (i.e. has the period of morbidity - bad health - in final years widened with increased life expectancy). This is important in relation to fears about increases in health expenditure and attitudes to retirement because the number of healthy years may be more important than total life expectancy (p29).

- **... has become more polarised by class and neighbourhood:**

Inequality of life expectancy has widened, mainly amongst women. Between the Social Classes 1-5 the gap is now 4.5 years.

It is important to use information on life expectancy at age 65 rather than at birth. The former gives an average life expectancy for manual male workers at State Pension Age of over 13 years as compared to little more than 65 + 5 years at birth. (The difference lies with those who die between birth and age 65) (p48).

Lessons from the last 25 years include ...

- **... a trend in retirement ages which ignored demographics:**

Had this remained constant from 1980, male retirement ages would have risen 5 years since then (to age 69 rather than 63). Instead they fell by one year. To keep pace from now on would require a rise of at least 4 years (p46).
- **... an era of generous early retirement which added to pension funds problems:**

Early retirements from occupational schemes were supported by actuarially generous pension settlements. As a result an extraordinary 36% of all current pension payments are now made to people below State Pension Age (p 24). Occupational pensions classically penalise early retirees at the expense of later retirees. In this period it was the other way round.
- **... two polarised groups of early retirees:**

Early departure from work is concentrated at the top and bottom ends of the labour market (fig 2.10 p36).

 - 50% the poorest quintile of over-50s are inactive and almost entirely welfare dependent;
 - 25% of the wealthiest quintile are inactive and are almost all early retirees;
 - 15% of the people in the middle of the wealth spectrum are neither fortunate enough to be able to retire on good occupational pensions nor poor enough to be benefit-dependent.

Early retirement is far more common amongst those with defined benefit/final salary pensions. This is the main explanation for earlier retirement in the public sector than in the private sector.
- **... an unrealistic Government target of 60/40 private/public pension provision:**

The recent trend has, if anything, been towards a higher proportion of public sector spending and weighted towards the state provision (6.9% of GDP compared to the private sector's 3.9%). The prospect of realising the Government's long-term objective since 1997 of making the mix 40% state and 60% private is not seen to be possible (p25).

- **... wrongly-timed actions by Governments, employers and pension funds included:**
 - Government action to put a ceiling on employer contributions into pension funds which were perceived as a form of tax minimisation (1986);
 - the taxing of dividends on pension investment income just before the three year decline in financial markets (1997);
 - large scale 'pension holidays' when employers made no contributions. As a result pension contributions peaked in 1980 and declined sharply in the years 1980-2000 when life expectancy was accelerating;
 - wholesale swings into and out of equity investment at the wrong time.

An excellent account of this history with the benefit of hindsight is in the Annex to Chapter 3 (p114).

State pension and role of Government ...

- **... is much more than the payment of State Pension:**

Public expenditure includes the costs of State Pension payments (£35 billion per annum), tax relief on private pension contributions (£11 billion), payments to occupational pension funds for opting-out of the second state pensions (contracting-out rebates, £11 billion) and public sector pensions (£21 billion). Normally statements about the proportion of GDP represented by the State Pension system refer only the first of these (p75).
- **... is regressive (ie increases inequality) in important respects:**

The means-tested State Pension has a progressive impact in concentrating public spending on those who need it most. In contrast, tax relief on pension contributions and the opting-out system are sharply regressive. 25% of all tax relief goes to the top 2% of the tax payers who receive it.
- **... is less generous than other countries:**

Typically the UK State Pension is 37% (including SERPS/S2P) of average earnings compared to 70%+ in continental Europe and 45% in the US. It also tapers off more for middle income Britain, giving a person on around £40,000 per annum a 24% replacement income while continental

systems give 50-70% replacement (p58). This impact of the State Pension on middle earners (£15-30,000 pa) will increase as means-testing protects low earners and higher earners are outside the system (p76).

- **... serves women badly:**

69% of women receive less than the full State Pension compared to only 15% of men. Shorter working lives and contributions, lower pay and longer life expectancy all contribute to poverty amongst older women. The Commission is clear that the future pensions system must give pensions to people in their own right (p268).

Funded occupational and private pensions...

- **... are one of the largest systems of their kind in the world:**

The UK has one of the most extensive systems in the world. Fund assets are equal to 80% of GDP compared to less than 5% of GDP in most of Continental Europe (except the Netherlands and some Scandinavian countries (p81).

- **... but are not as large as we thought:**

Total annual pension contributions are estimated at £40 billion by the Pension Commission compared to previous Government estimates of £55-60 billion (p101). This new discrepancy is itself an important negative factor in assessing adequacy of savings for retirement and an illustration of the degree of unknowns and potential surprises.

- **... have major gaps and inequalities in their distribution across the population:**

Only 18 million of the 34 million people of working age are contributing, either directly or via a partner, to a pension scheme. 1.7 million self-employed people, 70% of those working in firms of less than 50 employees, workers in retailing, construction and leisure industries, over 70% of all those earning under £9,500 and the great majority of women are amongst those strongly under-represented amongst savers.

The system serves men, the better-off half of the population and the public sector well (p62). Final salary schemes entail a "significant redistribution from low earners to high earners".

- **... are in decline:**

The decline in participation in pension schemes is linked to the decline in Direct Benefit (DB) Final Salary schemes (from 35% to 20% of employees between 1983 and 2003). This has accelerated in the last 10 years and amongst young people. Participation in Defined Contribution schemes has not declined in the same way. The Commission reckon that only 1.6-1.8 million people in the private sector will still have final salary pension schemes in 2020. In contrast 85% of employees in the public sector (over 4 million people) participate in Final Salary schemes, some funded, others not (p84).

- **... and have declining contributions from employers and employees:**

Average contributions to Final Salary (DB) schemes are 16-20% a year of which the employer puts in 10-14%. The average for the Defined Contribution schemes replacing them is 7-11%, of which the employer puts in 4-7%. To achieve pension replacing two-thirds of salary at 65 (not earlier) requires average contributions of 22-26% a year (p88). The gap is some measure of the current shortfall in savings. The reduction in contributions is more significant than the shift from DB to DC schemes per se.

Pension risk...

- **... needs to be identified as several types of risk:**

The investment (financial market) risk pre- and post-retirement: This has been borne by the employer in Final Salary schemes but transfers to the individual with Defined Contribution schemes.

The individual and average life expectancy uncertainty, both pre- and post-retirement: This is borne by the employer in Final Salary schemes and by a mix of the individual and the Life Insurance Annuity provider in Defined Contribution schemes.

The pension scheme default risk: Until recently this was generally thought not to exist or to be borne by the employer. The rude discovery in the last two years that it is borne by individuals has led to the planned Government-organised Pension Protection Fund to be funded by pension scheme levies. (The much altered and criticised Pension Bill passed in November 2004).

- **... needs to be shared:**

The Commission makes clear that all the risks cannot rest on the shoulders of either employers or individuals, but must be shared between both and the Government in the case of overall uninsurable life expectancy uncertainty. Clarification of this is very important; it is not just a matter of raising the overall level of savings.

Levels of savings...

- **.... need to be related to an agreed 'adequate' level of retirement income:**

The Commission discusses what constitutes an adequate pension, including analysis of typical spending patterns of people over age 65. It concludes that an appropriate benchmark for those close to average earnings (£17,500-£25,000) is two-thirds. For those on low incomes (less than £9,500 a year) an adequate pension would be 80%, while for those on higher earnings (over £50,000 a year) it need be no more than 50% (p143).

- **... are not currently adequate:**

The Commission has strenuously tried to avoid a single figure estimate of the pension savings gap although a figure of £57 billion gained currency. From a thorough analysis it concluded that that two-thirds of over-35s are under-saving; or, expressed another way, that up to 12 million people are under-saving, a number within the Government's range in the Green Paper on Work and Pensions (Dec 2002) (p160).

- **... are highly unequally distributed:**

The Commission concludes that a striking feature is the increasing inequality of pensions (p165). 40% of senior executive pension schemes have employer contributions of more than 10% of salary. Only 17% of main employee schemes have employer contributions at this level. This reinforces unequal asset distribution. Those earning over £25,000 have 7 times the financial wealth of those earning under £9,500 (although housing is less polarised with a ratio of 2.5 rather than 7) (p178).

- **... are worse for women:**

Whilst this is the case now, the Commission suggests that the increasing employment and pay of women, improved educational achievements and concentration of women in the public sector may improve the gender balance over the next 20 years. Women in full-time employment are now more likely to be members of an occupational scheme than men and annuity rates are starting to converge (p276).

- **... are surrounded with barriers to voluntary increased saving:**

Chapter 6 sets out a formidable range of barriers to increased voluntary savings:

"The most complex pension system in the world";

Distrust of all the institutions involved;

Disincentive of means-testing of the state pension;

The cost of saving.

One calculation shows that a typical person saving for 30 years for retirement would spend 30% of their total contribution on paying the financial institution.

- **... are expensive to manage:**

The cost of running the state system is 0.1% per annum compared to 2% for large occupational pension schemes and over 1% for personal pension schemes (p251).

Costs are a significant factor weighing against those who have to look after their own savings for retirement. Following the Sandler Report recommendations for popular savings channels (2002) and the introduction of Stakeholder Pensions (2001), the issue of whether the financial services industry can supply savings vehicles at competitive cost, taking account for the need for advice on risk, remains unresolved.