



## Factors Influencing Work and Retirement: Pensions

A good pension is one of the best ways of ensuring a satisfactory quality of life in older age, free from poverty and unnecessary hardship. Adequate pension provision is a hall mark of a civilised society which respects and values its older people.

One of the influences on patterns of working life and when people choose to retire is the pension system. If the system of saving for retirement holds out the prospect of a reasonable level of secure income then it can be an incentive to stop working and retire sooner. If there is little or no prospect of an adequate pension income then that is an incentive to stay in work and delay retirement.

Different social security and pension systems amongst EU countries are a major explanation of the different patterns of retirement in Europe. Many of the continental countries such as France, Italy and Germany have predominantly state-run pension schemes. The image that all will be well looked after by the state in retirement, whether justified or not, goes a long way to explain why the average retirement age in those countries is up to five years younger than in the UK.

For the last quarter of the 20<sup>th</sup> century similar confidence about retirement income reigned in the UK. This was the context for the steady reduction in average retirement age which took place from the mid 1970s. Since 2000, however, changes in the outlook for both state and private/occupational pensions in the UK have radically altered that situation. Uncertainty about adequate retirement income has become a major motivation for extending working life and delaying retirement.

This briefing examines these changes and the government's pension reform agenda and what they mean for individual choices about work and retirement.

### Employer and private pension schemes

The UK is unique in Europe (but much more like the USA) in that 70 per cent of pension provision is made up of employer (occupational) and private schemes provided commercially by the financial services industry. The main types of schemes are:

1. Occupational schemes with employer and employee contributions and a level of pension based on the number of years service multiplied by a percentage of final pay e.g. 1/60<sup>th</sup>, 1/50<sup>th</sup> or 1/80<sup>th</sup> for each year of service (known as defined benefit or final salary schemes).

2. Occupational schemes with employer and employee contributions and a pension based on the accumulated value of those contributions (known as defined contribution or money purchase schemes).
3. Group or personal pensions schemes with contributions from the individual, but not an employer, and pensions based on the accumulated value of the contributions.
4. Hybrid schemes: more recent schemes which mix the characteristics of defined benefit and defined contribution schemes and share the risk between employer and employee more equally. This is a possible trend for the future.

There are several ways of drawing down income from a pension scheme once retirement has been reached:

- a tax free lump sum of up to 25 per cent of the value can be taken (obviously then reducing the amount paid out each year thereafter);
- income can be drawn down annually from the accumulated fund; and
- the accumulated fund can be converted into an annuity (a guaranteed annual income for the remaining years of life, the size of which depends on the assumptions about life expectancy, investment returns, etc). Under current rules, the remaining accumulated value has to be converted into an 'annuity' when one reaches the age of 75.

These occupational and personal pension schemes attract tax relief at an individual's marginal rate. Contributions to them by employers and individuals can be deducted from taxable income. For higher rate tax payers this is especially attractive. In contrast, when the proceeds are paid out as pensions they are taxed as income in the same way as other earnings (for those pensioners whose incomes reach the threshold for paying tax).

Pensions generally do not form part of an estate on death, unlike other assets, and therefore the residual value cannot be passed on to inheritors. Life expectancy risk is shared between all members of a scheme, with transfers between those who die early and survivors to old age. They do however offer widows' or dependants' pensions at a proportion of the rate payable to a living pensioner. Scheme members are typically invited to register an 'expression of wish' identifying the person to whom the benefits should be directed. The trustees of a pension scheme will take such 'expressions of wish' into account, but the mechanism is not the same as writing a will.

Many of the complex rules about ceilings on contributions, levels of lump sum payments and other matters are designed to ensure that occupational pensions are used for what they are intended: an efficient way to transfer income between different stages of life, rather than as a method of tax minimisation.

For several decades in the later 20<sup>th</sup> century the system provided adequate or good pensions to about 60 per cent of retirees. Indeed the preoccupation was with pension funds becoming over-funded and benefits over-generous. Governments therefore put caps on how much employers and individuals could contribute while still attracting the tax relief. They also put limits on the calculations of allowable benefits.

Since 2000 a number of things have happened, undermining the previous comfort of the UK employer pension scene.

- Actuaries' forecasts of life expectancy have risen dramatically, even faster than the actual rise in life expectancy (which in turn has been running ahead of all past forecasts). In 2004-05 major reports by the Pensions Commission for the government rammed home this message. There was a new awareness that life expectancy for 65-year-olds is increasing at between two and three years every decade, with no sign of when it will start to slow down. It is estimated that each increase of one year in life expectancy adds 3 per cent to pension liabilities (Purple Book, Pension Regulator, 2007). This blows a hole in employers' commitment/capacity to pay pensions based on final salaries.
- Bond and stock markets became more volatile with a consensus developing that in the longer term average real as opposed to nominal returns on investment would not be more than half the levels typically seen in the last quarter of the 20<sup>th</sup> century. Falling inflation has had a similar effect on pension schemes to that seen on the mortgage market. This means volatility in forecasts of the capacity of pension funds to meet their liabilities: recent figures have ranged from + £21 billion surpluses to - £200 billion deficits for the leading company pension funds, depending on assumptions about life expectancy and returns. Over 35 per cent of larger companies are considering buying out their liabilities because of concerns about open-ended commitments (Pricewaterhouse Coopers, 2008).
- The biggest influence on the decline of defined benefit schemes (DB) has been the prescriptive effect of legislation. Costly benefits that were once discretionary have now become obligatory. The shift from DB schemes to defined contribution (DC) schemes has been accompanied by a decline in employer contributions. The average employer contribution to DB schemes is 15 per cent; to DC schemes it is 6 per cent. To put this in context, typically a contribution of 20 per cent+ of pay each year is needed to yield a pension equivalent to half of final pay (though this varies greatly according to circumstances: the later saving commences, the higher the contribution has to be). So there is a large and growing gap between levels of actual contributions and the widespread assumption of many people that they will get a pension equalling half or more of what they were earning when they were in work.
- Confidence in employer and private pensions has declined sharply. The government had a target for a growing share of pension provision to be privately sourced; in practice the proportion of employees in occupational schemes has been in steady decline. Savings levels are at an historic low, rather than responding to the message that saving for more years of retirement is an imperative.
- Once the market returns on investment had declined, it became apparent just how expensive it was to save through personal pensions and the commercial financial services sector. The economics of smaller pension schemes simply did not stack up.
- In addition, it came as a shock to discover that defined benefit pensions schemes in the private sector, thought to be guaranteed safe, were nothing of the sort. A number of high profile company closures left pension scheme members who had made decades of pension contributions facing sudden total loss of retirement income. This has added greatly to declining confidence, even though the government has now put in place a collective guarantee scheme, the Pension Protection Fund. Many of those whose expectations were not fulfilled were then adversely affected by prescriptive government rules on the order of priorities following a scheme's cessation.

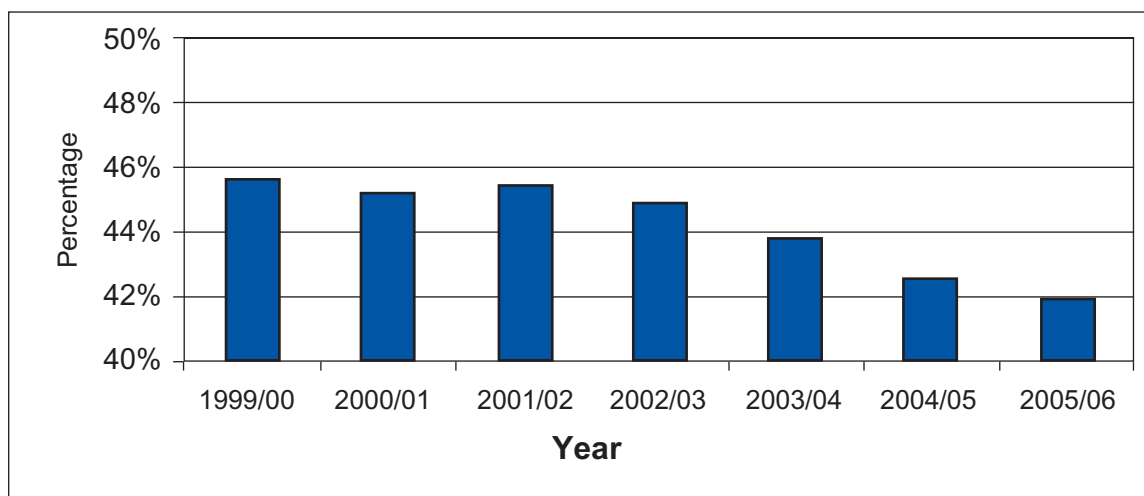
As a result:

- Final salary schemes in the private sector have been in retreat. Over 80 per cent have now closed their schemes to new employees and substituted a new defined contribution scheme. In the case of existing employees, it is harder for employers to go back on past commitments, but the general objective has been to renegotiate the balance of risk between the employer and employee. The overall impact is that the number of employees in the private sector who can look forward to a certain retirement date relying on the security of a final salary scheme is diminishing steadily. (It is now down to less than five million out of a private sector workforce of 25 million.)
- Defined contribution pension schemes no longer yield the kind of pension that had been expected. A pension pot which would have given an annual pension of £10,000 for the rest of life on the basis of calculations in 2002 will now only yield a pension of £5,000 a year.

All this has a profound impact on savings and decisions about staying on in work and when to retire. The leverage of delaying a pension is considerable. A pension which yields £7,500 at 65 will yield £11,500 if taken at age 70 (Pensions Commission, 2005).

The household savings ratio has fallen to 1.1 per cent of earnings. In 1993 it was 10.7 per cent. Household debt has risen to historically high levels at 120 per cent of average income compared to 40 per cent in 1975; clearly saving for retirement is not going to be a high priority when there are debts on this scale.

**Figure 1.1: percentage of the working age population in Great Britain contributing to a private pension**



Source: Family Resources Survey

Note: Working age is defined as between 20 and State Pension age. Data is for Great Britain.

As shown in the Figure 1, the numbers contributing to private pensions is falling rather than rising as the government hoped would be the case. The average occupational pension is now £4,628 a year (Pension Facts PPI), hardly a princely sum. The average pot in a personal pension in 2007 for purchasing an annuity was £33,500, enough to produce a pension of £1,380 a year.

## **The public sector**

Twenty per cent of the workforce is employed in the public sector. Their pension situation is different from the private sector. Final salary pensions are widely available to existing and new employees. It is estimated that public sector workers will soon make up 80 per cent of all workers with the security of a final salary pension, which in turn is likely to influence average retirement age in the public sector compared to the private sector.

The government has renegotiated some of these long term commitments but with limited changes in the situation. As a result, it is estimated that the government (the taxpayer) is spending more annually on funding the pensions of the 20 per cent of the workforce in the public sector than employers are spending on the 80 per cent of the workforce who are working for them. Current pension liabilities for the 20 per cent of the workforce in the public sector total £1,000 billion compared to liabilities of £800 billion for the other 80 per cent (Cass Business School, 2008).

With some exceptions, public sector pension schemes are not funded from past contributions of workers and employers; future final salary pensions will be funded by future tax payers. Whether this situation can be sustained may become a major headache for future political leaders. Enthusiasm to retire early rather than extend working life is widespread in the public sector. Part of the solution could be radical improvement in public sector workforce management aimed at improving the motivation and job satisfaction of employees as they approach retirement age.

## **State pension age**

When Bismarck introduced the first old age pension programme in 1889, pension age was set at 70 years. At the time, life expectancy for the average Prussian was 45 years. Lloyd George, introducing the first state pension in the UK in 1909, also set the age for receipt of the new 'means tested' benefit at 70, higher than average life expectancy at the time. The current state pension age (SPA) of 65 for men and 60 for women has remained fixed while average life expectancy has increased by more than 15 years. The government's planned rises in the SPA therefore do not catch up with life expectancy increases or keep pace with the forecast rate of increase. The woman's pension age will rise from 60 to 65 in the period 2010-20. The SPA for men and women will rise in stages from 65 to 68 between 2024 and 2046. A three-year increase over 22 years is less than the likely increase in average life expectancy in the same period, so this will not diminish the average number of years of dependency on pension income.

Only a minority of people actually retire in the year they reach the SPA (20 per cent of men and 10 per cent of women according to DWP Research Report No 200, 2003). Nevertheless, the SPA is an important influence on patterns of retirement. It is crucial for the 40 per cent of the population who have no occupational or personal pension and will depend on the state pension and therefore have to keep working up to the SPA. It also influences attitudes on when to retire. It is however becoming less influential. The numbers of pensioners registered as working after SPA rose from 0.8 million in 2000 to 1.4 million in 2008.

## **State pension**

The trends in the state pension have also made it a less sure basis for a comfortable retirement, thus encouraging longer working life and later retirement.

How much basic state pension you get depends on your level of National Insurance Contributions and years of working. Although there have been amendments to take account of years of child rearing this has traditionally disadvantaged women. Seventy per cent of women arrive at pension age without sufficient contributions or credits to receive the full basic state pension; this compares to only 15 per cent of men.

The policy has been to allow the value of the basic state pension (BSP) to diminish so that it is no longer a viable basis for retirement on its own. Since 1979 it has been linked to the Retail Price Index which typically increases about 2.5 per cent a year less than the increase in average earnings. The BSP has reduced from 24 per cent of National Average Earning in 1974 to 16 per cent in 2008 (for reference National Average Earnings are £24,500 - ONS and DWP). Meanwhile, the add-on pension credit system for those who needed it has expanded. Less public funding is spent paying a universal state pension to everyone regardless of need, but more is channelled where it is needed most through Pension Credits.

This may make sense in theory but the problems lie in the delivery. Also, it is complicated to manage and a significant minority of eligible people fail to take it up. Far more people (around half all pensioners) are eligible than originally intended, making it a massive administrative burden. Also, any system of mean-tested state payments that phases out as the level of an individual's own income or resources rises automatically sets up a motivation trap: why bother to save and build up your own retirement income if all it does at a certain level is to stop you getting the same money free from the state?

### **The government reform programme**

The 2004-05 Reports of the Pensions Commission chaired by Adair Turner were very detailed and seminal studies of the pension system. They pointed out that the options boiled down to:

- saving more
- working longer
- paying more tax to fund pensions
- being poorer in retirement

none of which were obviously popular.

Their recommendations were:

1. A gradual rise in the amount of the basic state pension to reduce the dominance of means testing for pension credit.
2. A reduction in the role of the complicated add-on second state pension.
3. A new National Personal Accounts scheme, with automatic enrolment of employees and compulsory employer and employee contributions. This is aimed at the 9-12 million workers with few or no current savings. It is therefore situated 'between' the state pension/National Insurance system and private sector pension industry. Its low operating cost compared to personal pensions will make it viable for smaller scale savers who do not come within the orbit of commercial personal pension schemes.
4. A gradual rise in state pension age.
5. Encouragement to defer retirement.

Broadly, the government's action since then has been aimed at implementing these proposals. The Pensions Act 2007 made changes to the state pension system. The Pensions Bill currently going through Parliament will introduce the Personal Accounts Scheme (as set out in point 3 above).

Increases to the state pension will be based on the link with earnings some time after 2012 (depending on affordability), rather than the link with the lower level of price increases. The position of women (and others) will be improved by reducing the number of years to qualify for a full basic state pension and improving the allowance for time spent in caring roles.

Arrangements have been introduced to make delaying taking the state pension and staying in work more attractive. The pension received increases by 1 per cent for every five weeks delay in taking it. This is equivalent to 10.4 per cent for every year's delay and a delay of five years from age 65 to 70 means that the state pension eventually paid is over 50 per cent higher. Alternatively one can choose to take a lump sum benefit and then receive the state pension at the normal rate. One may delay taking the state pension as long as one wishes though personal decisions are clearly influenced by perceptions of likely life expectancy (often underestimated by individuals). This may be one reason why the scheme is little known and little used.

Nor is it well known that there is a recent new right to stay in work part time, continue earning and at the same time draw a part of an occupational pension from the same employer. Previously this was not allowed, forcing people to either be in work or completely retired, and/or transfer to another employer. Despite the fact that employers campaigned for this reform, the main barrier to its use is widespread employer reluctance to introduce the administrative machinery to enable it to happen. It is argued that it is too complex to pay out portions of pension entitlement. Whether or not this is true, availability of the one option to, in effect, take a 'partial pension' whilst working part time would be attractive to many people.

The second state pension will become a flat rate scheme and the fiendishly complicated interaction between the second state pension and occupational schemes (known as contracting in and contracting out) will be ended.

The Personal Accounts Scheme will be introduced from 2012 and be based on a minimum compulsory employer contribution of 3 per cent of pay, an employee contribution of 4 per cent and tax relief of 1 per cent employer contribution and an overall minimum level of 8 per cent. The maximum annual contribution will be £3,600 (in order that it is concentrated on lower earners and does not threaten to undercut the private pensions industry). The government forecast that this will lead to an additional 6-9 million people saving for retirement.

There are many contentious issues surrounding the scheme, including:

1. The quality of administration and regulation of the scheme under the Personal Accounts Regulatory Authority, given the credibility and track record of very large state-run schemes for efficiency and comprehensibility;
2. The impact it has as a competitor to the commercial financial services sector, given its lower cost operating base;
3. The principle of obligatory employer contributions and their impact on small businesses including the risk that the cost will be offset by lower pay;
4. The danger that some of those automatically enrolled will not benefit once the impact of means testing for pension credit has been taken into account.

## Future trends and conclusions

It seems highly probable that the current tough outlook for retirement income will continue. There is no sign yet of confidence in long term savings vehicles returning or of real saving rates increasing.

Despite the messages from government about thinking ahead, saving rates remain very low. Family budgets do not leave spare cash to put towards retirement, after taking account of housing costs, for many people. The modest level of participation in employer pension schemes amongst younger workers shows a willingness to forego the offer of an employer contribution now in order not to have to make a matching personal contribution out of current income.

All the evidence suggests that the modest outlook for many people's retirement income will continue to be a strong incentive to stay in work and defer retirement.

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## Further information

More detail can be found in:

*Pensions Reform – 2010 Onwards*, Department for Work and Pensions on [www.dwp.gov.uk/pensionsreform](http://www.dwp.gov.uk/pensionsreform) (See especially Chapter: Overview and summary of costs and benefits)

*Pensions: Choices and Challenges: The First Report of the Pensions Commission, 2004.* See [www.webarchive.org.uk/tep/16806.html](http://www.webarchive.org.uk/tep/16806.html)

*A New Pension Settlement for the Twenty-First Century: The Second Report of the Pensions Commission, 2005.* See [www.webarchive.org.uk/tep/16806.html](http://www.webarchive.org.uk/tep/16806.html)

*The Pension Primer and Pension Facts* plus an extensive series of Briefings, Pensions Policy Institute. See [www.pensionspolicyinstitute.org.uk](http://www.pensionspolicyinstitute.org.uk)

The Information and Advice section of [www.ageconcern.org.uk](http://www.ageconcern.org.uk)

Advice leaflets on [www.helptheaged.org.uk](http://www.helptheaged.org.uk)

The Pension Service on [www.thepensionsservice.gov.uk](http://www.thepensionsservice.gov.uk)