UK Pensions Policy

Rowena Crawford

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Outline

• State provision of pensions
  – Why might we want it?
  – What kind of provision is possible/desirable?
• The structure of the UK pension system
  – BRIEFLY!
• Are UK state pensions adequate?
  – The effect of the Pensions Act 2007 reforms
• Is pension income more generally adequately?
• Auto enrolment
  – Likely effects?
How do we think about pensions saving in economics?

Life-cycle model of consumption smoothing

- **Earnings**
- **Smoothed consumption**
Why might people have insufficient resources in retirement? (1)

- Rational individuals
  - Insufficient earnings over the lifetime
Why might people have insufficient resources in retirement? (1)

- Rational individuals
  - Insufficient earnings over the lifetime
  - Adverse shocks (particularly near or after retirement)
Why might people have insufficient resources in retirement? (2)

- Behavioural issues
  - Bad planning/Myopia
Role for the state in pension provision?

- Redistribution?
- Insurance?
- Paternalistic intervention?
What do we want state provided pensions to do?

• Avert poverty in older age?

• Ensure a decent replacement rate?
What do we want state provided pensions to do?

- Avert poverty in older age?
  - Universal benefits
  - Means tested benefits

Diagram:
- Remove poverty
  - Universal benefits: No disincentives
  - Means tested benefits: Low cost
  - No provision!
UK State Pension System

- 3 main components:
  - Basic State Pension (BSP)
  - Additional pension (SERPS/S2P)
  - Means-tested Benefits

- State Pension Age (SPA): Earliest age at which an individual can start to claim their state pension
  - 1948 – 2010: 65 for men, 60 for women
  - From April 2010: female SPA will gradually increase to 65
  - Under current legislation SPA will increase to 68 by 2046
UK state pension system: BSP

• Flat rate benefit (£97.65 per week in 2010-11)
• Payable to those aged over the state pension age who have made sufficient National Insurance contributions
  – Also credits for caring responsibilities and some out-of-work benefits
• Since 1981 (until 2011), value was linked to prices
  – Made the pension system much more sustainable
  – Value relative to average earnings declined
UK state pension system: BSP value over time

Source: Bozio et al (2010)
UK state pension system: Additional pension

- State Earnings-Related Pension Scheme (SERPS)
  - Operated between 1978 and 2002
  - Value of the pension related to level of earnings
  - Made successively less generous over time once the future cost of the pension commitments became clear

- State Second Pension (S2P)
  - Replaced SERPS in 2002
  - Aimed to give more help to those who may not have previously qualified for SERPS (carers, low incomes etc)

- Individuals can (currently) contract out of the additional pension
UK state pension system: Means tested benefits

- Pension credit: Guarantee credit (PCGC)
  - Ensures all over the female SPA have a minimum level of income
  - 100% taper

- Pension credit: Savings credit (PCSC)
  - Reduce the disincentives to save created by the PCGC
  - Available to those aged over 65
  - Effectively reduces the PCGC taper to 40%

- Pensioners also eligible for other benefits if they have low incomes
  - Most important: housing benefit, council tax benefit
How do we measure pension ‘adequacy’?

- What is an ‘adequate’ retirement income?
  - Sufficient to avoid poverty?
    - Absolute poverty?
    - Relative poverty?
  - Certain level of earnings replacement?
    - Same for everyone?
    - Decreasing with income level?
Are current state pensions likely to be adequate? (pre Pensions Act 2007 reforms)

- Sufficient to avoid poverty
- Provide a low replacement rate on average
Income replacement by the state pension (pre Pensions Act 2007 reforms)

Income replacement rates for a median male earner

Source: Bozio et al (2010)
Income replacement by the state pension (pre Pensions Act 2007 reforms)

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Source: Bozio et al (2010)
Are current state pensions likely to be adequate? (pre Pensions Act 2007 reforms)

- Sufficient to avoid poverty
- Provide a low replacement rate on average
- Reliance on means tested benefits even for those on median earnings
UK State Pension Reform: Pensions Act 2007

- **Aim** was to **reduce poverty** for all pensioners, while ensuring **incentives remain to save privately** to increase pension incomes above the level that would be provided by the state.

- **Changes:**
  - Entitlement to the full BSP to be more widespread.
  - Value of BSP relative to average earnings to be maintained.
  - S2P to become flat rate.
  - In the long run, BSP and S2P will end up being near universal flat-rate benefits, reducing the reliance on means tested benefits.
  - Increased the SPA to improve the financial viability of the system.
    - Increase from 65 to 68 by 2046.
Income replacement by the state pension (post Pensions Act 2007 reforms)

- Income replacement rates for median male earner

Source: Bozio et al (2010)
Income replacement by the state pension (post Pensions Act 2007 reforms)

- Income replacement rates for median male earner

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Are current state pensions likely to be adequate? (post Pensions Act 2007 reforms)

• Sufficient to avoid poverty
• Provide a low replacement rate on average

• $\Rightarrow$ Need for private saving
Adequacy of total retirement incomes

- Banks et al (2007) calculated the likely retirement income of the generation approaching retirement (aged 50 to SPA)
- Proportion of individuals who will have income below a variety of thresholds:

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<tr>
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<td>PCG</td>
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Encouraging private saving

- Still a lot of concern that individuals aren’t making appropriate retirement decisions

Source: British Household Panel Survey (2005). Base population is employees aged 22 to the SPA, earning above £5,035
Encouraging private saving: Pensions Act 2008

• Requires employers to **automatically enrol** all eligible jobholders into a workplace pension scheme
  - Aged 22 to SPA
  - Earn more than income tax threshold (£7,475 in 2011-12)
• Employees **can** choose to opt out
• Pension scheme must be of a minimum standard
  - DC scheme: 8% contribution.
  - ‘Minimum’ contribution composition: **Employer contributes** 3%, employee contributes 4%, government contributed 1% (tax relief on the employee contribution)
  - Employer/employee can choose to contribute more
  - Employee can choose to contribute less but is likely to lose the employer contribution (effectively opted out)
Will auto enrolment boost pension saving?

- Likely to increase participation
  - Easier to be a member of a pension (standard economic model)
  - Choice made for those who ‘do not choose’ (behavioural economics)
US evidence on auto enrolment and coverage

Sources: Madrian and Shea (2001); Choi, Laibson, Madrian and Metrick (2004).
Will auto enrolment boost pension saving?

- Likely to increase participation
  - Easier to be a member of a pension (standard economic model)
  - Choice made for those who ‘do not choose’ (behavioural economics)

- Effect on contributions?
  - Could reduce the contributions of those who would have contributed more than the default amount
US evidence on auto enrolment and contributions

Source: Madrian and Shea (2001)
Will the employer contribution boost pension saving?

• Likely to increase participation
  – Incentive to join/remain in pension scheme to get employer’s contribution

• Effect on contributions?
  – Financial incentive for those contributing below 4% to contribute 4% (to get the employer match)
  – Employer match could reduce employee contributions if employee already saving optimally
Conclusions

• Need for state pension provision
  – Low lifetime incomes (redistribution), shocks (insurance)

• UK state pension system
  – Avoids poverty
  – Provides a relatively low replacement rate

• Recent reforms to state pensions:
  – Aim to reduce poverty for all pensioners by providing a flat-rate, near universal benefit
  – Remove disincentives from the state pension system (means testing)

• Policy to encourage private pension saving:
  – Aim to encourage a decent replacement rate through private pensions
  – Introduction of auto enrolment
References (1)

- Bozio, Crawford and Tetlow (2010), “The history of state pensions in the UK: 1948 to 2010”, *IFS Briefing Note BN105*
- Choi, Laibson, Madrian and Metrick (2004) “For better or for worse: default effects and 401(k) savings behavior”, in *Perspectives in the Economics of Aging* edited by David Wise
References (2)

- Emmerson and Wakefield (2009), “Amounts and Accounts: Reforming Private Pension Enrolment”, *IFS Commentary C110*
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