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UK Pensions Policy

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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
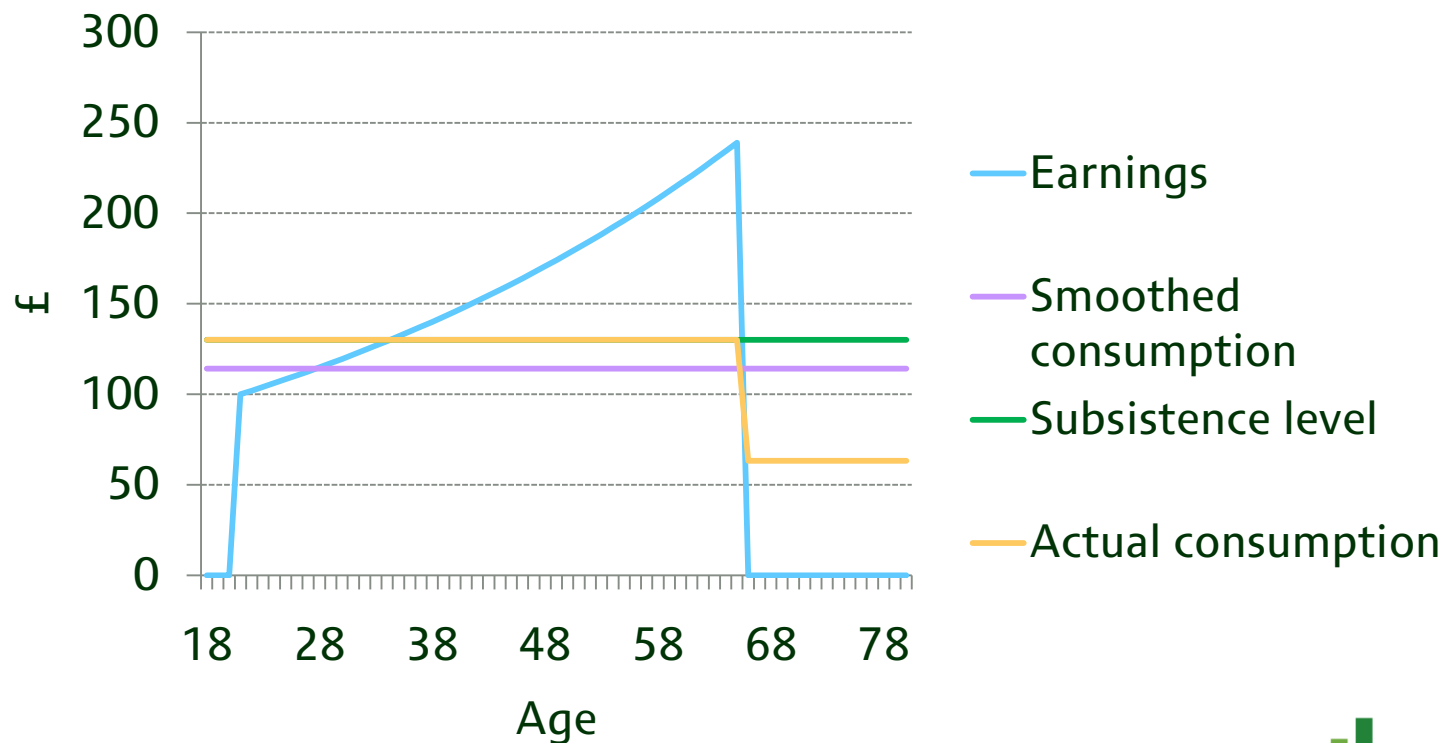- Is pension income more generally adequate?
- Auto enrolment
  - Likely effects?

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How do we think about pensions saving in economics?
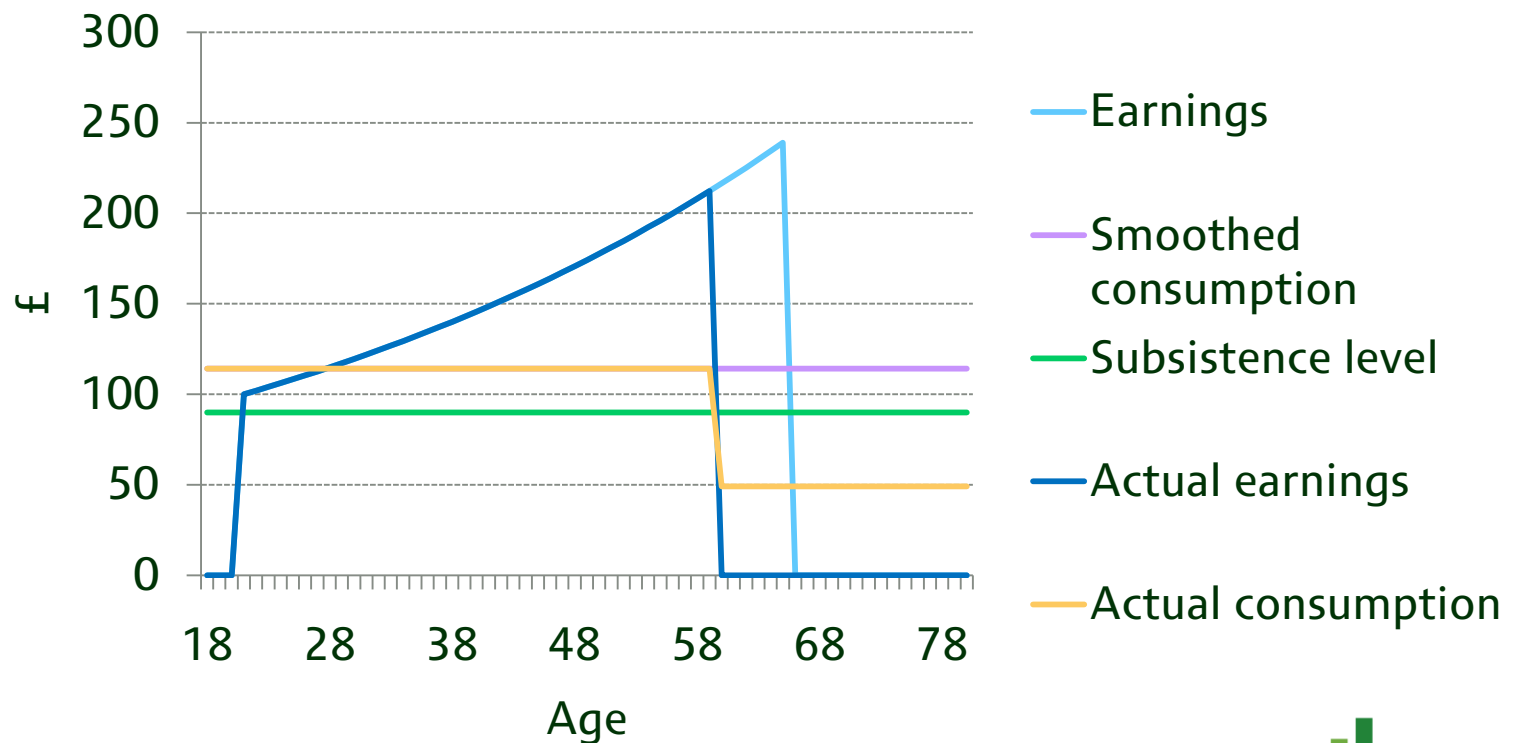
Life-cycle model of consumption smoothing
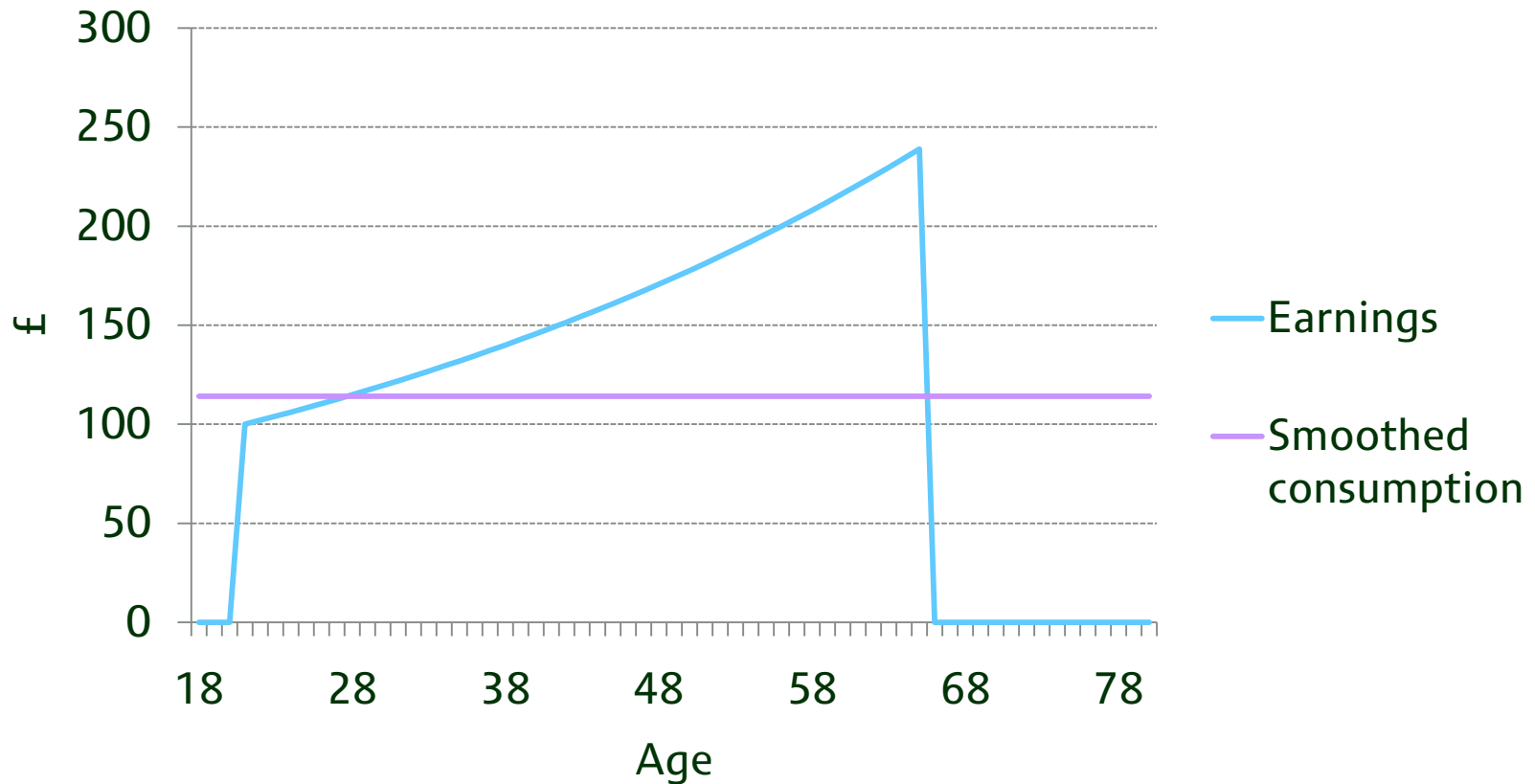
Why might people have insufficient resources in retirement? (1)

- 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
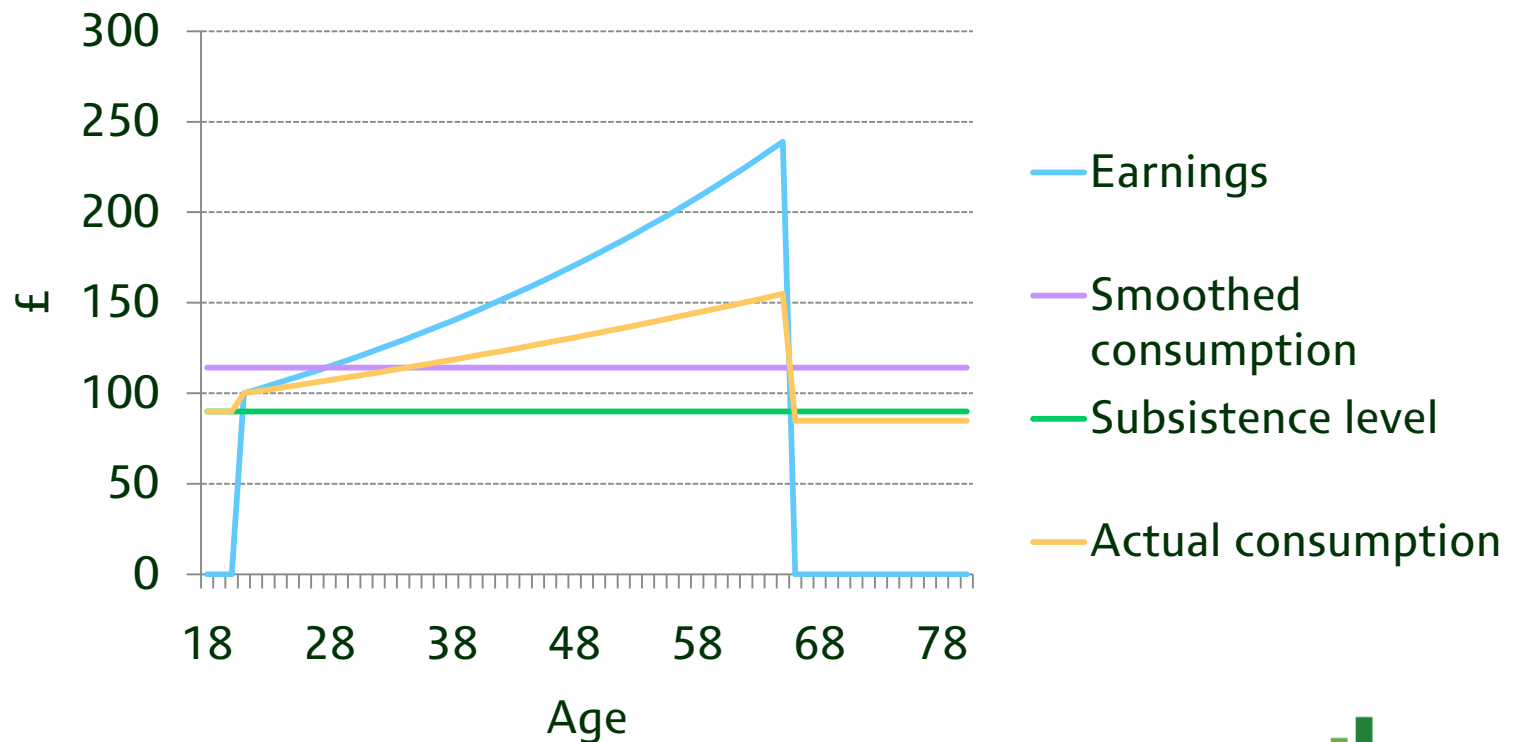
Role for the state in pension provision?

- Redistribution?

- Insurance?

- Paternalistic intervention?

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What do we want state provided pensions to do?

- Avert poverty in older age?

- Ensure a decent replacement rate?

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What do we want state provided pensions to do?

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

Remove poverty

Universal benefits

Means tested benefits

No disincentives

Low cost

No provision!

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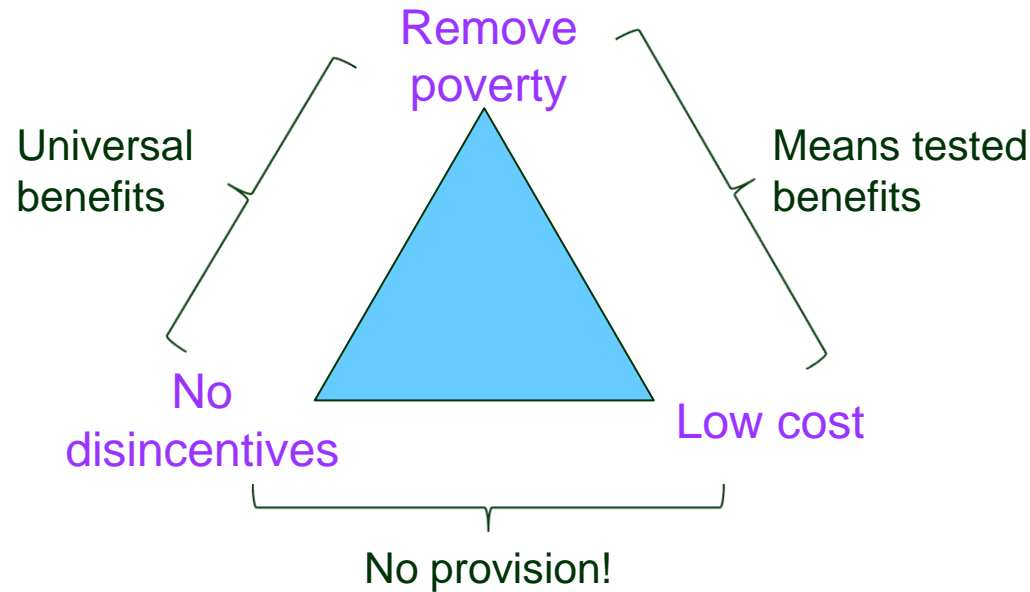
UK State Pension System

- 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

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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

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UK state pension system: BSP value over time

Legend:
- Real terms (LH axis)
- Relative to average earnings (RH axis)

Y-axis (left): £ per week (April 2009 prices)
Y-axis (right): Value relative to average earnings (%)

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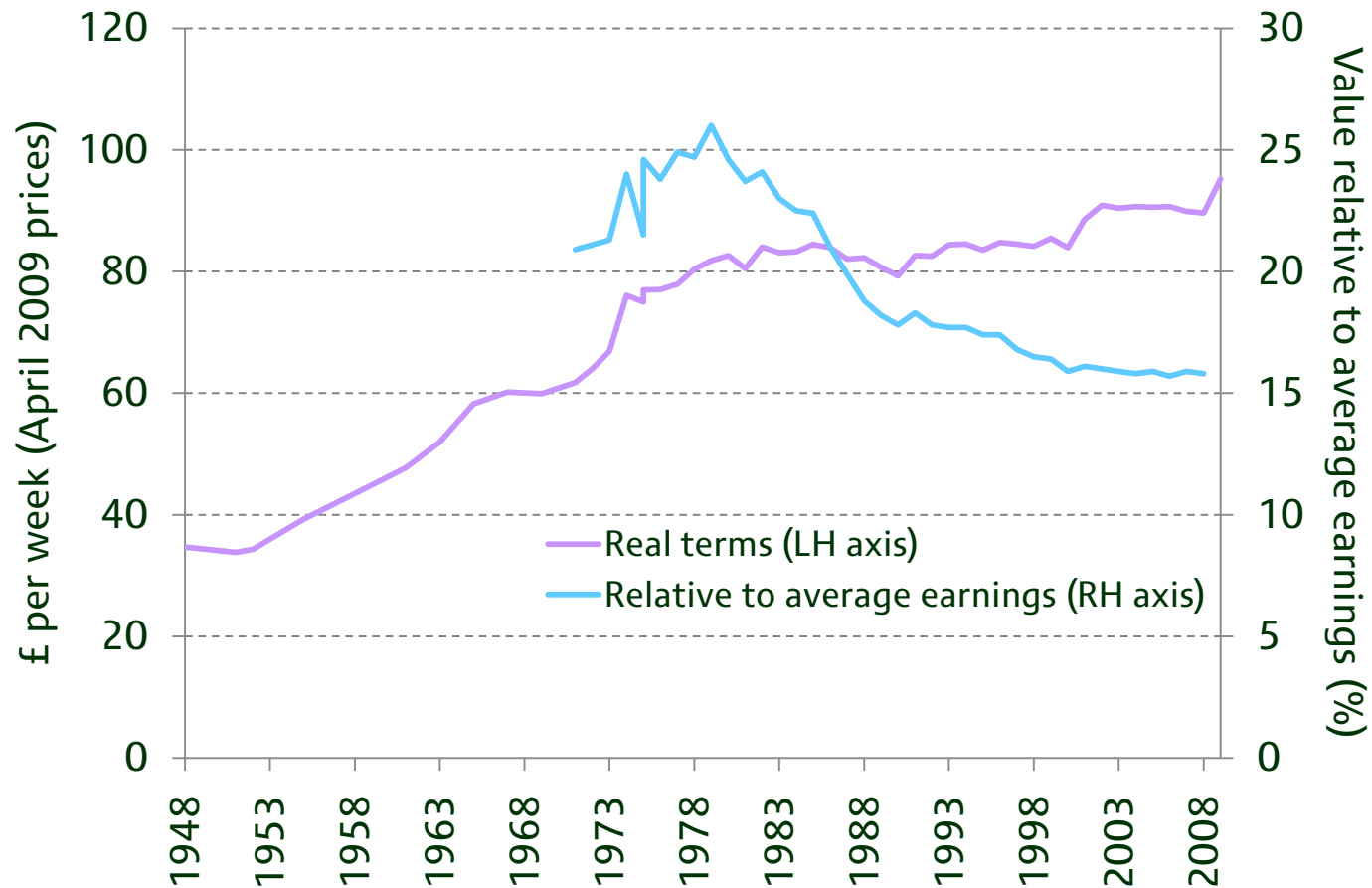
UK state pension system: Additional pension

- 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

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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

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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?
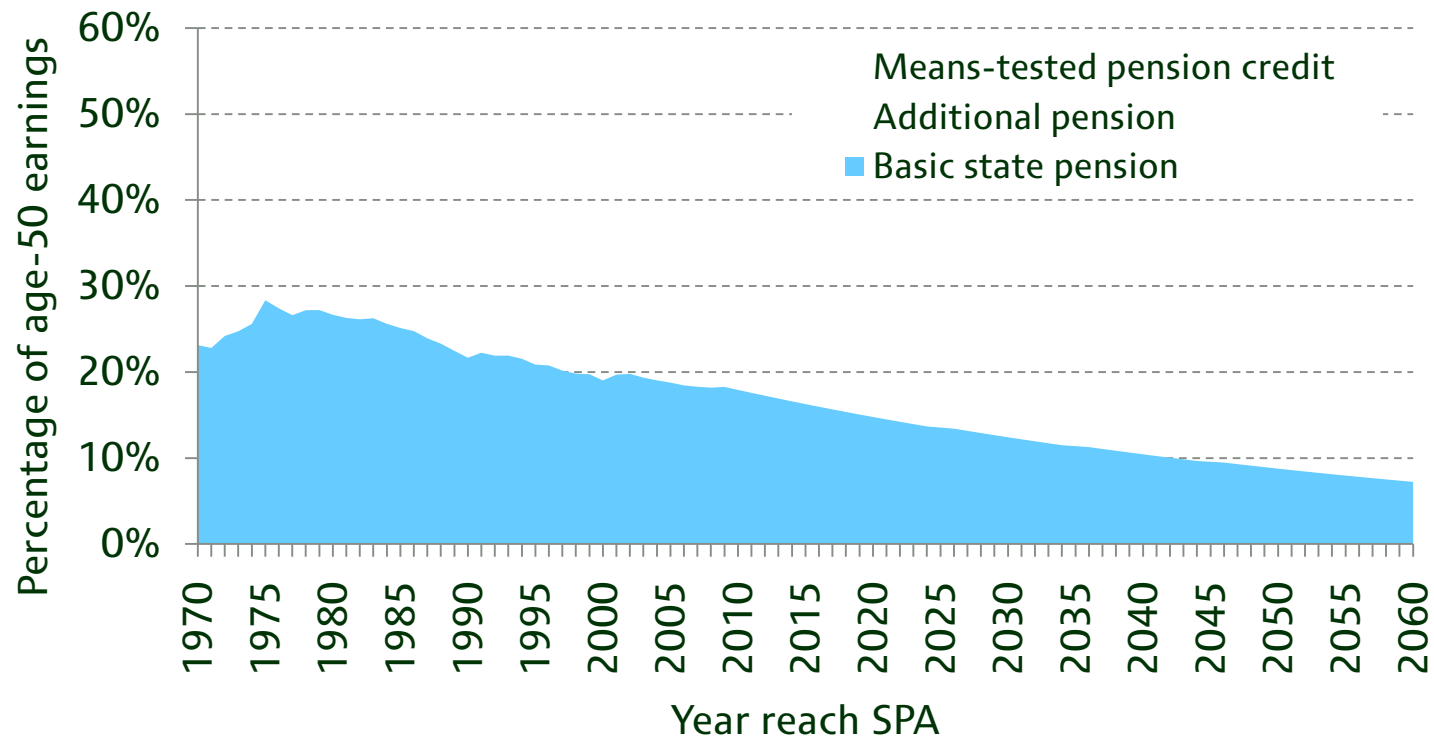   - Decreasing with income level?

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

- Sufficient to avoid poverty

- Provide a low replacement rate on average

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Income replacement by the state pension
(pre Pensions Act 2007 reforms)

- Income replacement rates for a median male earner

Means-tested pension credit
Additional pension
Basic state pension

Percentage of age-50 earnings

Year reach SPA

Source: Bozio et al (2010)

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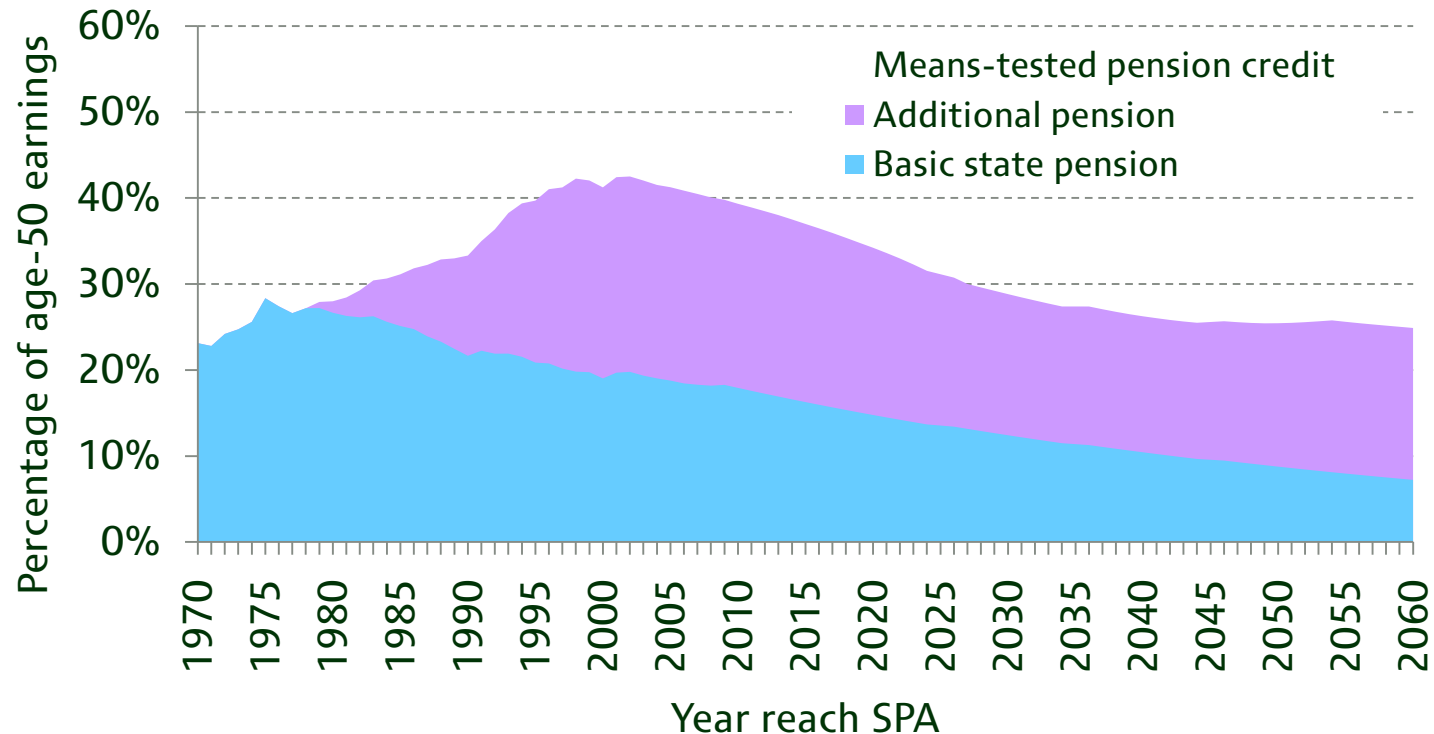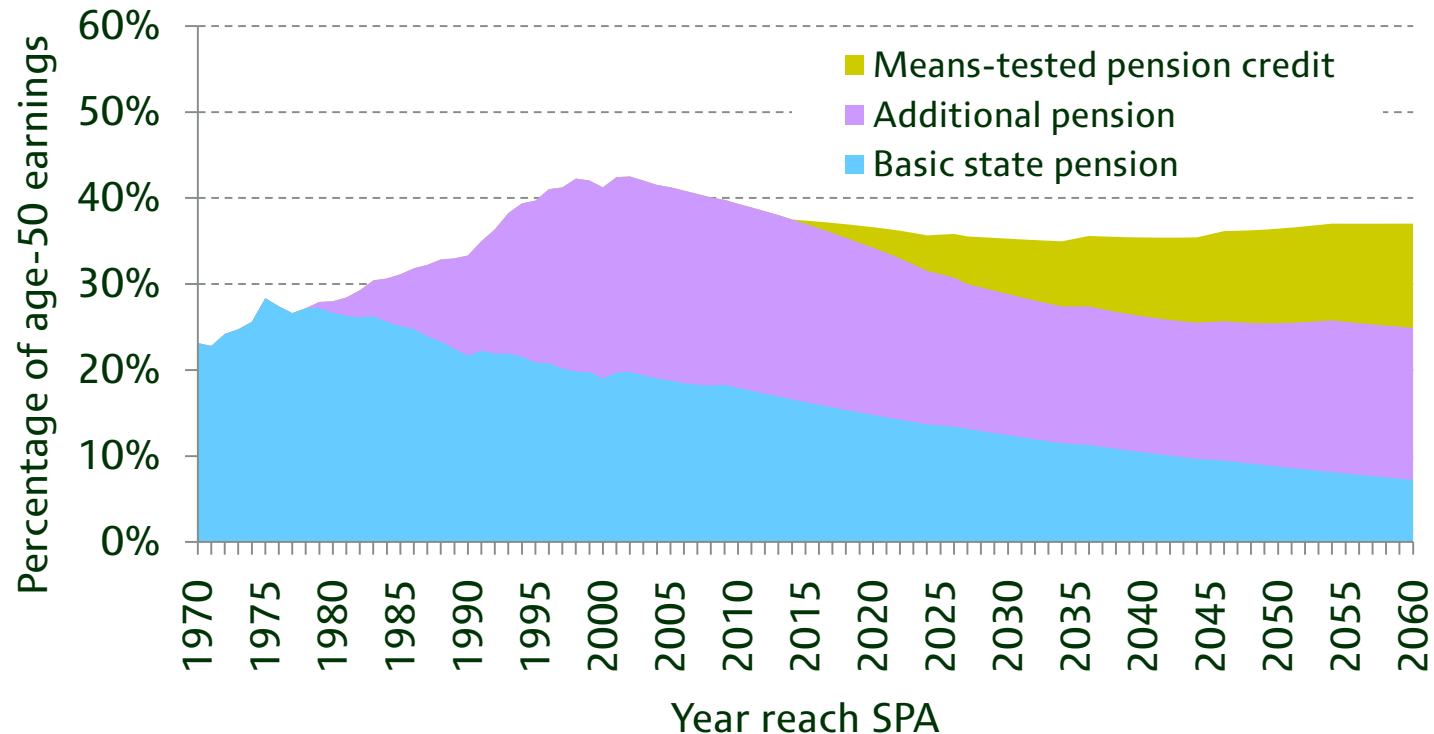- Provide a low replacement rate on average

- Reliance on means tested benefits even for those on median earnings

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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

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Income replacement by the state pension
(post Pensions Act 2007 reforms)

- Income replacement rates for median male earner

Source: Bozio et al (2010)

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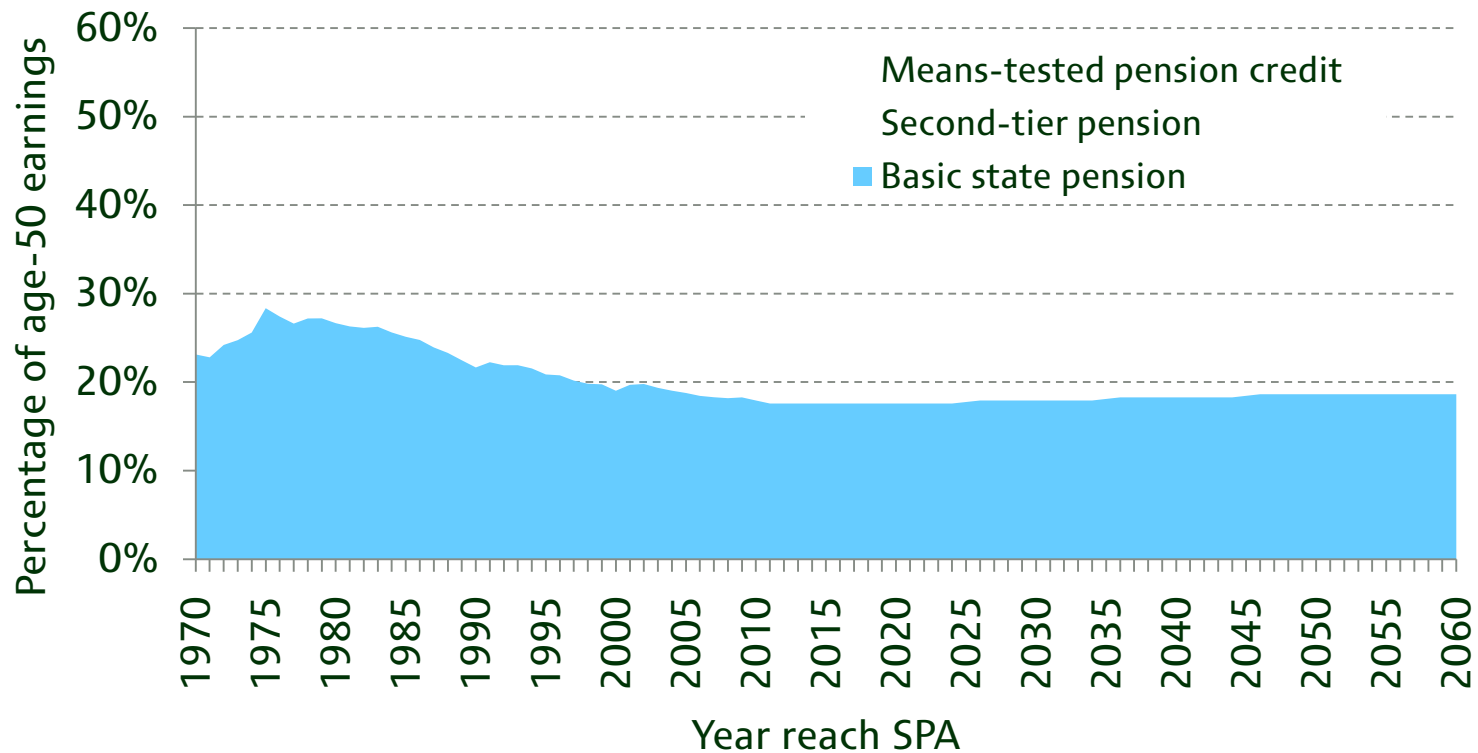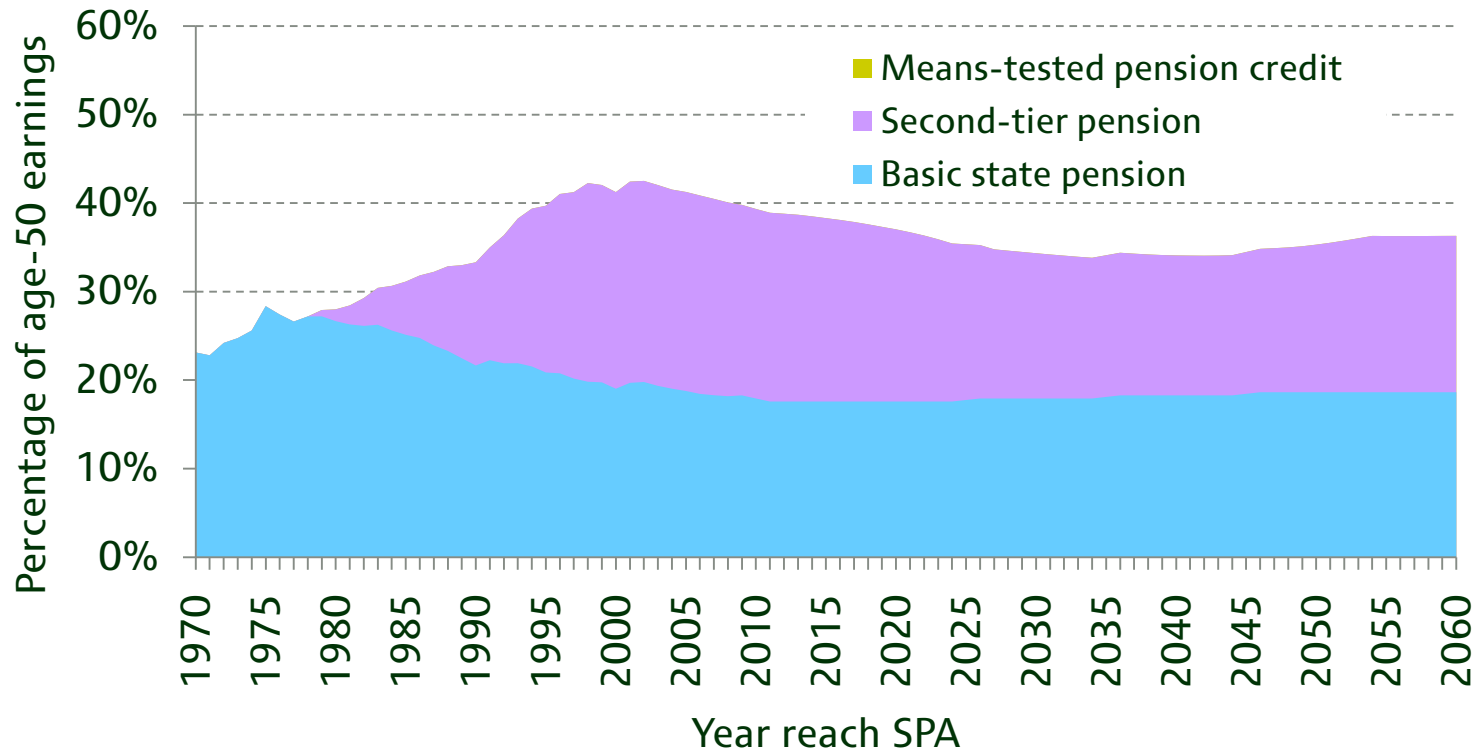
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(post Pensions Act 2007 reforms)

- Sufficient to avoid poverty

- Provide a low replacement rate on average

- **=> Need for private saving**

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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:

Income coming from:		Proportion falling below thresholds			
		PCG	67%	80%	Pen. Com.
(1)	Pension wealth only	18	37	52	39
(2)	(1) plus non-housing wealth				
(3)	(2) plus ½ housing wealth				
(4)	(3) plus expected inheritances				
(5)	(4) plus pension credit				

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Encouraging private saving

- Still a lot of concern that individuals aren't making appropriate retirement decisions
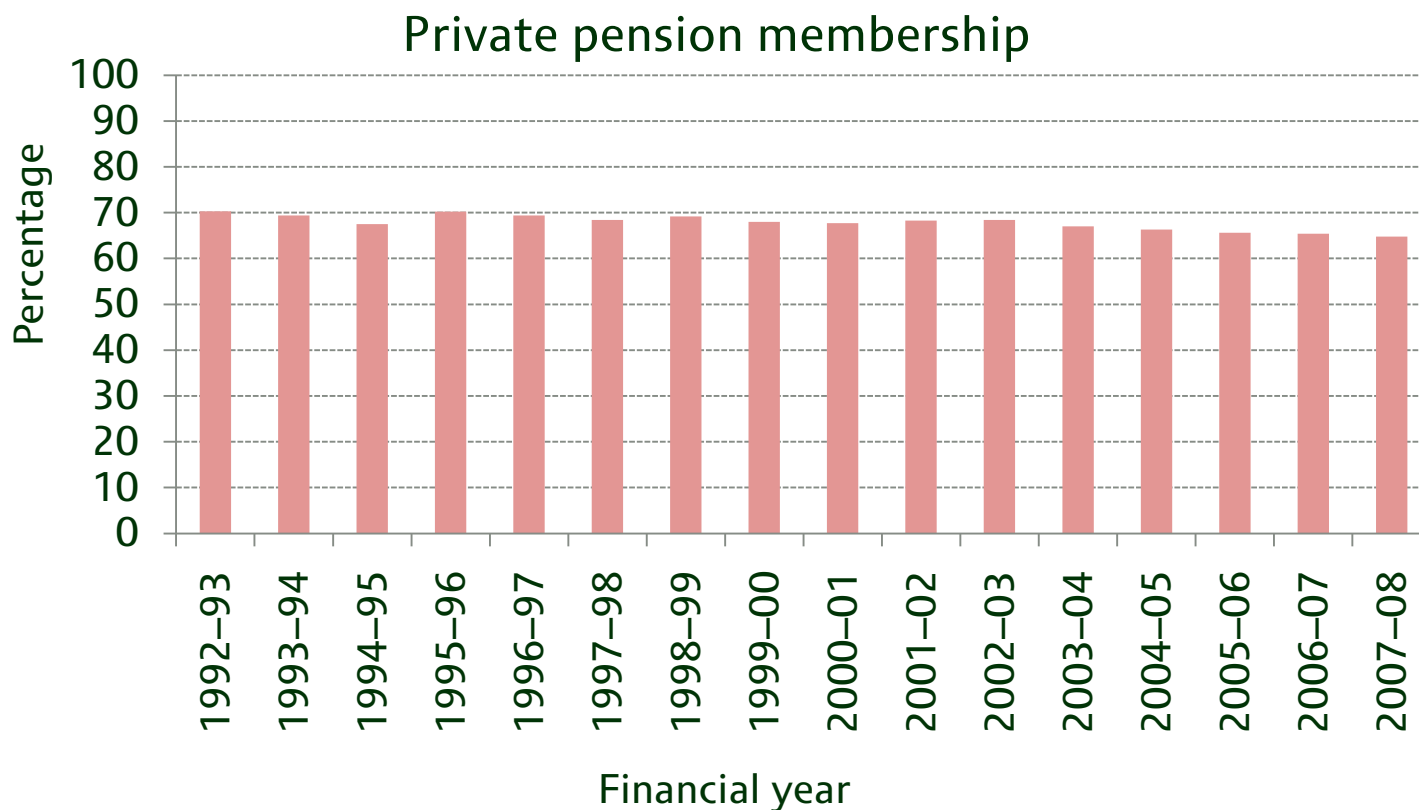
Private pension membership

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# 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)

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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)

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US evidence on auto enrolment and coverage
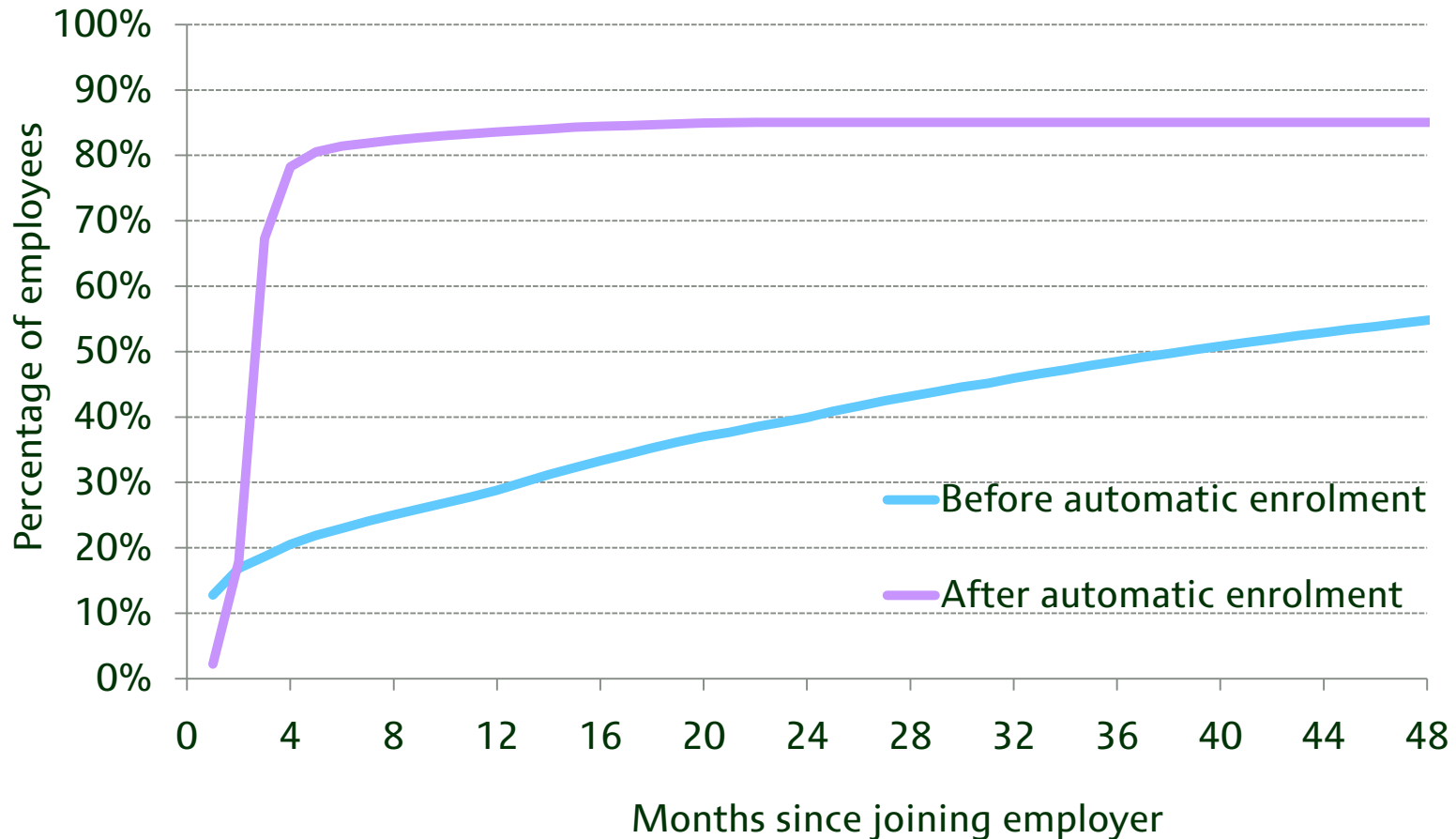
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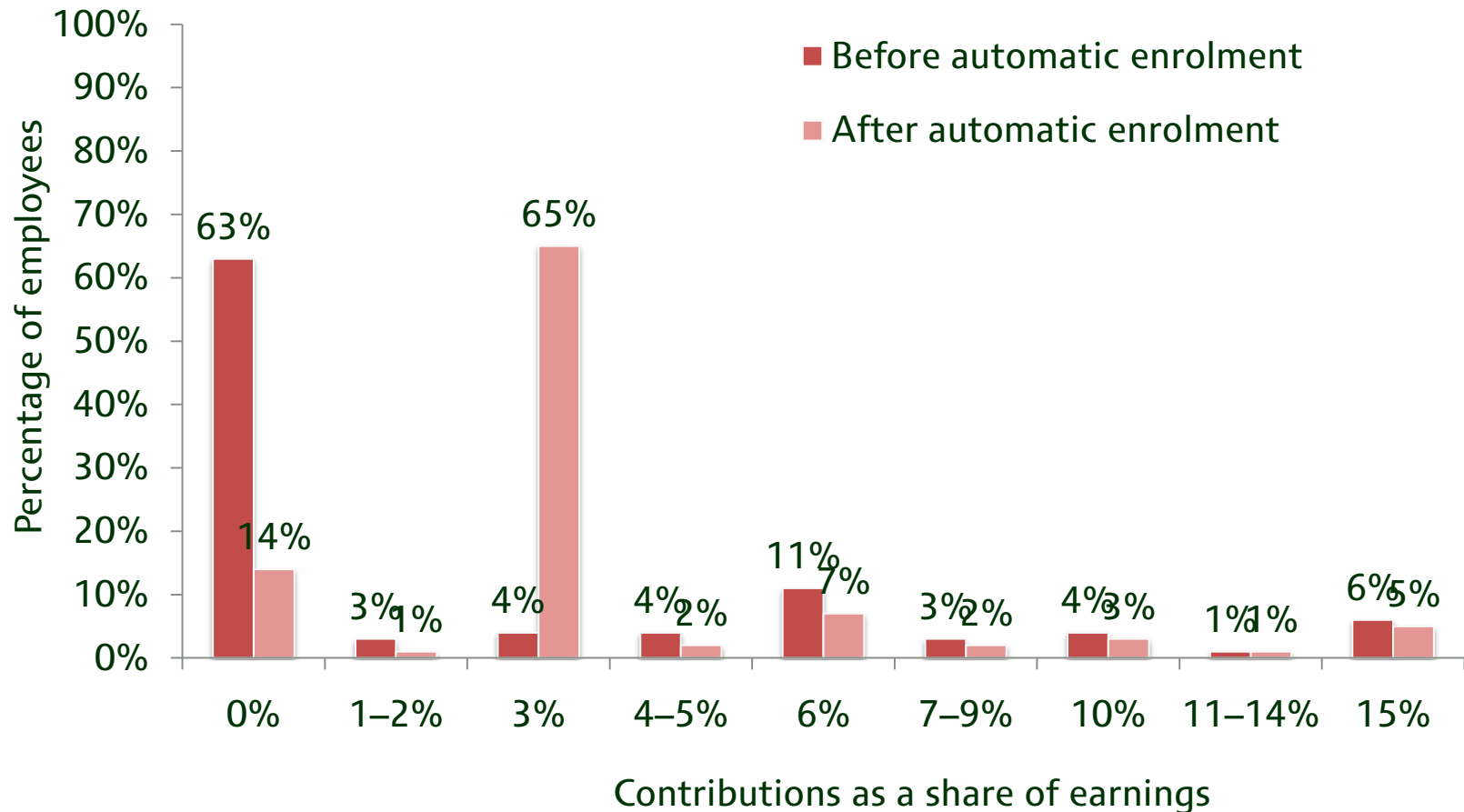 - Choice made for those who 'do not choose' (behavioural economics)

- Effect on contributions?
  - Could reduce the contributions of those who would have contributed more than the default amount

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US evidence on auto enrolment and contributions

Source: Madrian and Shea (2001)

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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

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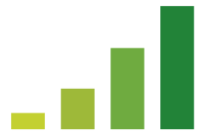Fiscal Studies

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

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