Pension policy – where have we been, where are we going?

Paul Johnson

Introduction

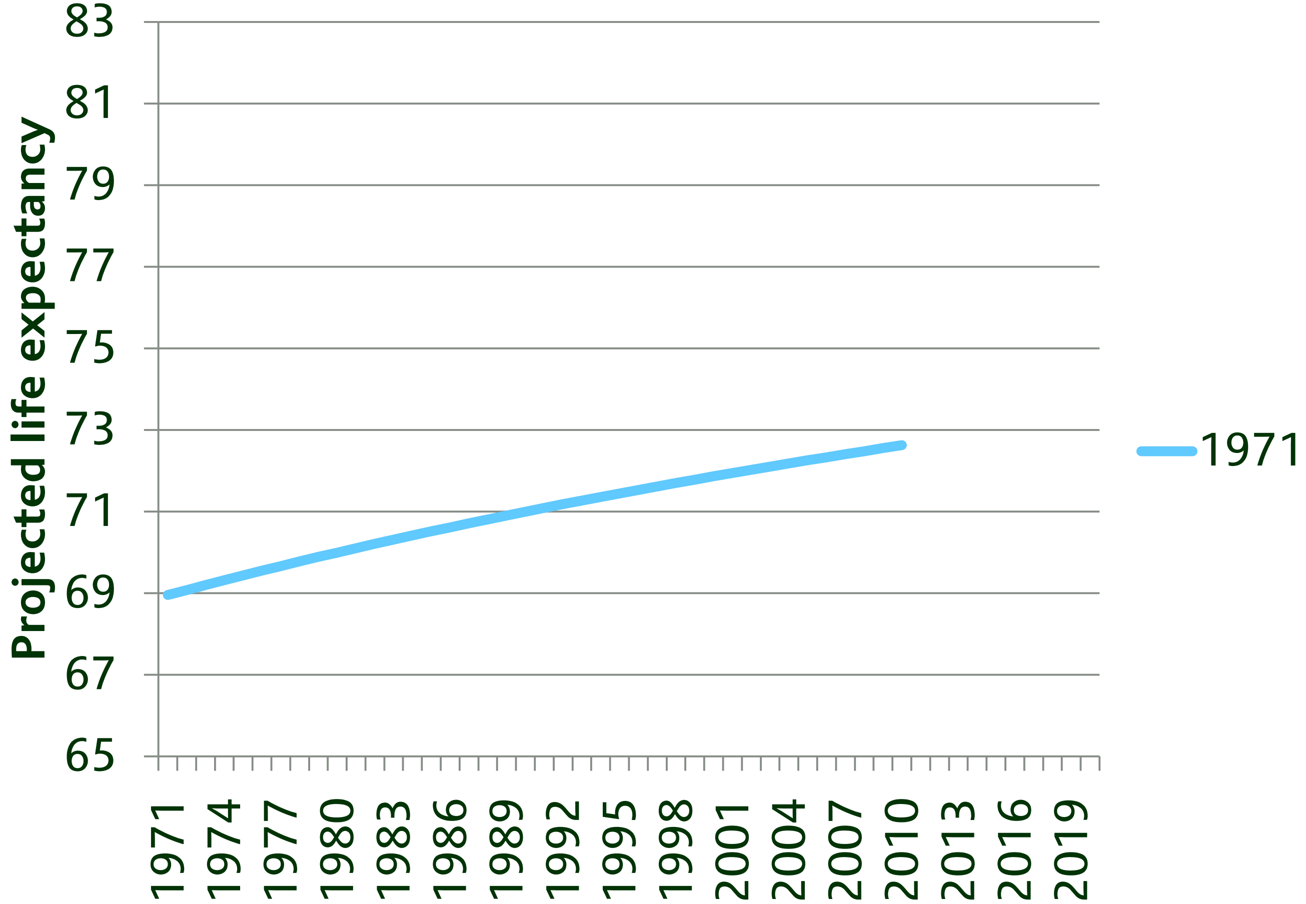
- People living longer and incomes in retirement rising
  - Incomes higher than non-pensioners on average
  - Next decade likely to see continued rise in pensioner incomes
- Longer term future looks less certain
  - Lower state pensions
  - Collapse of private sector DB schemes
  - Falling home ownership
- Policy on state pensions looks stable
  - Subject to sorting out the triple lock
- We have got ourselves into a difficult place on private pensions
  - No risk sharing
  - Tax treatment

Good news

- Life expectancy has been rising
  - unexpectedly

Rapid, unexpected change in life expectancy

Predicted life expectancy at birth



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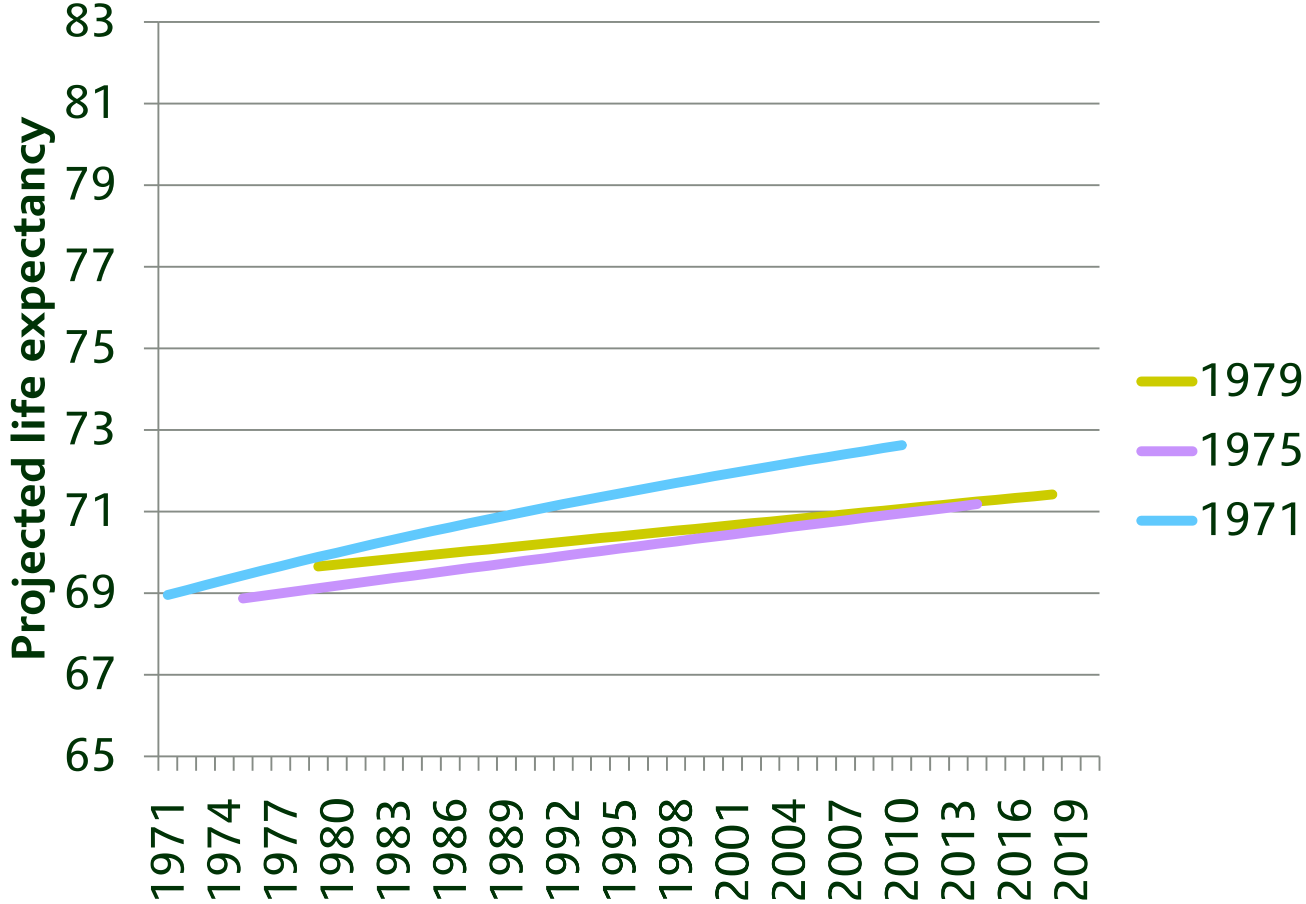

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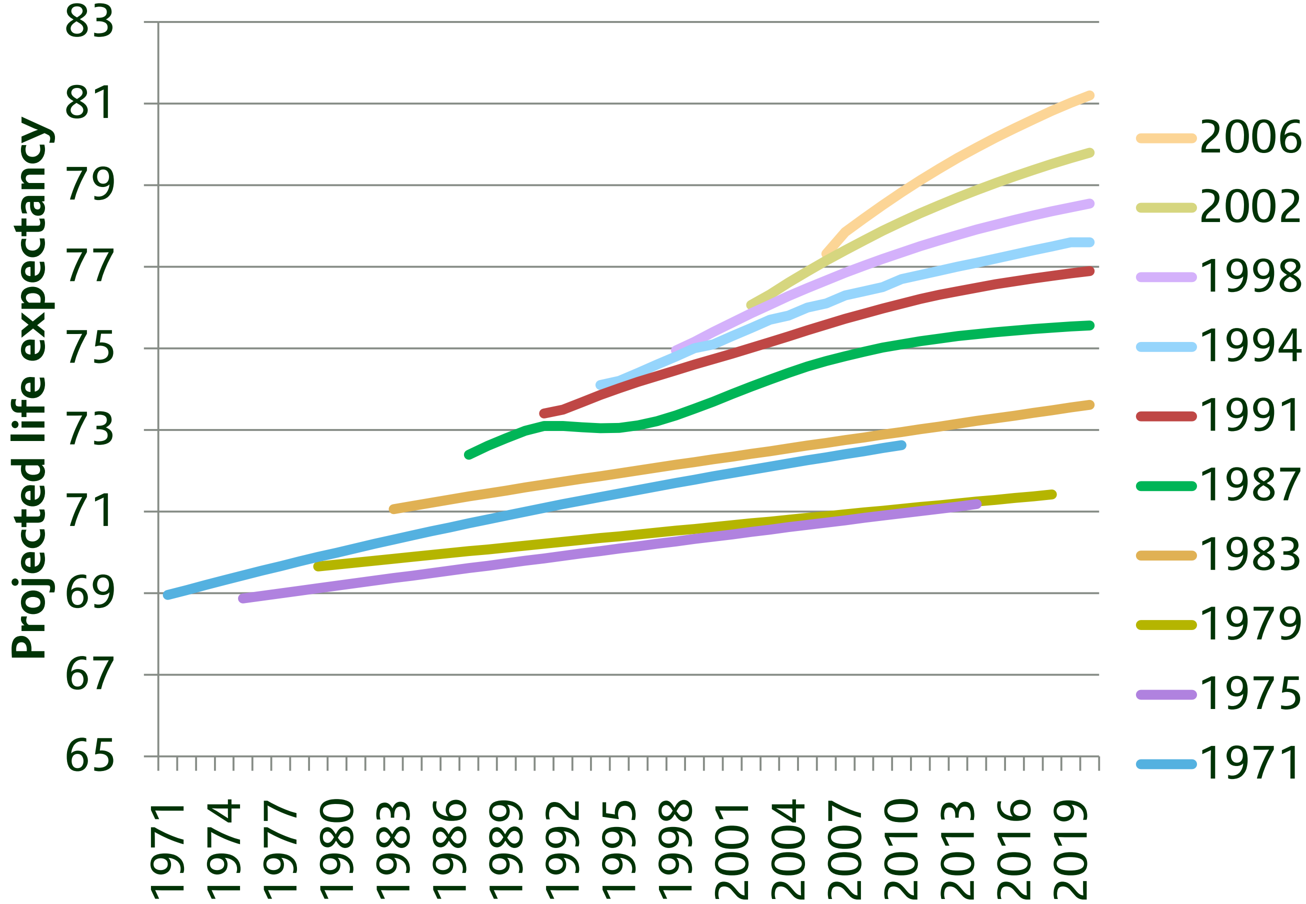

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  - And much more than for working age population

The remarkable catch-up in pension incomes

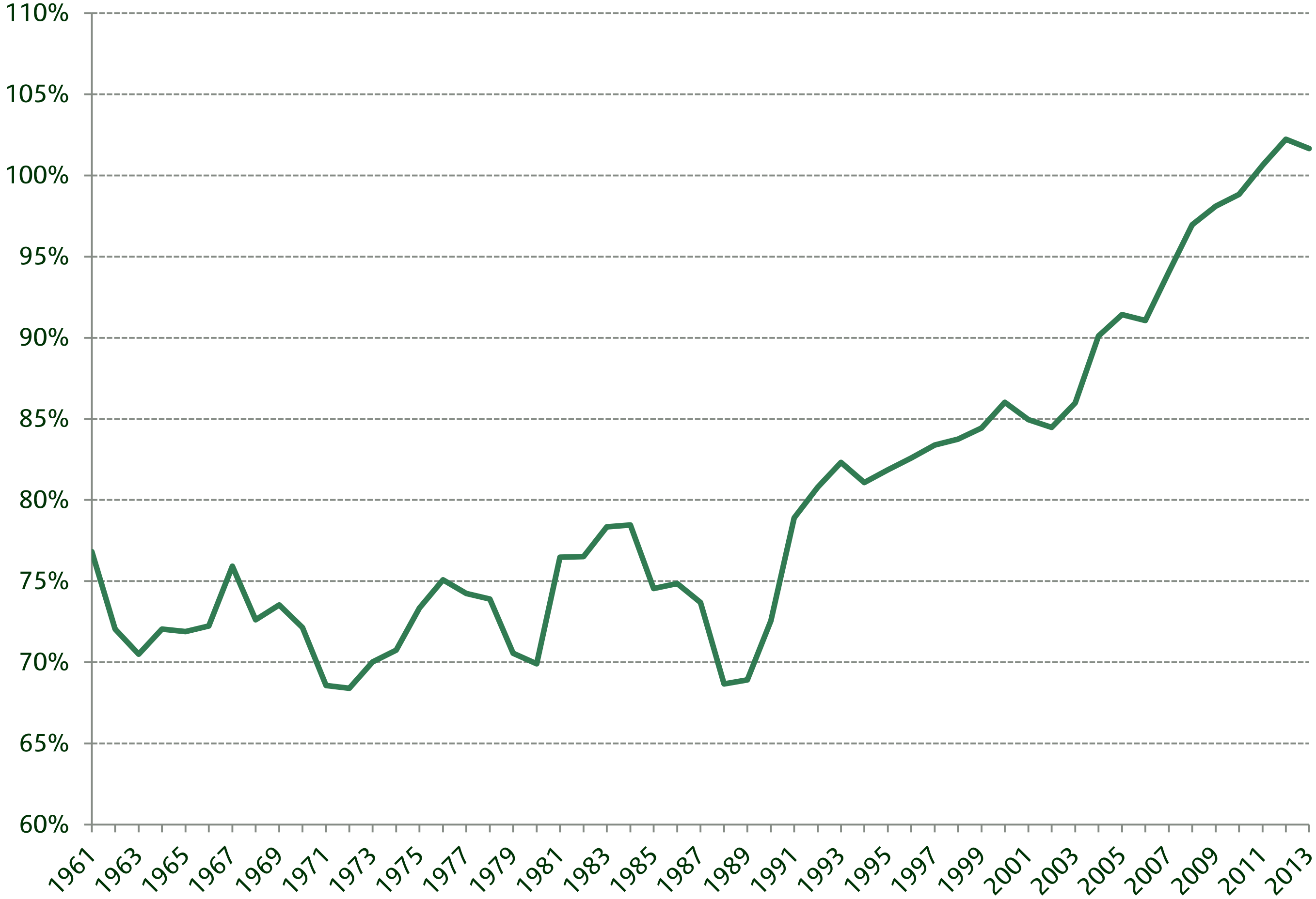

chart shows median after housing costs incomes of pensioner households as % of median for non-pensioners (HBAI income definitions)

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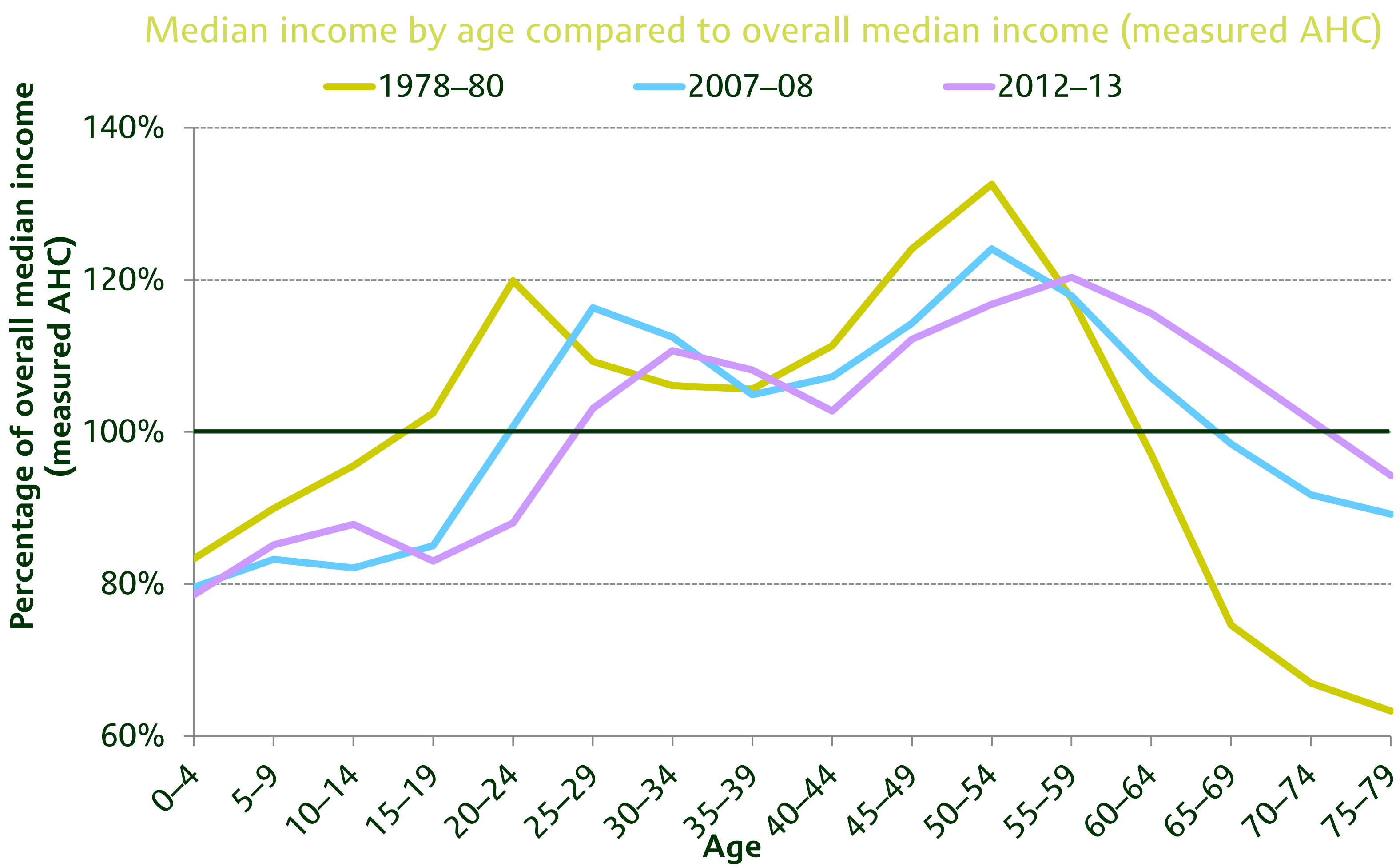
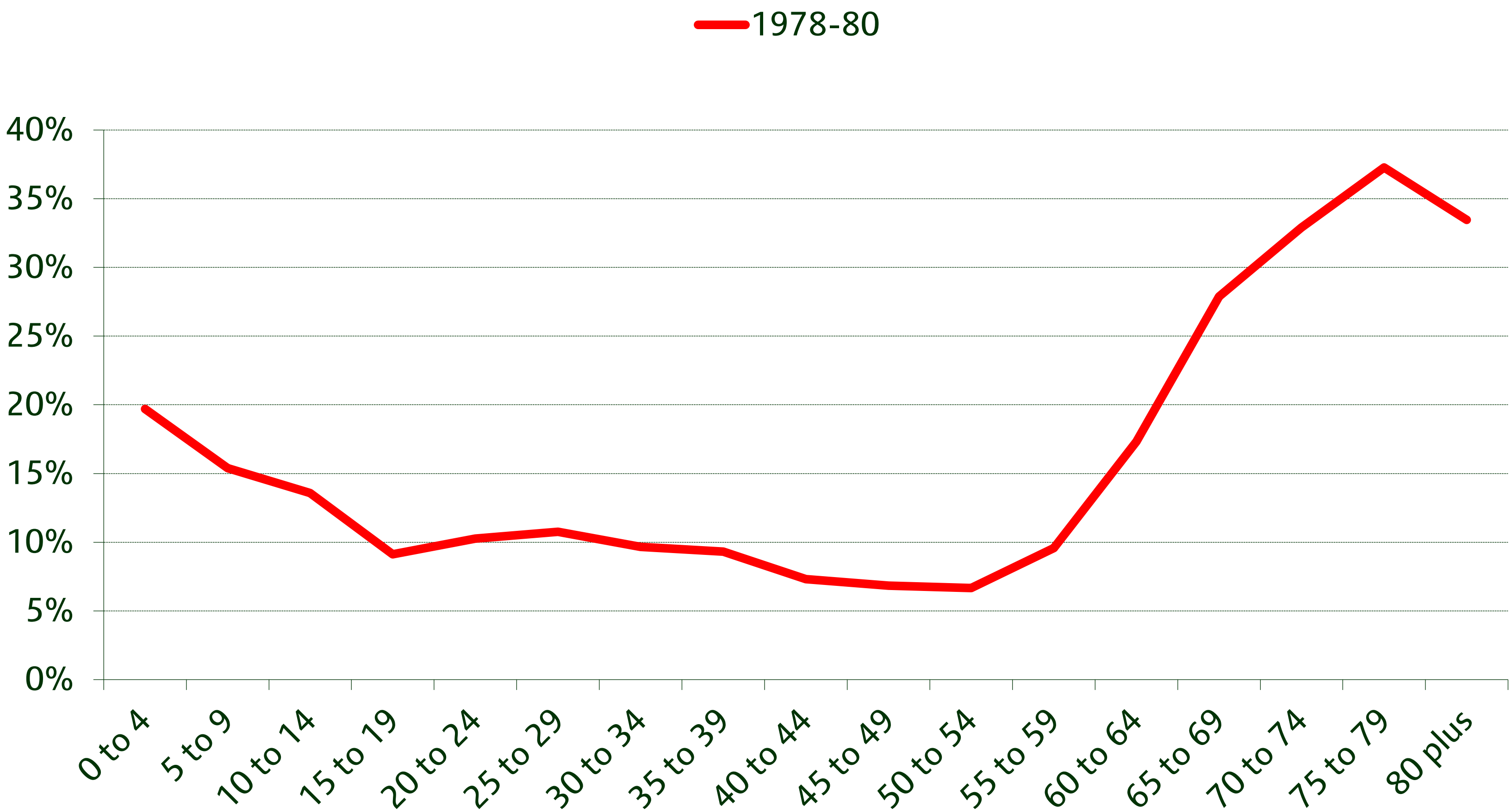
Income by age 1978-80 to 2012-13



Source: Figure 3.7b of *Living Standards, Poverty and Inequality: 2014*
http://www.ifs.org.uk/publications/7274

Notes: Household income is equivalised and measured after housing costs are deducted

Poverty rates by age



Source: Figure 6.3a of [Living Standards, Poverty and Inequality: 2013](http://www.ifs.org.uk/publications/6759)

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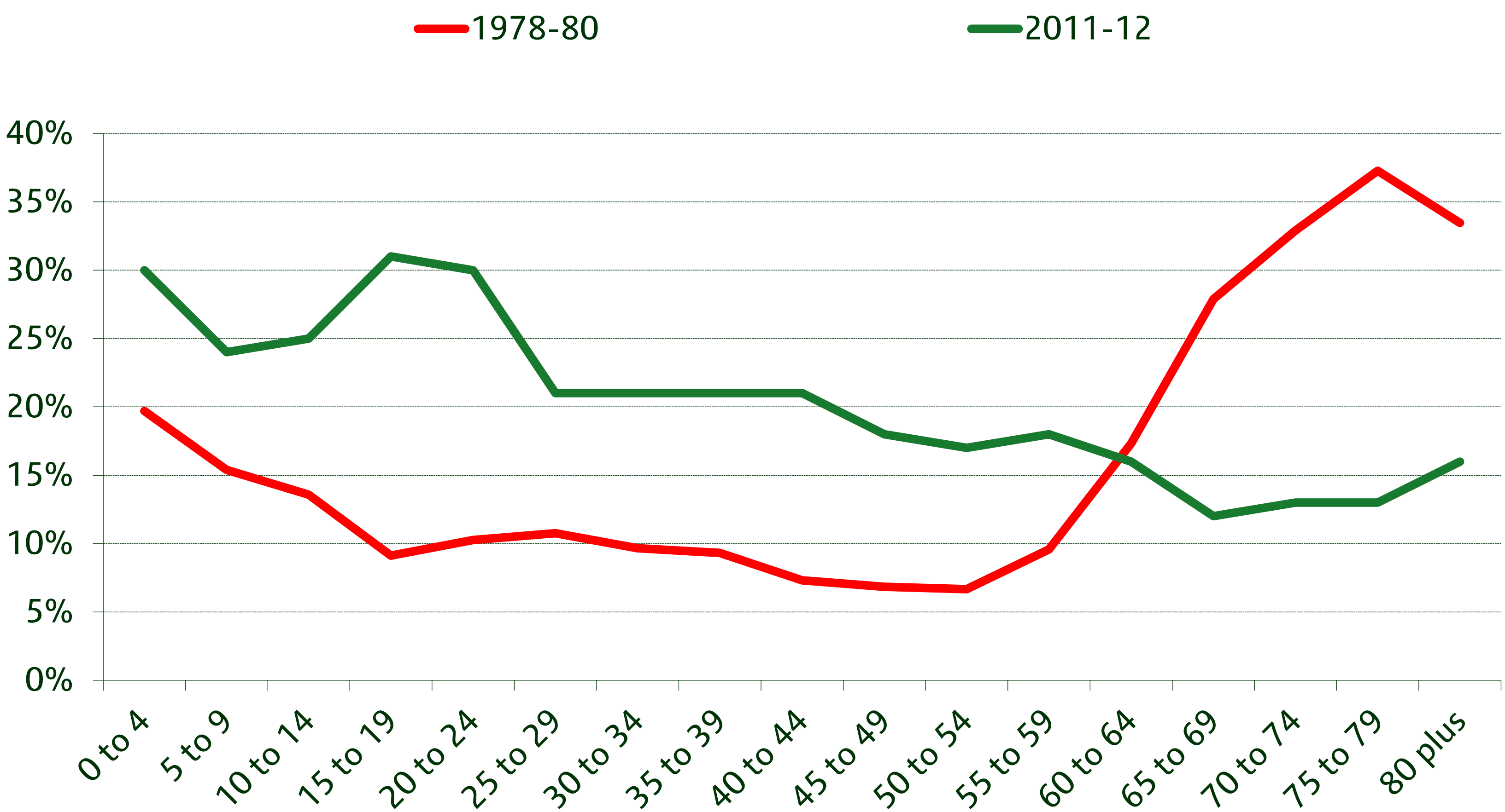

Source: Figure 6.3a of [Living Standards, Poverty and Inequality: 2013](http://www.ifs.org.uk/publications/6759)

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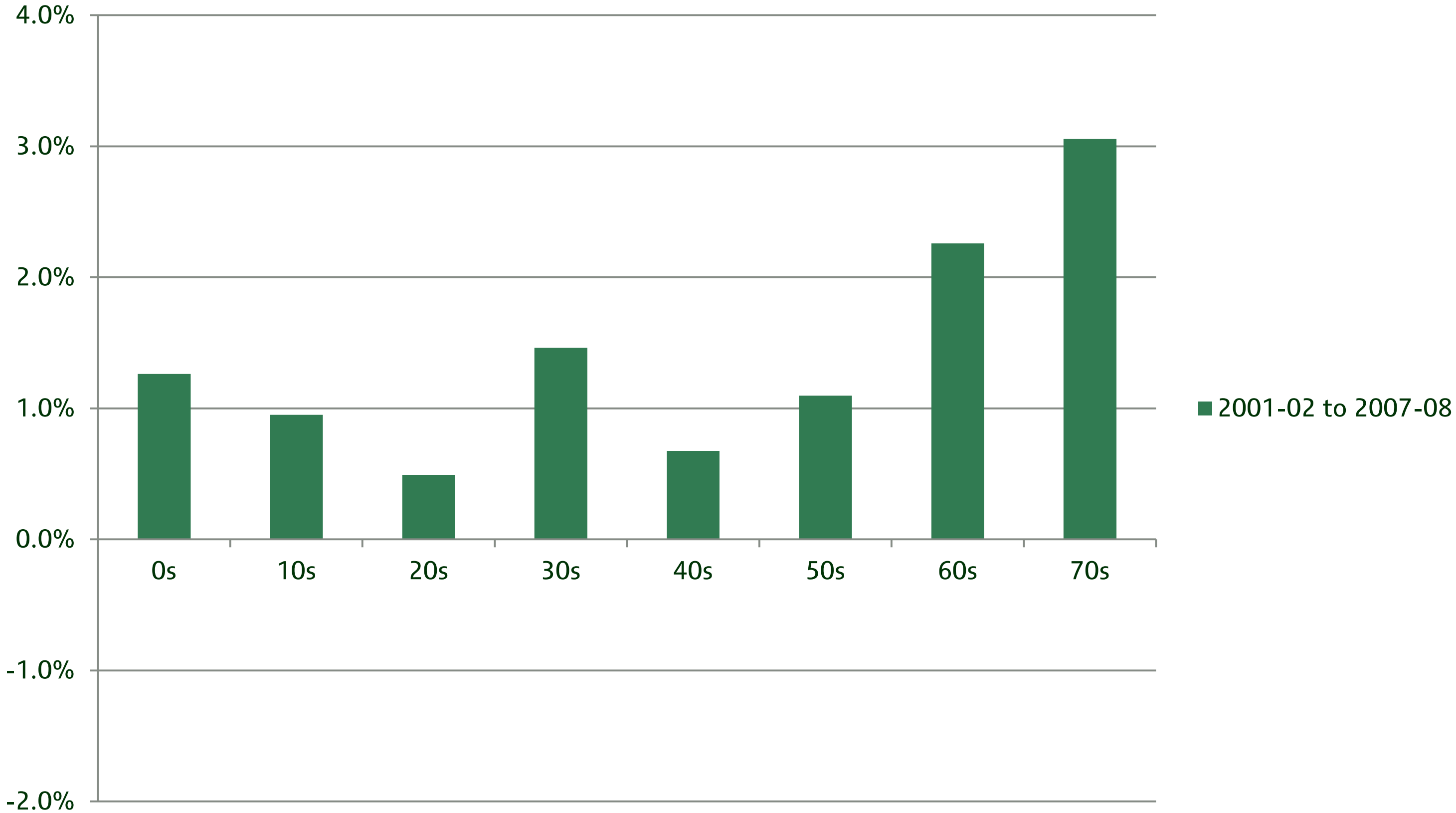
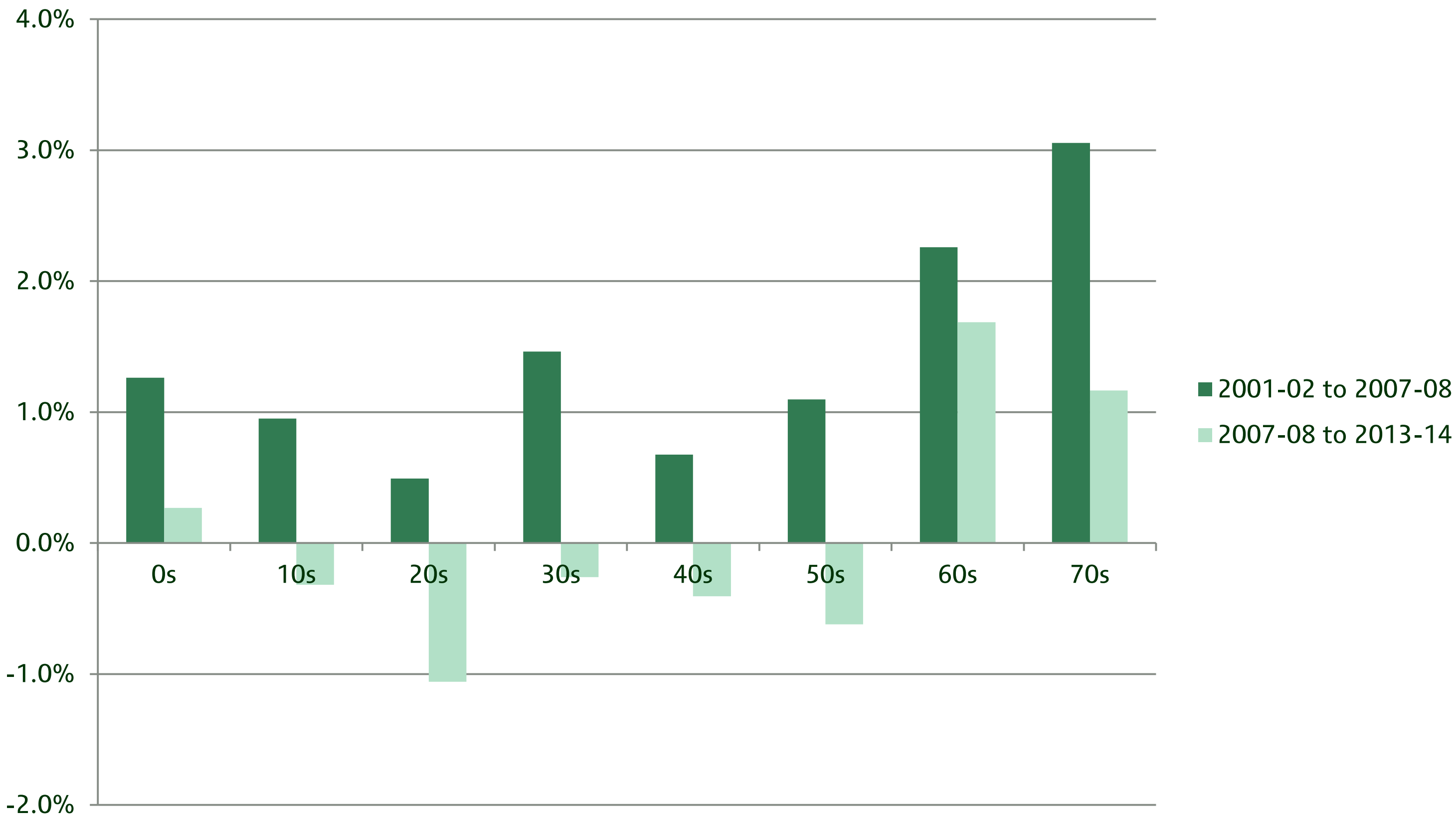
Pensioners doing better before the recession



Annual real income change by age

…and after



Annual real income change by age

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- Life expectancy has been rising
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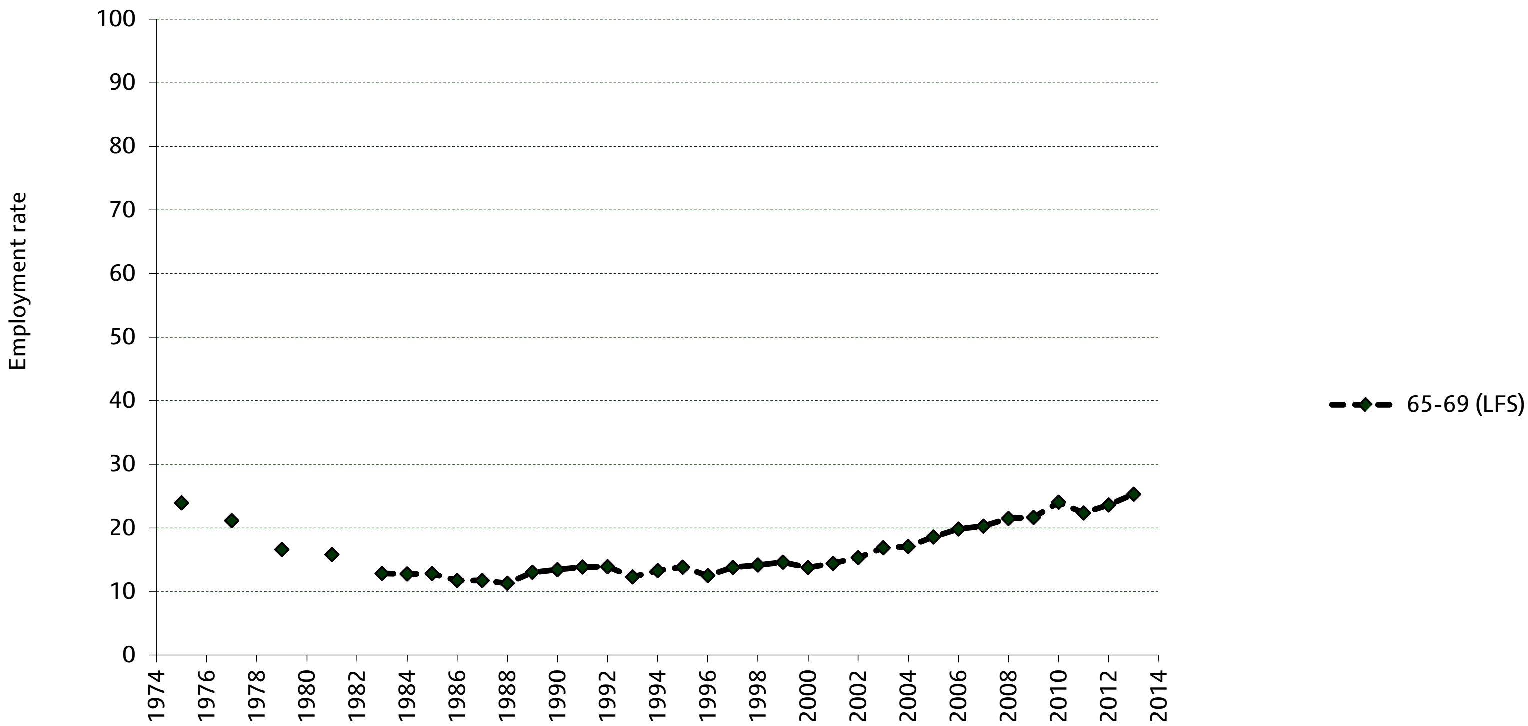
- Incomes in retirement have been rising fast
  - And much more than for working age population
- Reflecting rising state and private pensions
  - And also later retirement and increased earnings

Male employment rates slumped but have been rising for some time



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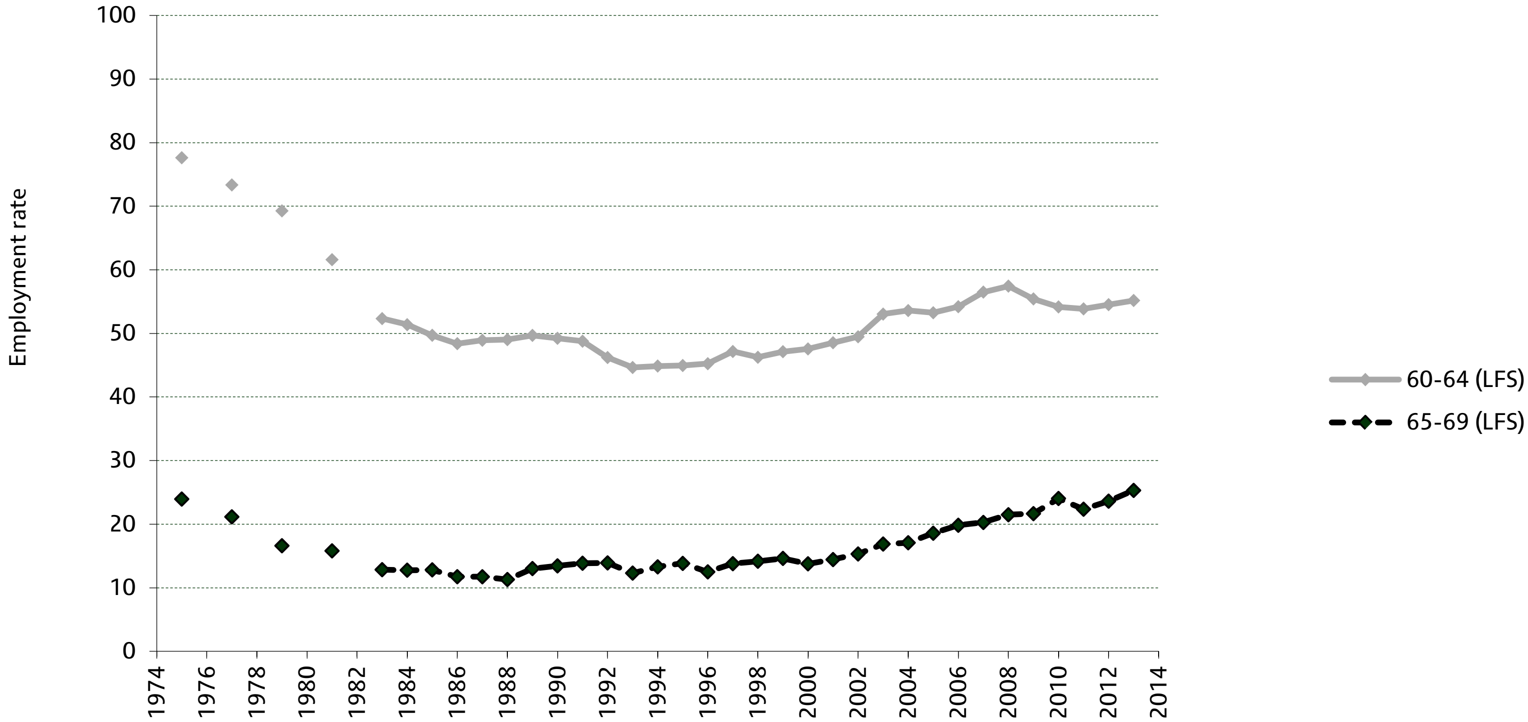

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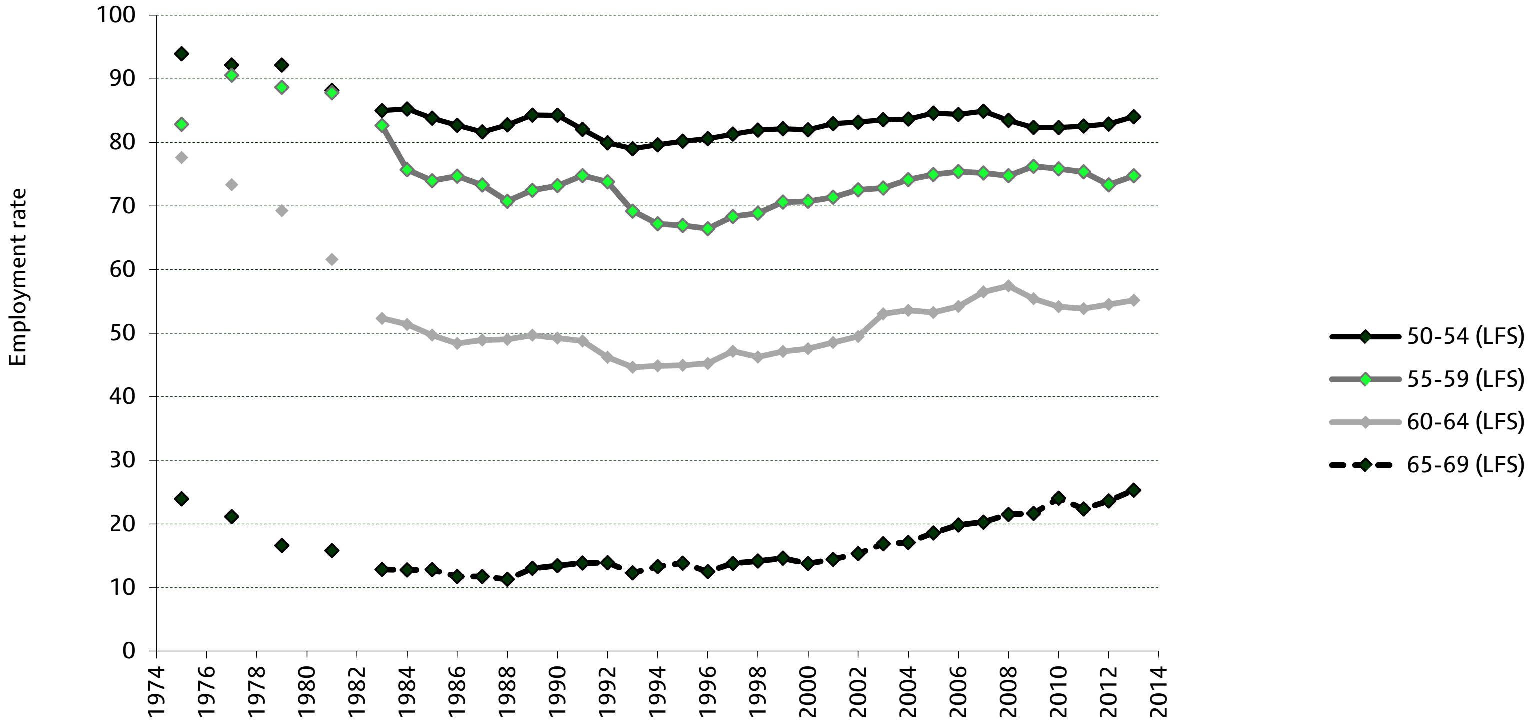

Chandler and Tetlow (2014) http://www.ifs.org.uk/publications/7384

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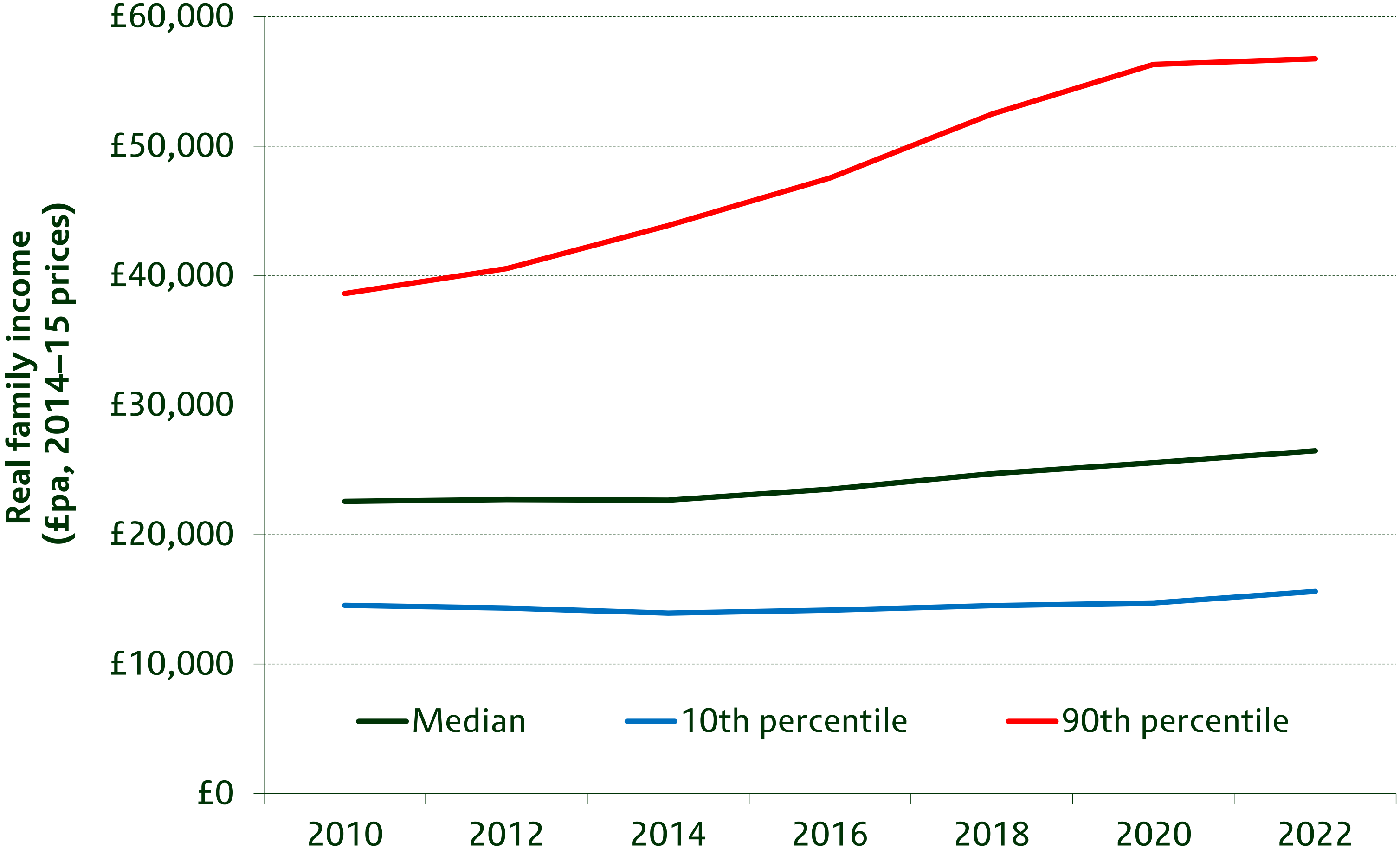
- Reflecting rising state and private pensions
  - And also later retirement and increased earnings
- And our projections suggest continued improvements over the next decade
  - http://www.ifs.org.uk/publications/7251

Equivalised family income projections: 65+ population



Source: Figure 5.1, Emmerson, Heald and Hood (2014) http://www.ifs.org.uk/publications/7251

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But are we doing too well?

- One way of thinking about that is to ask how well off people are in retirement relative to during their working life
- Traditionally looked at how much of gross final earnings are replaced by pensions
  - This was the basis for much of the Pension Commission’s work
- But is this a good measure?
  - Should be interested in net, not gross incomes
  - Why just consider pensions and not other wealth?
  - And aren’t we interested in incomes compared to average over a working life, not just final earnings?

Replacement of average lifetime earnings

- For couple households born in the 1940s we define:

$$\text{Replacement rate} = \frac{\text{Estimated real income at a}}{\text{Average equivalised real earnings age 20 - 50}}$$

Consider several definitions of income

Taking into account household size

Adjusting for inflation; considering average *purchasing power*

Source: Table 6.2, Crawford & O'Dea (2014): Retirement sorted? The adequacy and optimality of wealth among the near-retired? http://www.ifs.org.uk/publications/7358

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Percentage of couple with:	Total pension income
<=67% replacement	20%
<=80% replacement	35%
<=100% replacement	59%

Source: Table 6.2, Crawford & O'Dea (2014): Retirement sorted? The adequacy and optimality of wealth among the near-retired? http://www.ifs.org.uk/publications/7358

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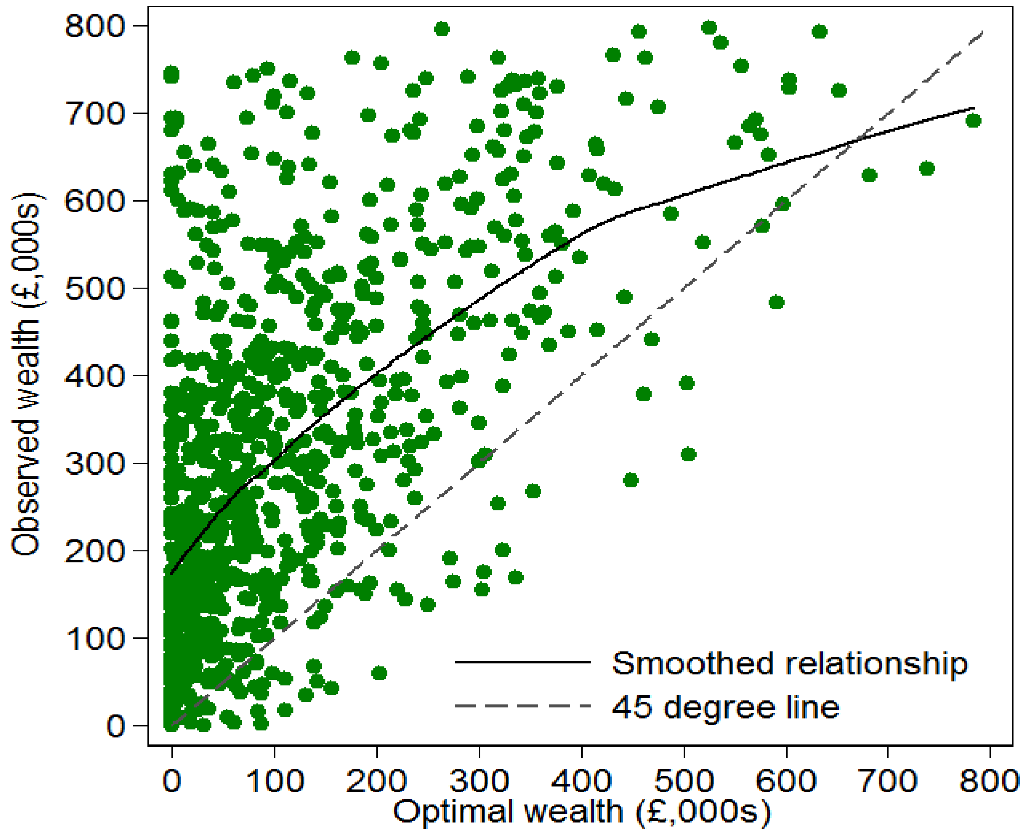
Percentage of couple with:	Total pension income	... plus annuitised non-housing wealth
<=67% replacement	20%	10%
<=80% replacement	35%	20%
<=100% replacement	59%	41%

Source: Table 6.2, Crawford & O'Dea (2014): Retirement sorted? The adequacy and optimality of wealth among the near-retired? http://www.ifs.org.uk/publications/7358

Comparing 'optimal' and actual (private) wealth



For the current generation of pensioners

- A remarkable triumph
  - Despite longer lives and earlier retirement incomes are higher than they were during working life for most
- Down to a combination of
  - Increasing state pensions
  - More generous means tested benefits
  - Occupational pensions
  - House prices

What about the future?

- For the next decade at least things still look quite positive
- Further ahead things may look less rosy
  - Earnings have fallen and savings rates were lower

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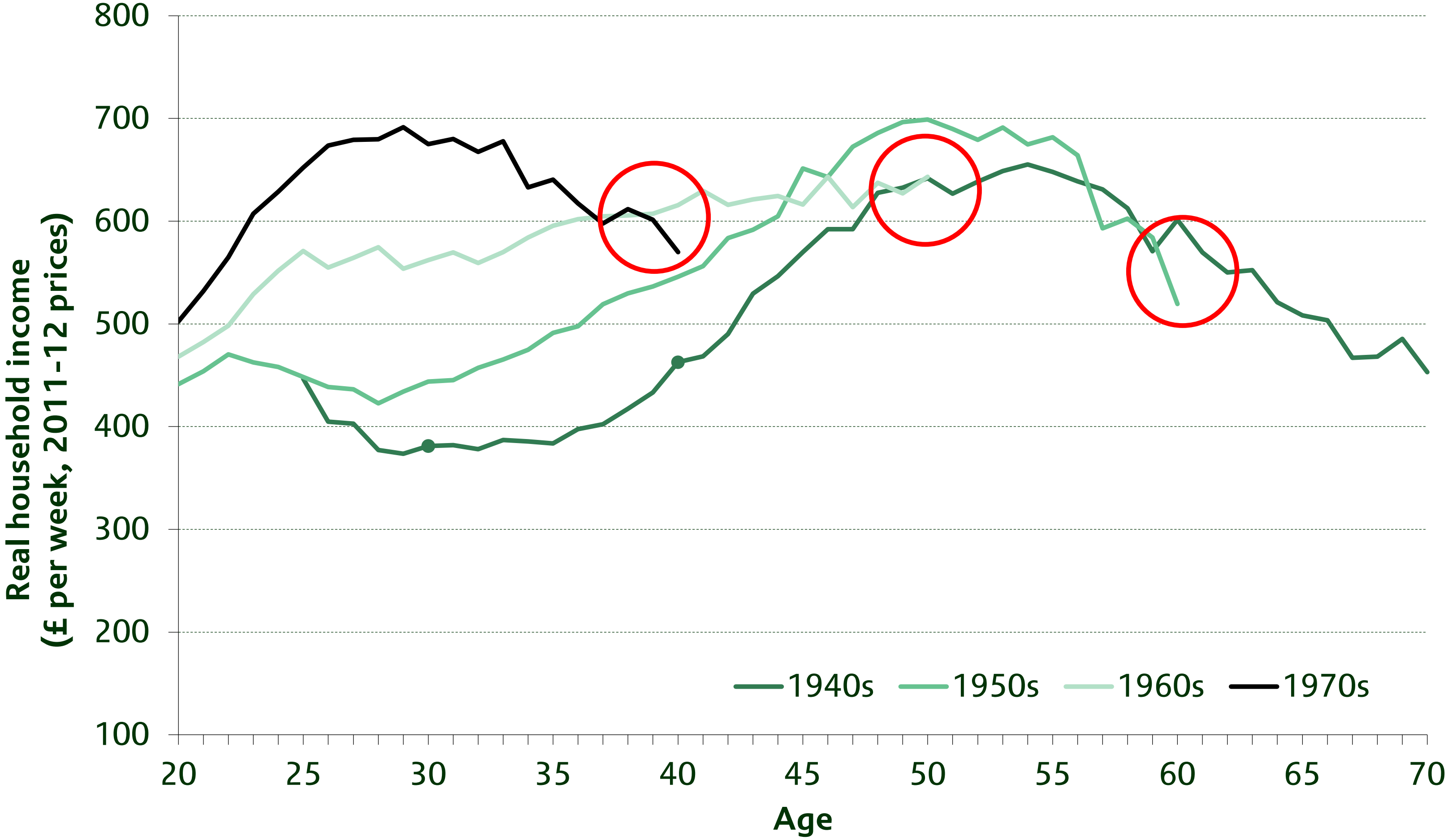
Incomes are dipping



Source : Authors' calculations using FES/EFS/LCF, various years

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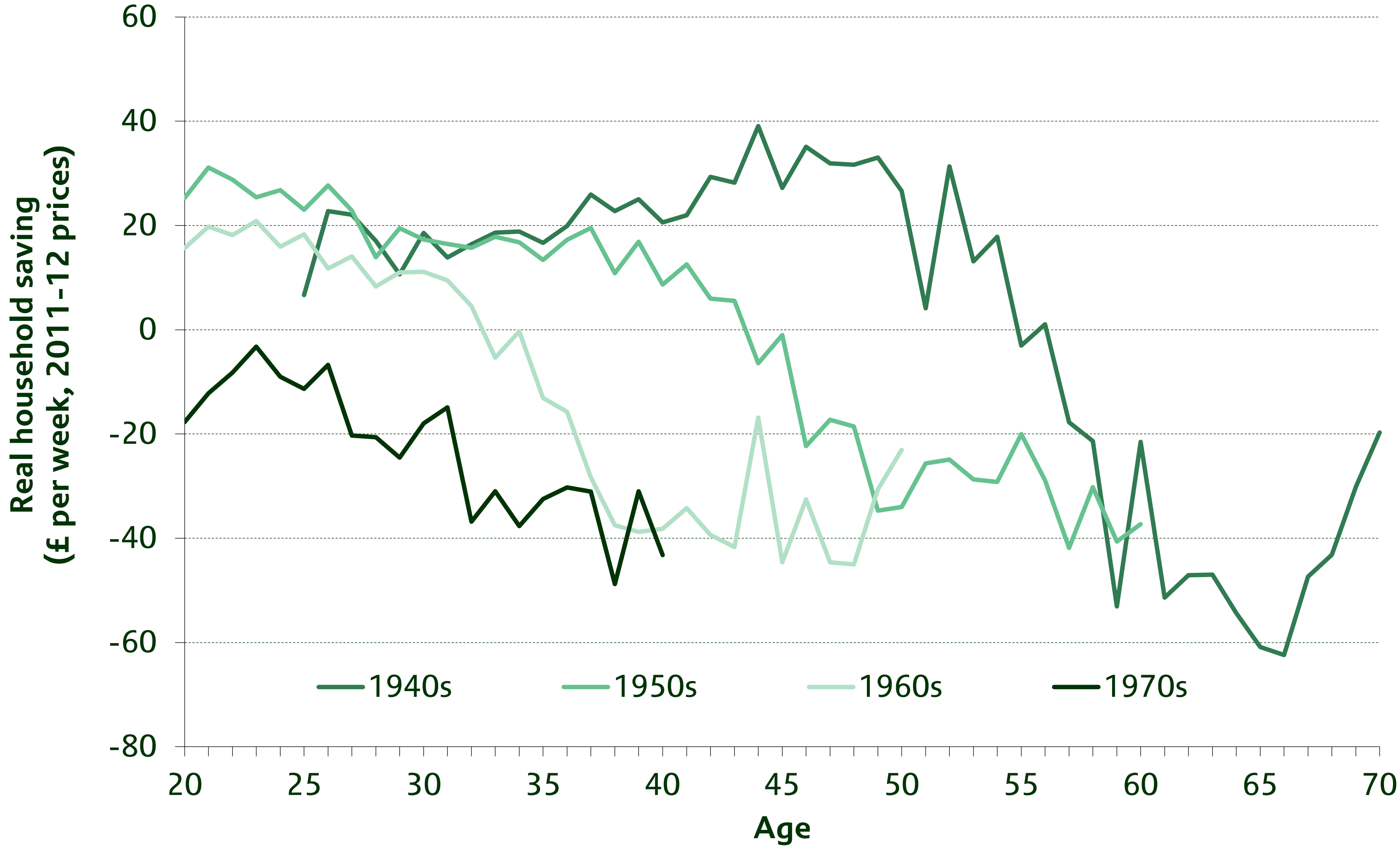
As are savings rates

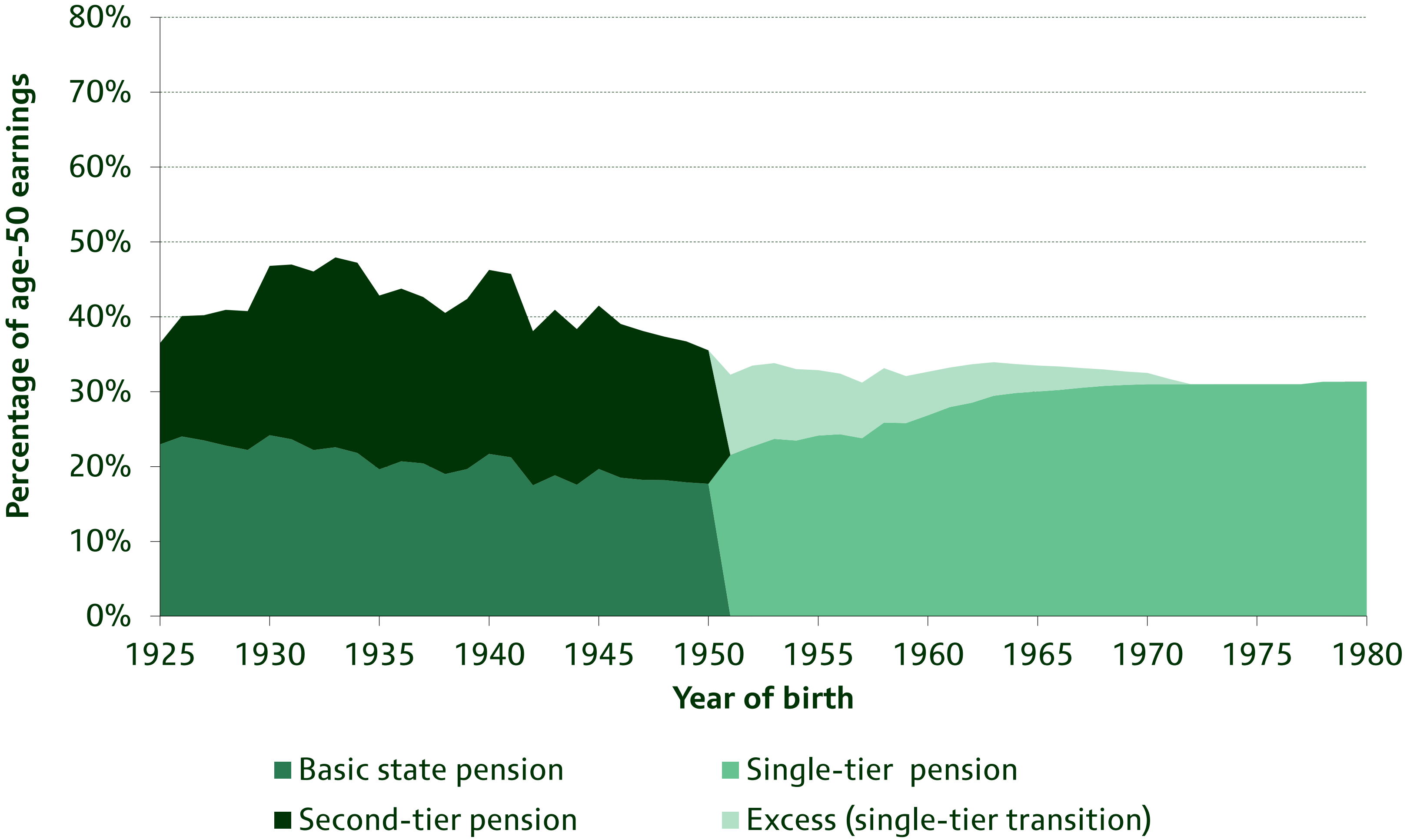


Source : Authors' calculations using FES/EFS/LCF, various years

What about the future?

- For the next decade at least things still look quite positive
  - We can model incomes really quite well that far ahead given what we know about pensions, health, working patterns etc
- Further ahead things may look less rosy
  - Earnings have fallen and savings rates were lower
- The state pension is becoming less generous for many
  - The single tier is worth less than basic pension plus SERPS/S2P

Male median earner who works continuously up to his state pension age



Source : Authors' calculations using earnings profiles from FES/EFS/LCF, various years

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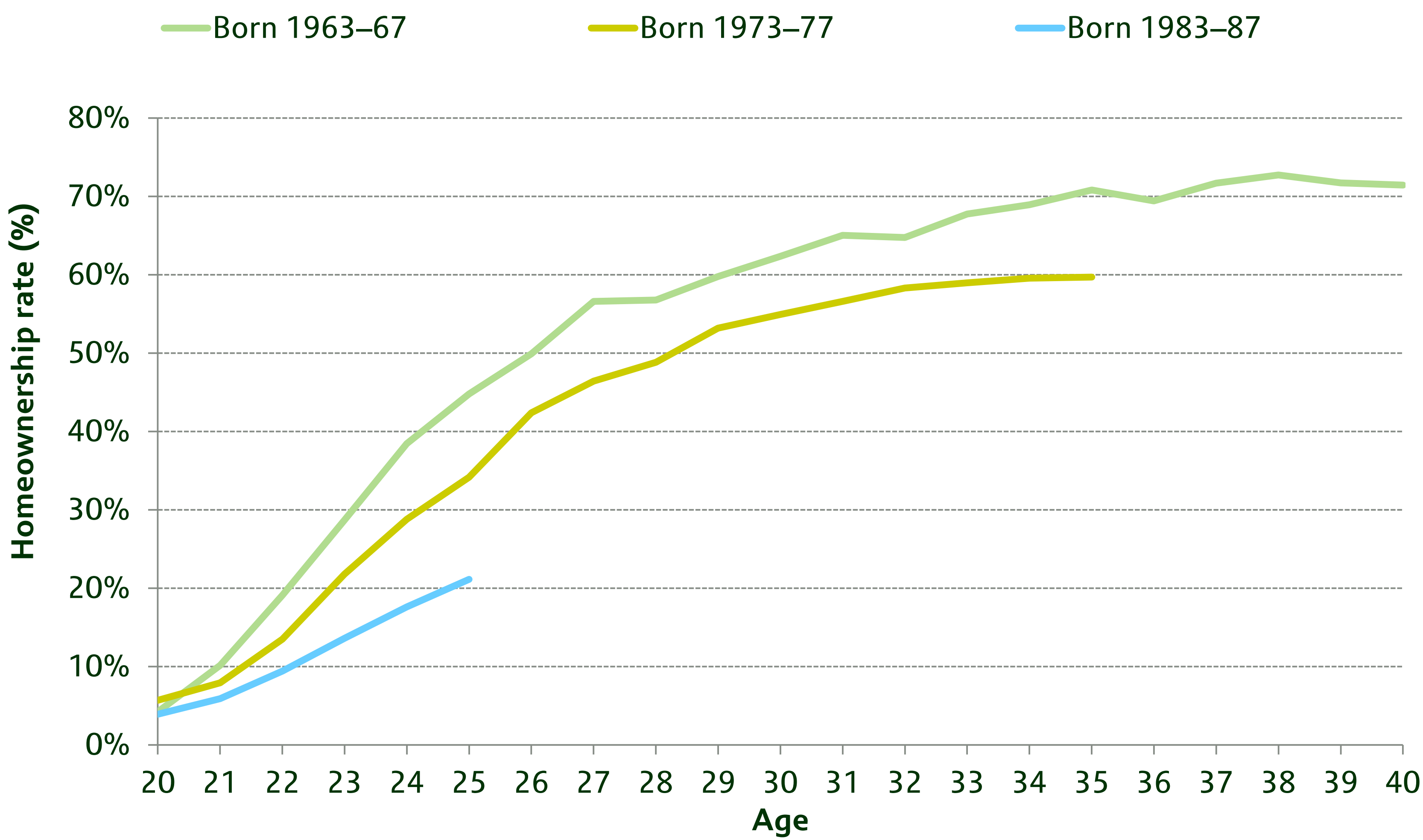
- Home ownership rates are declining

Recent cohorts are also less likely to own a home



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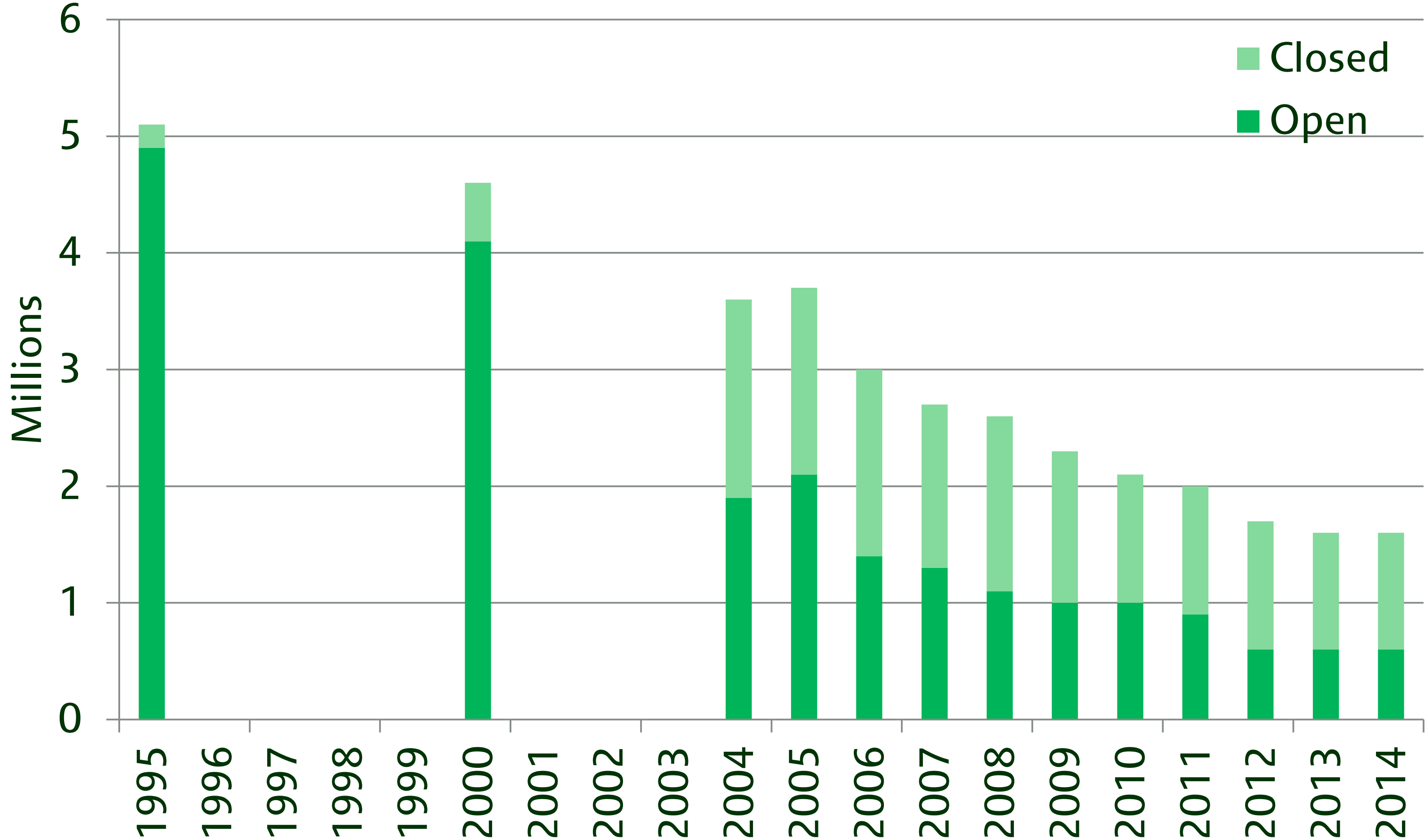
- Home ownership rates are declining
- The collapse in DB scheme membership outside the public sector is huge
  - A double whammy on earnings

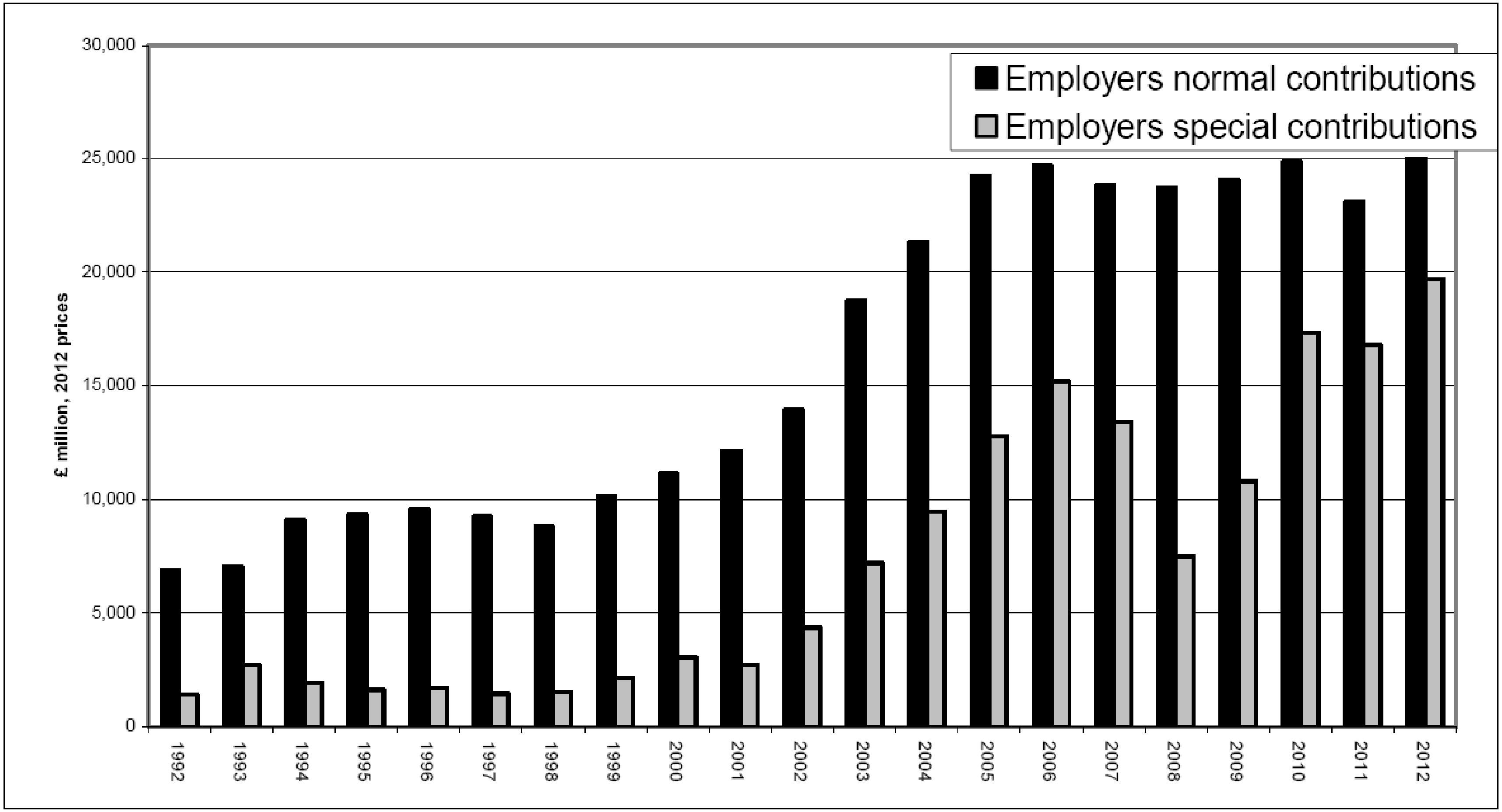
Declining private sector DB coverage

Active members of private sector defined benefit schemes



Source: Occupational Pension Scheme Survey.

Employer contributions to pension funds – in constant prices terms



Source: Office for National Statistics

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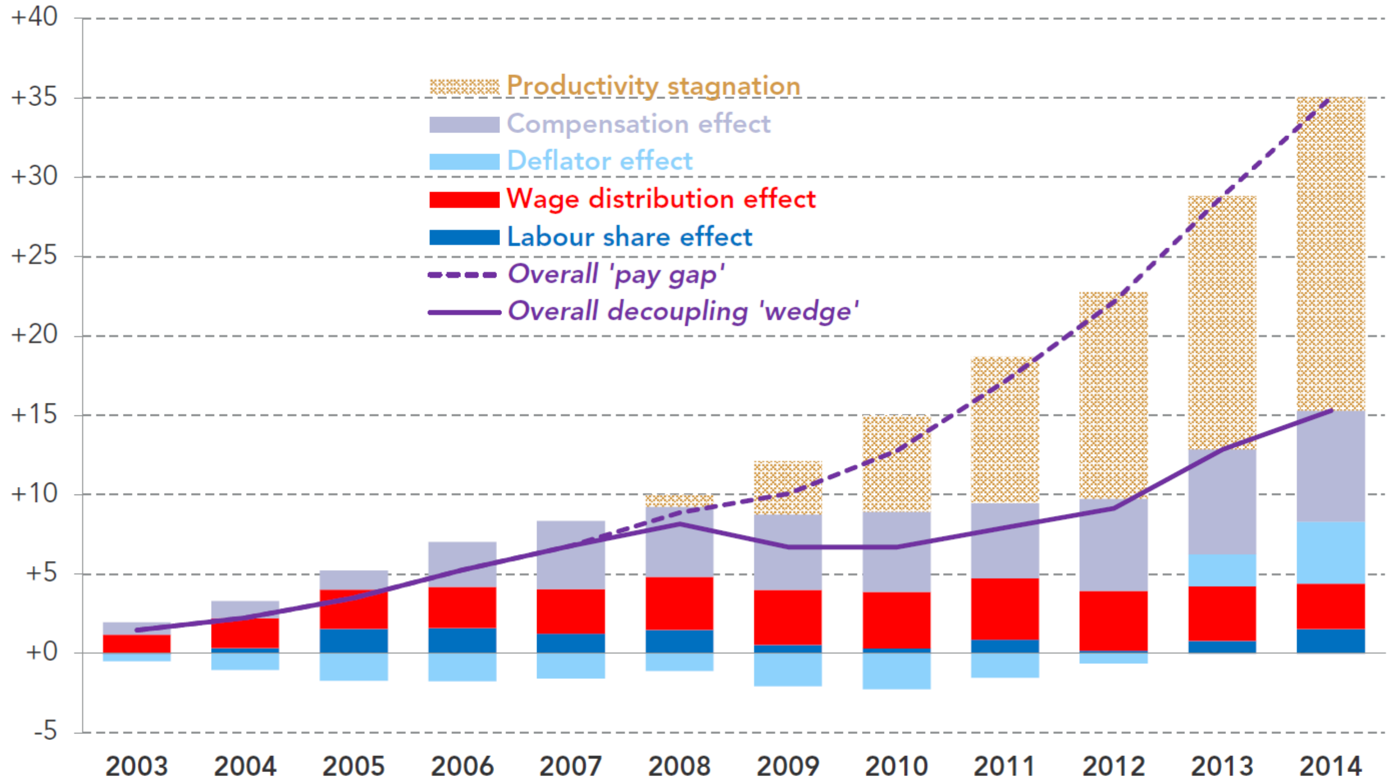
Pension costs have played a big role in average wages rising less quickly than productivity



Notes: 'Pay gap' refers to how much higher median pay would have been in the period 2002-2014 in the absence of any further decoupling of median pay growth from productivity growth and the absence of productivity stagnation after 2007.

Source: RF analysis of ONS, *National Accounts*; and ONS, *Annual Survey of Hours and Earnings & New Earnings Survey*

http://www.resolutionfoundation.org/wp-content/uploads/2015/09/Productivity-briefing.pdf

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To recap…

- The current generation at and near retirement are doing very well
- To some extent at the expense of younger generations
  - Who can expect lower retirement incomes
- What about policy?

The recent history of state pensions

- SERPS was introduced in 1978
- Governments have spent the whole period since un-introducing it
  - A long and tortuous path given the complexities around contracting out
- Any link between contributions and entitlement has effectively ended
- The single tier is the logical final step
  - Very close to a flat rate “citizens’ pension” based on history of residence
  - Note that it reduces expected future generosity for almost everyone

Remaining policy issues

- Pension age
  - Rising over coming decades
  - We know that increasing female SPA is increasing employment
    - http://www.ifs.org.uk/publications/7323
  - Commitment to raise with life expectancy so people live a third of adult life (over 20) in retirement

Legislation to increase pension age

Age	Legislated		
66	2020		
67	2028		
68	2046		
69			
70			
71			
72			
73			
74			
75			

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Legislation to increase pension age

Age	Legislated	Population variant	
		central	
66	2020	2020	
67	2028	2028	
68	2046	2036	
69		2049	
70		2063	
71			
72			
73			
74			
75			

Legislation to increase pension age

Age	Legislated	Population variant	
		central	high
66	2020	2020	2020
67	2028	2028	2028
68	2046	2036	2031
69		2049	2034
70		2063	2037
71			2040
72			2045
73			2051
74			2057
75			2064

Remaining policy issues

- Pension age
  - Rising over coming decades
  - We know that increasing female SPA is increasing employment
    - http://www.ifs.org.uk/publications/7323
  - Commitment to raise with life expectancy so people live a third of adult life (over 20) in retirement
- Level and indexation
  - Triple lock adds £15bn to costs by 2050 relative to earnings indexation
  - Introduces an element of pure randomness into pension level
  - Makes no sense as a policy

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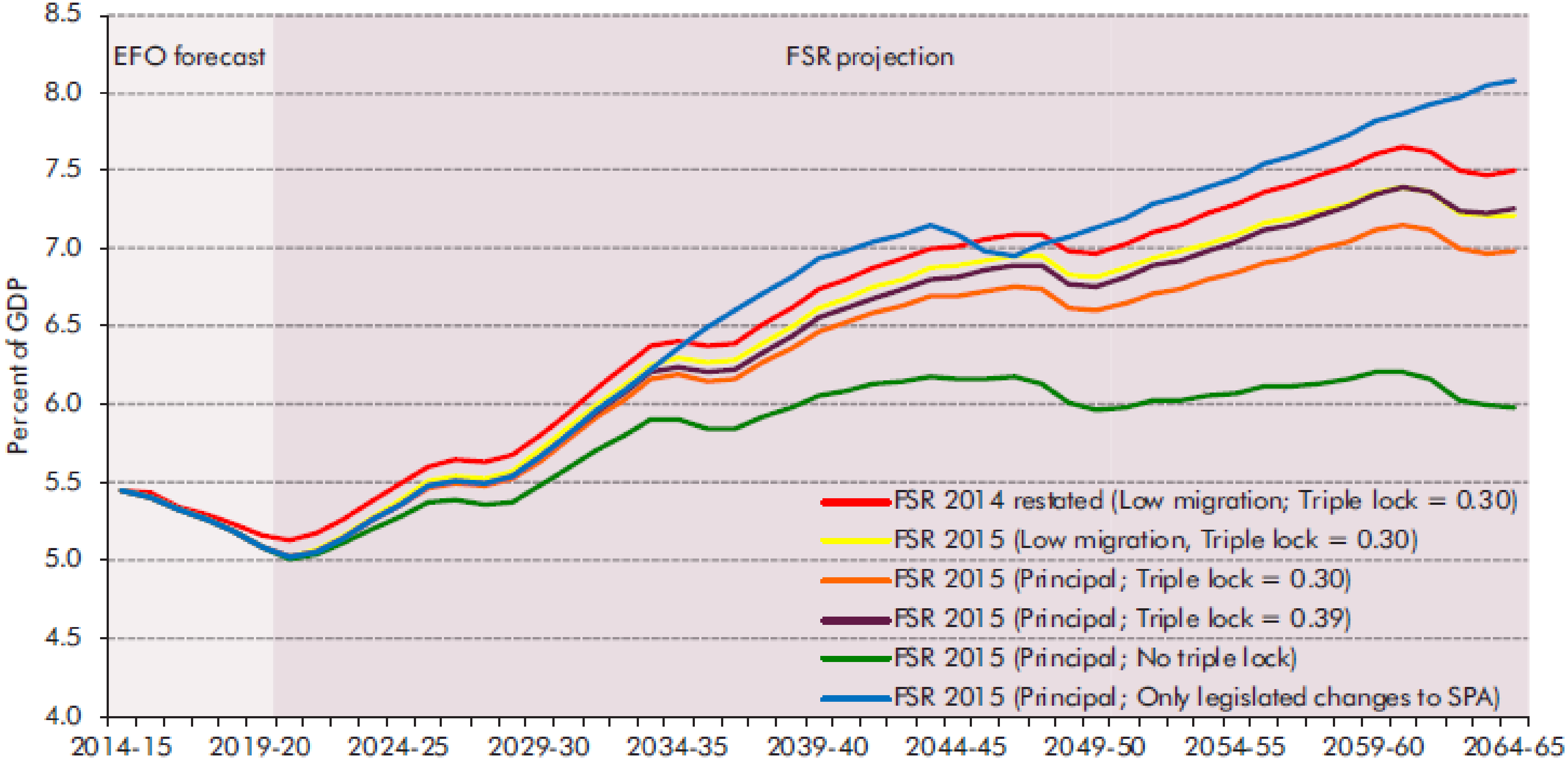
Effects of triple lock and pension age on spending



Source: OBR

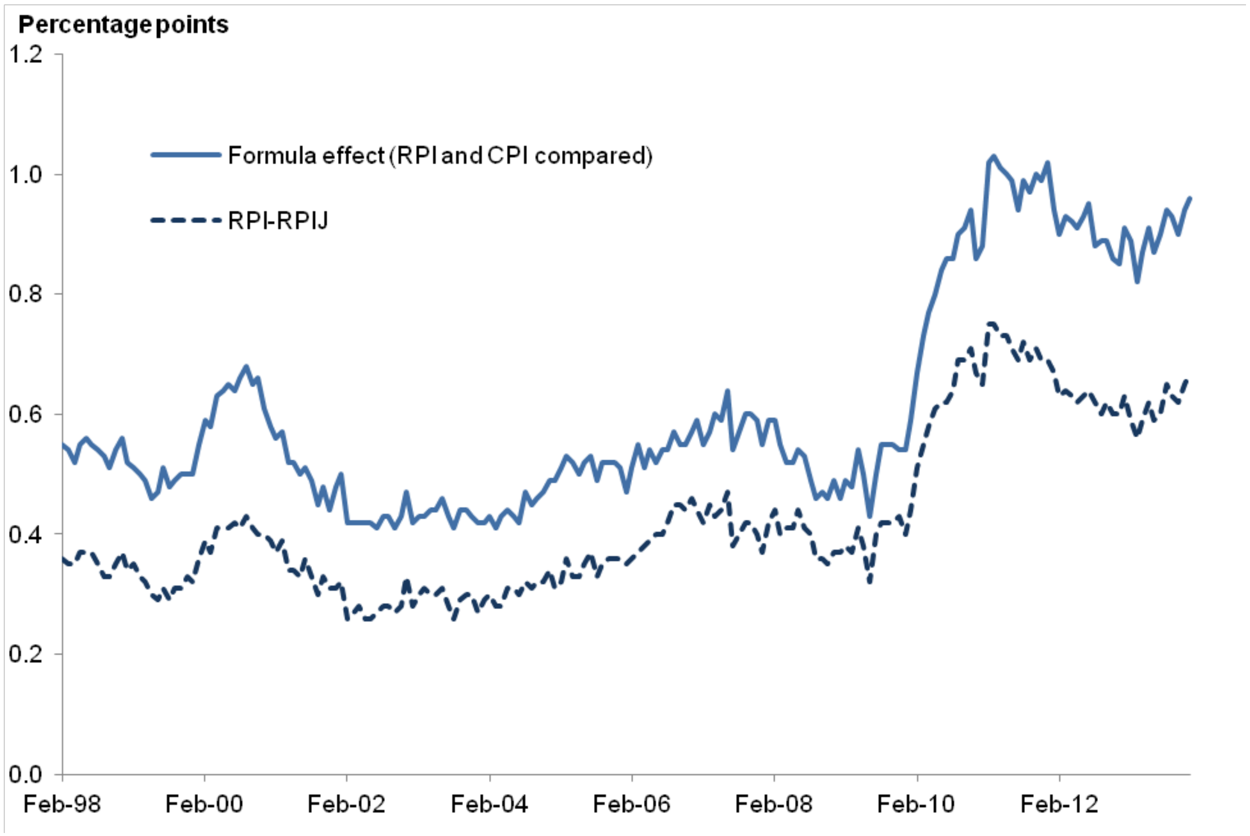
Recent history of private pensions

- Regulation and demise of private sector DB schemes
  - This looks irreversible
- Spread of DC
- Introduction of auto-enrolment
  - Successful so far (but minimum default contributions very low)
- Ending of compulsory annuitisation
  - Effects unknown
- Chaotic changes to tax treatment
  - And continual change to tax treatment of other forms of savings

Policy priorities for private pensions

- Risk sharing
  - No risk sharing in DC schemes
  - None now in retirement without annuitisation
  - This CANNOT be optimal
- In my view the overwhelming priority must be to find some way of achieving more risk sharing
  - Defined ambition?
- Also to limit the windfall to those with accrued rights
  - Move from RPI to CPI indexation
  - (note this was easily the biggest change to public service pensions)
    - http://www.ifs.org.uk/budgets/gb2012/12chap5.pdf

The formula effect



[http://www.ifs.org.uk/publications/7513]

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Urgent need to sort out tax regime

- Annual allowance cut in stages to £40,000 and lifetime allowance cut to £1 million
  - Raising c. £5 billion a year
- From April 2016 annual allowance phased down once income exceeds £150,000 reaching just £10,000 when at £210,000
  - Introducing very high effective marginal rate
- No attempt to tackle the genuinely generous parts of the system
  - The tax free lump sum
  - NI treatment
- And now consultation on the whole structure
- This is no way to make policy in an area where stability and certainty matter a lot

What should be done?

- Unambiguous conclusion about what an efficient, neutral tax treatment of pensions should be
  - Contributions exempt from tax, returns free of tax, tax paid on withdrawal (EET)

Cost of tax relief

- HMRC says £35 billion =
  - Tax relief on contributions, +
  - tax relief on investment returns, +
  - NI relief on employer contributions, -
  - Tax paid on pensions in payment
- "True cost" against an expenditure tax benchmark is closer to £16-17 billion
  - £14 billion of NI relief, +
  - Cost of tax free lump sum
    - perhaps £2.5 billion but, bizarrely, not published by HMRC

What should be done?

- Unambiguous conclusion about what an efficient, neutral tax treatment of pensions should be
  - Contributions exempt from tax, returns free of tax, tax paid on withdrawal (EET)
- From current situation that means:
  - income tax treatment makes sense (other than lump sum)
  - NI treatment much too generous
- Treatment at death bizarrely generous and distorting
- Focus of consultation elsewhere entirely
  - Move to TEE (unlikely to happen)
  - Move to flat rate relief
    - Which would be redistributive but move away from rational tax system

Policy conclusions

- State pensions
  - Stick with single tier but move away from contributory fiction and make dependent on, say, 30 years residence
  - Get rid of triple lock: link to earnings, raising in line with prices when they rise more but claw back later
  - Raise pension age at least in line with longevity
- Private pensions
  - Focus on finding a way to reintroduce some risk sharing
  - Consider reducing DB benefits by enforcing CPI indexation
  - Move to rational, stable EET tax system
  - Over time increase employee auto enrolment contribution rates