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
Rapid, unexpected change in life expectancy

Predicted life expectancy at birth

Projected life expectancy

- 1979
- 1975
- 1971
Rapid, unexpected change in life expectancy

Predicted life expectancy at birth

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Good news

• Life expectancy has been rising
  – Unexpectedly

• Incomes in retirement have been rising fast
  – And much more than for working age population
The remarkable catch-up in pensioner incomes

chart shows median after housing costs incomes of pensioner households as % of median for non-pensioners (HBAI income definitions)
Income by age 1978-80 to 2012-13

Median income by age compared to overall median income (measured AHC)

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
Poverty rates by age

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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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Good news

• Life expectancy has been rising
  – Unexpectedly

• 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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Good news

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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
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:

\[
\text{Replacement rate} = \frac{\text{Estimated real income at age } 65}{\text{Average equivalised real earnings age } 20 - 50}
\]

- Consider several definitions of income
- Adjusting for inflation; considering average purchasing power
- Taking into account household size

Replacement of average lifetime earnings

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<th>Percentage of couple with:</th>
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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
Incomes are dipping

Source: Authors’ calculations using FES/EFS/LCF, various years
As are savings rates

Real household saving (£ per week, 2011-12 prices)

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

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  – 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

- Born 1963–67
- Born 1973–77
- Born 1983–87
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• 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

Millions

© Institute for Fiscal Studies   Source: Occupational Pension Scheme Survey.
Employer contributions to pension funds – in constant prices terms

Source: Office for National Statistics
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

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

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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
Effects of triple lock and pension age on spending
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]
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?

• Unambiguos 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