



Why are incentives to work and save important?

**Background paper to Seminar 2 in
the series
Shaping a stable pensions solution
May 2005**

Why are incentives to work and save important?

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Introduction

Pension policy is at a critical juncture. Previous PPI research has shown that there is consensus on the UK's pensions problems and that reform of the state pension system is needed. Yet Government was preoccupied with private pension provision until *Principles of Reform*, published in February 2005, set out the Government's commitment to seeking a consensus for reform. The pensions community wants a simple and sustainable solution.

The aim of *Shaping a stable pensions solution* is to build up a picture of the possible shape of a consensus pension solution that could work for the long-term, through a series of seminars to debate the most critical pension issues on the interaction of state and private pensions. Expert individuals from a wide range of backgrounds, and who between them have a variety of perspectives, will be able make an important contribution to the debate.

Each seminar will examine a critical and topical pension policy question. This paper provides the background to the second issue to be considered *How does the interaction between state and private pensions affect the incentives to work and save?*

How does the interaction between state and private pensions affect the incentives to work and save?

These issues are addressed directly in the main paper by Carl Emmerson, Director of public spending and pensions research at the Institute for Fiscal Studies.

This PPI background paper will look at:

- Why work and saving are important in the context of pension provision
- What the current trends are in working at older ages and saving
- How much more saving and longer working is needed

Subsequent seminars will tackle other major issues such as:

- Should state pensions be universal or contributory?
- Should earnings-linked pensions be voluntary or compulsory?
- What should be the role of means-testing in state pensions?

Feedback from the seminar to discuss *What should be the balance between state and private pensions?* can be found on the PPI website.

Feedback from the papers presented at each seminar, and each seminar discussion will be consolidated into a report to be published in 2006. The report will contribute new facts, analysis and insights to the public debate highlighting where consensus lies and where and why the areas of disagreement exist.

Summary of conclusions

Future retirement income could be - although not necessarily will be - increased by:

- Better state pensions,
- Higher private saving, and/or
- Working longer.

Increased saving for retirement could be through:

- Starting to save earlier,
- Making larger pension contributions, and/or
- Saving outside of a pension (for example in property).

Working longer can increase private retirement income through:

- Allowing more saving,
- Increasing the value of existing saving, and
- Reducing the length of retirement.

Working longer appears to go with the flow of recent trends, while saving more appears to go against them:

- There has been an increase in the number of people working at older ages, and there are suggestions that these trends are likely to continue.
- Private pension saving appears to be in decline as employers switch from Defined Benefit to Defined Contribution provision. It is not clear how much of this decline will be offset by increases in non-pension saving, including housing.

The current debate on future retirement income adequacy centres on filling a 'gap' predicted to open up if there is:

- No general increase in working longer, and
- A fall in private saving, and
- A decline in state pensions.

To fill the 'gap' and maintain current standards of living for pensioners relative to the rest of society:

- Without an increase in state spending on pensions, a levelling of private saving **and** working longer would be needed.
- A combination of more spending on state pensions and working longer could close the 'gap' even if private saving does fall as predicted.

Incentives to work longer and save more are important parts of the policy mix that could be used to prevent future pensioners being relatively poorer on average than today's pensioners. But incentives for working and saving need to be considered in the context of what could plausibly be delivered by state pension reform.

Chapter 1: Why are saving more and working longer important?

Future retirement income could be – but not necessarily will be – increased by:

- Better state pensions,
- Higher private saving, and/or
- Working longer.

Increased saving for retirement could be through:

- Starting to save earlier,
- Making larger pension contributions, and/or
- Saving outside of a pension (for example in property).

Working longer can increase private retirement income through:

- Allowing more saving,
- Increasing the value of existing saving, and
- Reducing the length of retirement.

Ways to increase future retirement income

To fund a retirement income of any size, more money has to be contributed into a pension today than used to be the case because:

- We are living longer on average¹.
- Expected future returns to pension funds are lower than the returns seen in the past².
- The average amount received from state pensions is declining³.

Actual contributions to private pensions are not keeping pace with this required increase⁴, which has led to a suggestion of a ‘savings gap’, which could be filled by more voluntary or compulsory saving (usually just considering pensions)⁵. In fact retirement income can be increased by:

- Better state pensions,
- Higher private saving (in pensions or other forms of saving), and/or
- Working longer.

Better state pensions would be funded by an increase in the amount collected by taxation, or by transferring money from other areas of government spending, so there may be limited scope to redirect resources in this way. Other PPI work has looked at improving state pensions⁶.

This seminar focuses on saving more and working longer.

¹ O’Connell (2003 SPA)

² Pensions Commission (2004), Curry (2004)

³ Curry & O’Connell (2003), O’Connell (2003 GTSPR), PPI Briefing Note 14

⁴ See Chart 6 in Chapter 2

⁵ See for example, Oliver Wyman and Co (2001)

⁶ Such as O’Connell (2003 GTSPR), O’Connell (2004 CPNZ), PPI (2005 PC), PPI (2004 MT)

Individual Modelling

The examples used in this chapter show the potential impact of different patterns of saving on the private pension income of the 'median woman' and the 'median man' reaching age 65 in 2053.

- The 'median woman' has a mixture of full-time work, part-time work and career breaks for caring⁷. When working she has the median earnings of women of her age.
- The 'median man' works mainly full-time but has short spells of unemployment and part-time work⁸. When working he has the median earnings of men of his age.

Both the median woman and median man are assumed to:

- Start pension saving when reaching age 41, as pension saving is less common at younger ages⁹.
- Save (or have an employer contribute on his or her behalf) the average pension contribution of 6%¹⁰.

To look at the ways in which saving can increase private income, different patterns of saving are modelled, changing one assumption in each scenario:

- Start pension saving earlier, at age 35 rather than 41.
- Save 10% each year in a pension, rather than 6%.
- Have access to equity release from the median value house. The house is worth £150,000¹¹, and 20% of the value can be released at age 65.

Both the median woman and man are assumed to work until reaching state pension age (65 for both). To look at the impact of working longer on private pension income, this assumption is changed to:

- Age 66
- Age 68, and
- Age 70.

⁷ Throughout this chapter the 'median earning woman reaching age 65 in 2053' is used to illustrate the potential impact of saving more and working longer. She started work at the age of 21, working full-time until 28. She then had a career break to care for her children for six years. She returned to part-time work for four years. She then worked full-time until taking another 5-year career break in her 50s to care for an elderly relative. She returned to full-time work again, until reaching state pension age (or a higher retirement age in some examples). In the years that she worked full-time she had the median earnings of women in full-time work of her age, and she had 40% of full-time median earnings when working part-time. She only made pension contributions when in work (full-time or part-time).

⁸ Throughout this chapter the 'median earning man reaching age 65 in 2053' is used to illustrate the potential impact of saving more and working longer. He worked mainly full-time from age 21, but was unemployed for two years in his twenties and worked part-time between age 55 and age 60, returning to full-time work before retiring at age 65 (or higher in some examples). In the years that he worked full-time he had the median earnings of men in full-time work of his age, and he had 50% of full-time median earnings when working part-time. He only made pension contributions when in work (full-time or part-time).

⁹ See for example Curry & O'Connell (2003)

¹⁰ See Chart 6 in Chapter 2

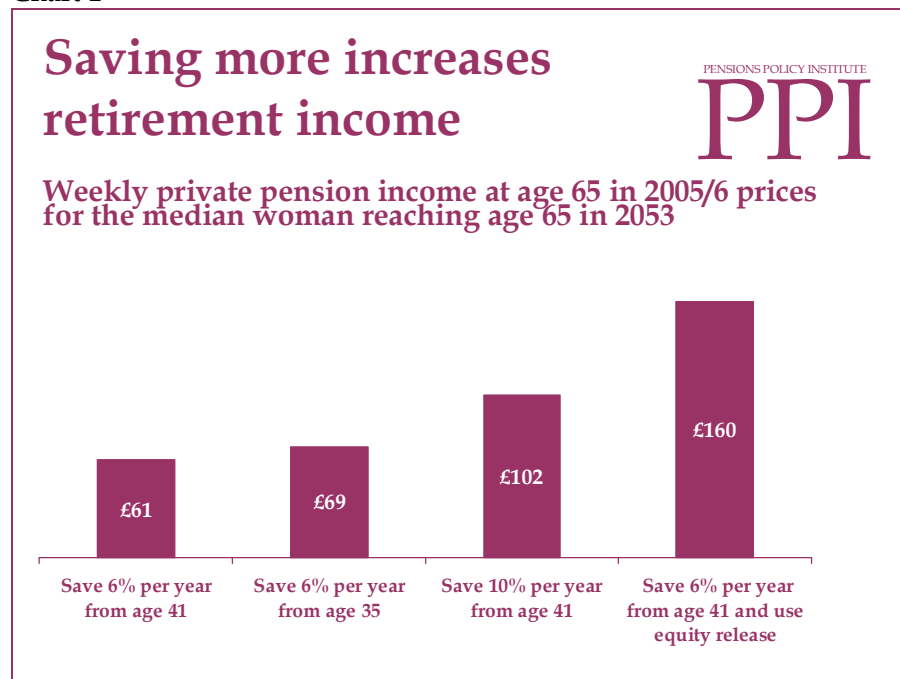
¹¹ The median house value is assumed to grow in line with average earnings. See Curry (2004).

Saving more and working longer can increase retirement income

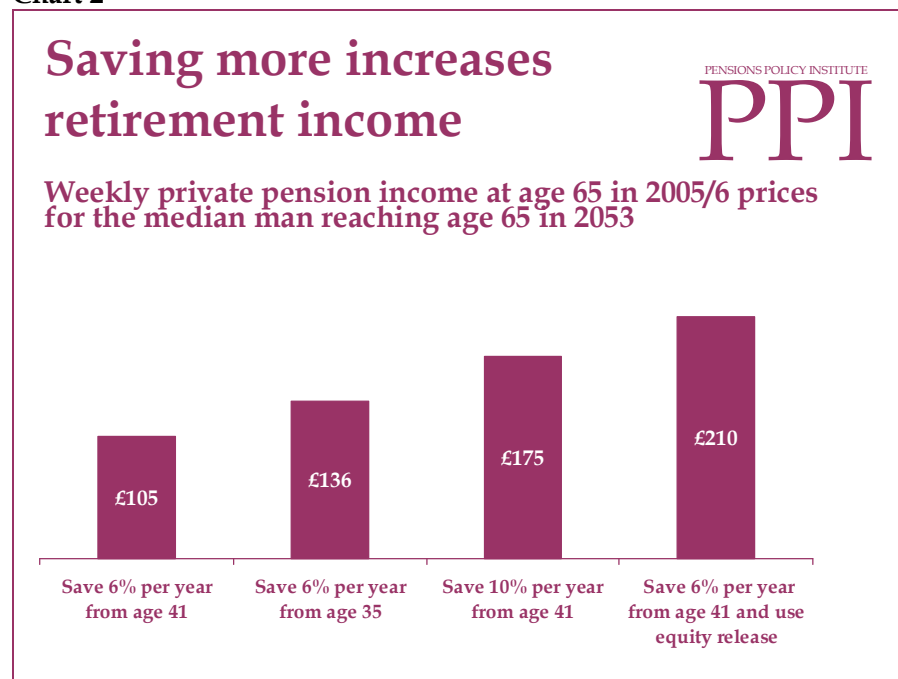
Saving more can increase the private retirement income of an individual in three ways (Charts 1 and 2):

- **Saving the same amount but start saving earlier:** Starting to save in a private pension earlier allows individuals to make more contributions before retirement, and also allows the earlier contributions to accrue more interest. Starting to save at age 35 instead of age 41 can increase private retirement income for the median woman retiring at age 65 in 2053 by £8 a week (13%). For the median man the increase is £31 a week (29%).
- **Making larger pension contributions:** Increasing the amount paid in pension contributions increases the amount of pension income in retirement. Contributing 10% of earnings rather than 6% from age 41 could increase private retirement income for the median woman by £41 a week (67%). For the median man the increase is £70 a week (67%).
- **Saving outside of pensions:** Saving in an investment vehicle other than pensions can also help increase retirement income. This could be in a specific savings vehicle, such as an ISA, or in a different type of asset, such as housing. For example, being able to release housing equity could increase private retirement income for the median woman by £99 a week (160%). For the median man the increase is £105 a week (99%).

Chart 1¹²



¹² PPI analysis using the Individual Model. For further information about the Individual Model see Curry (2003 TP).

Chart 2¹³

As well as earnings from paid work directly increasing income, working longer can increase retirement income through:

- **Allowing more saving:** Working for longer can allow people to carry on saving (in a pension or in other savings) for longer, which increases the total amount available to be used in retirement.
- **Increasing the value of saving already made:** Because earlier savings remain in a pension fund (or other asset) for longer they can benefit from investment returns for a longer period of time, again increasing the total amount available to be used in retirement¹⁴.
- **Reducing the length of retirement:** Working longer reduces the amount of time that an individual spends not working at the end of his or her life. The accumulated pensions and savings can therefore be paid out over a shorter period of time, increasing the amount available each week. For example an annuity bought with a lump-sum of £25,000 at age 65 would pay out £32 a week, but if it was bought at age 70 would pay out £36 a week¹⁵.

Taken together, these three factors can have a substantial impact on private pension income. The median woman could see her private pension income increase by £26 a week (43%) by working an extra 5 years

¹³ PPI analysis using the Individual Model

¹⁴ Although this also increases the risk that the value of investments in a Defined Contribution plan goes down in the intervening period

¹⁵ Information taken from the FSA's Comparative Tables as at 20/04/05. Based on the best rate a female non-smoker single life annuity with no guarantee and unrestricted availability ©Financial Services Authority.

past state pension age (Chart 3). For the median man the increase could be £54 a week (51%) (Chart 4).

Chart 3¹⁶

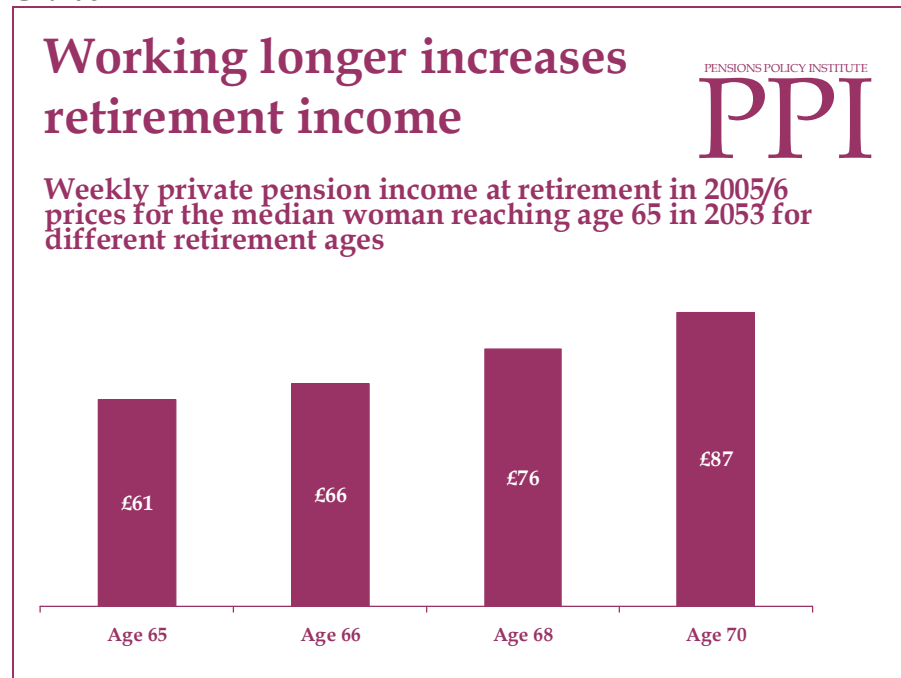
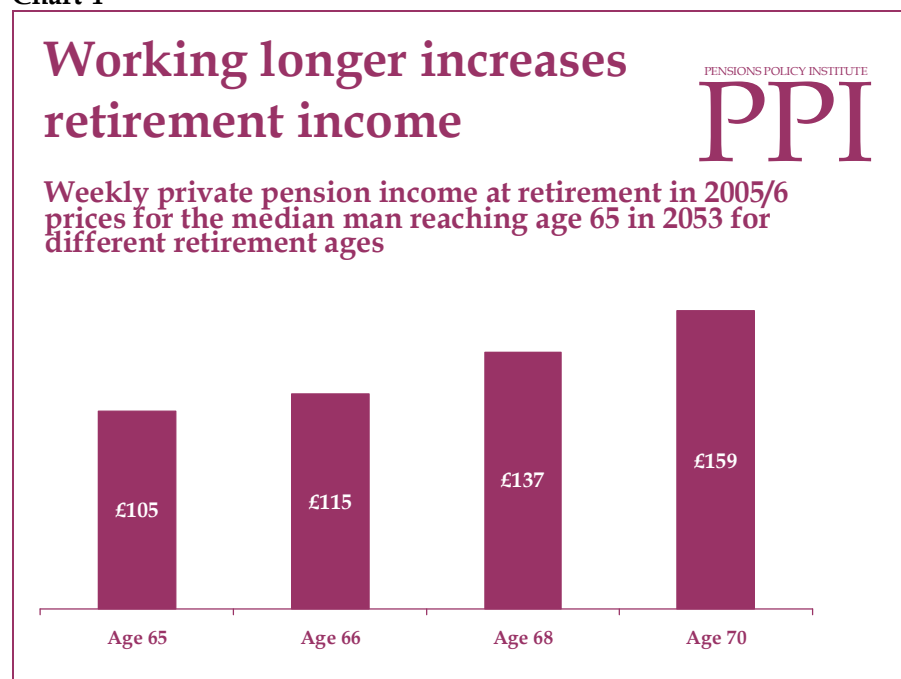


Chart 4¹⁷



¹⁶ PPI analysis using the Individual Model

¹⁷ PPI analysis using the Individual Model

Saving more or working longer does not automatically increase retirement income

Even if individuals do choose to save more or to work longer, retirement income will not always be higher (and a higher income should not be confused with a higher standard of living).

There is a trade-off between saving and working. Someone who saves more may choose to retire earlier if he or she has saved enough to achieve a target retirement income.

Working longer does not necessarily mean that private pensions are taken later and private pension income is increased. If private pensions are taken at a later age, there is an 'opportunity cost', which is the amount of benefit that would have been paid if the pension had been taken. For example, the median man can increase his pension income from £105 to £115 a week by taking it one year later. But the 'cost' of this is the £105 a week he did not receive for that year.

People may therefore prefer to start taking a private pension even while still working, especially if they are working part-time or for low pay. Income would still be boosted by earnings, but private pension income would remain unchanged.

In the same way, working longer can also increase state pension income if the choice is made to defer¹⁸. The median earning woman could increase her weekly income from Basic State Pension and State Second Pension from £220 a week to £334 a week¹⁹ (£114 a week, or 50%) by deferring for 5 years, although at the 'opportunity cost' of not receiving £220 a week for 5 years.

There are, therefore, alternative possible ways to increase private pension income. For example, if the median man wanted to get a private pension income of around £135 a year, he could do so by starting saving earlier (at age 35 instead of 41), by increasing saving from age 41 by 2% of salary, or by working longer and deferring taking his pension until age 68.

¹⁸ As with private pensions there is not necessarily a direct relationship between deferring state pensions and working. Someone working can choose to take their state pension, and someone not working can choose to defer. See PPI Briefing Note 19 *The gain from deferring state pensions*.

¹⁹ PPI estimates based on the Individual Model. Figures are adjusted for inflation, so are in 2005/6 price terms.

Chapter 2: What are the trends in working at older ages and saving?

The previous chapter suggested that both saving more and working longer have the potential to increase future pension incomes.

Working longer appears to go with the flow of recent trends, while saving more appears to go against them:

- There has been an increase in the number of people working at older ages, and there are suggestions that these trends are likely to continue.
- Private pension saving appears to be in decline as employers switch from Defined Benefit to Defined Contribution provision. It is not clear how much of this decline will be offset by increases in non-pension saving, including housing.

There has been an increase in working at older ages

- There has been an increase in the proportion of people working aged between 50 and state pension age²⁰, from less than 64% in 1996 to almost 70% by 2004. There has also been an increase in the proportion of people older than state pension age in employment, from 7.6% in 1996 to 9.3% in 2004. Employment above age 50 has increased for men and women.
- The increase in employment has resulted in an increase in average retirement ages. The average retirement age for men is now 63.8, almost a year higher than in 1995. A similar rise occurred in the average retirement age for women, which is now 61.6 years²¹.
- There are indications that these trends are likely to continue:
 - An increase in state pension age for women is likely to increase the employment rate and average retirement age for women. The Pensions Commission's central assumption is that the average retirement age for women increases to the current average for men, 63.8 years by 2020.
 - The Government has a long-term aspiration of an employment rate for working age people (including those aged between 50 and state pension age) of 80%²², and is implementing policies to encourage working at older ages²³.
 - The trend in older working is likely to be helped by demographic trends, such as increases in healthy life expectancy, and a smaller pool of younger workers²⁴.

²⁰ 65 for men and 60 for women

²¹ Pensions Commission (2004) page 53

²² HM Government (2005)

²³ Such as anti-age discrimination legislation and policies to help people receiving Incapacity Benefit back in to work

²⁴ O'Connell (2003 SPA)

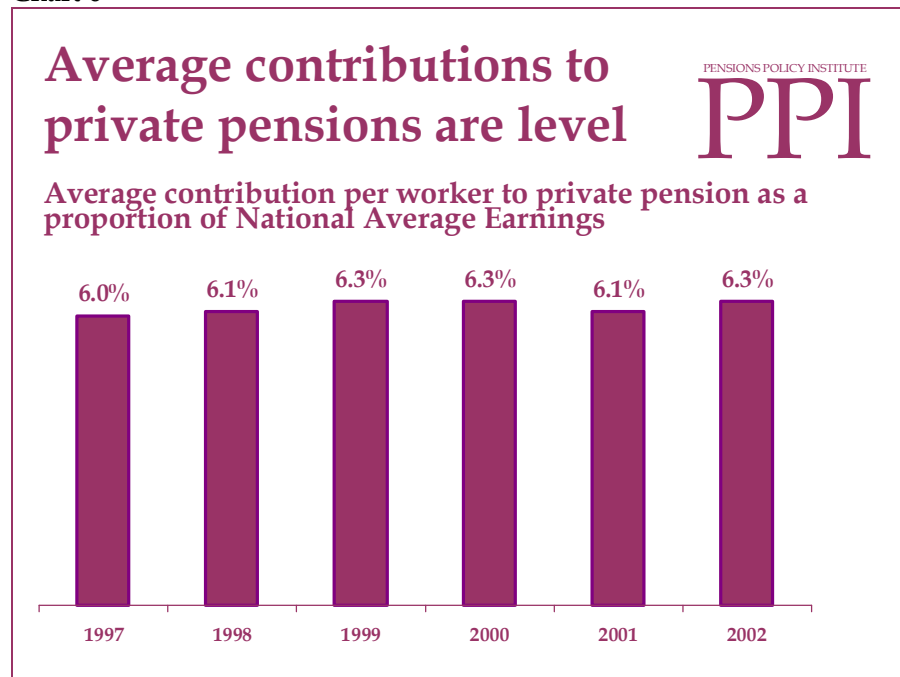
Private pension saving appears to be declining

- There has been little apparent change in the proportion of people of working age making contributions to private pensions, with just under half contributing in 2003/4 (Chart 5).
- The average private pension contribution per worker has also remained steady in recent years, at around 6% of National Average Earnings (Chart 6).

Chart 5²⁵



²⁵ DWP (2004) and PPI estimates. Figures are based on the Family Resources Survey (FRS) and include both individual and employer contributions. Pension questions on the FRS were changed in 1999/2000, so results from 1999/2000 onwards are not directly comparable with earlier figures.

Chart 6²⁶

But despite this apparent stability, there are signs that pension saving, if not already declining, is about to decline.

- There does seem to be evidence that people are starting to save later, rather than earlier. Of people now aged between 30 and 34, 33% had a private pension by age 24. Of people 5 years older, 49% had a private pension by age 24²⁷.
- There appears to have been a change in employer pension provision, away from Defined Benefit occupational pension schemes to Defined Contribution arrangements. This movement has tended to be accompanied by a reduction in employer contributions. However total contributions to private pensions appear level (Chart 6) because many employers are making additional contributions to cover deficits in Defined Benefit schemes. These contributions do not increase future pension income, although they do make it more likely that benefits already accrued will be paid.
- **This is reflected in the central estimate used by the Pensions Commission of a fall in contributions to private pensions of around one-third over the next 15 years.**
- However, some of the fall in contributions to private pension saving could be offset by increases in non-pension saving. It is not clear how much saving in other assets, and particularly housing, could be used to help fund retirement. For people with access to relatively large housing assets, releasing equity could play a significant part in retirement income²⁸.

²⁶ PPI calculations based on data from Forrest et al (2004) and the Inland Revenue

²⁷ Curry and O'Connell (2003)

²⁸ Curry (2004)

Chapter 3: What are the options for maintaining pensioners' incomes?

Chapter 2 of this report suggests that working longer is in line with current trends; saving more is not. The current debate on future retirement income adequacy centres on filling a 'gap' predicted to open up if there is:

- No general increase in working longer, and
- A fall in private saving, and
- A decline in state pensions.

To fill the 'gap' and maintain the current standard of living for pensioners relative to the rest of society:

- Without an increase in state spending on pensions, a levelling of private saving **and** working longer would be needed.
- A combination of more spending on state pensions and working longer could close the 'gap' even if private saving does fall as predicted.

Current debate is focused on a particular view of the future

The most often used minimum target for pension and saving policy is to achieve the same average level of income for each pensioner in future as today²⁹. Under the Pensions Commission central assumptions, by 2050 a 'gap' appears between the 11% of GDP transferred to pensioners by state and private pensions and the 14% of GDP target, required to ensure that on average pensioners are not poorer relative to the rest of society than today³⁰ (Chart 7).

The central assumptions are based on very little change from today:

- **State spending:** The state is projected to transfer 6.9% of GDP to pensioners in 2050, based on the continuation of current policies³¹.
- **Private saving:** The Pensions Commission central estimates of the contribution of private pensions to retirement income are based on a projected fall in overall contributions to private pensions of around one-third over the next 15 years, resulting in a similar amount of income transferred to pensioners through private pensions in 2050 as is seen today, less than 4% of GDP³². The central assumptions assume the same transfer per pensioner through other saving in 2050 as today.

²⁹ This is suggested as the minimum target level by the Pensions Commission, Pensions Commission (2004)

³⁰ Pensions Commission (2004) page 17

³¹ The DWP projections that this estimate is based on has since been updated, and now suggest that 6.5% of GDP will be transferred by state pensions in 2053. The figure of 6.9% is used here to be consistent with the other Pensions Commission figures used in the analysis.

³² Pensions Commission (2004) page 17 central point of the range for private pension income in 2050 from 2.9% to 5.0% (including 0.8% of GDP from unfunded public sector pension schemes). This is based on private pension contributions falling from 3.8% of GDP today to 2.9% of GDP by 2030, and a real rate of investment return of 3% - 4%.

- **Longer working:** The Pensions Commission central estimate assumes that the average retirement age for women increases from 61.6 to 63.8, the same as it is for men as state pension ages are equalised³³.

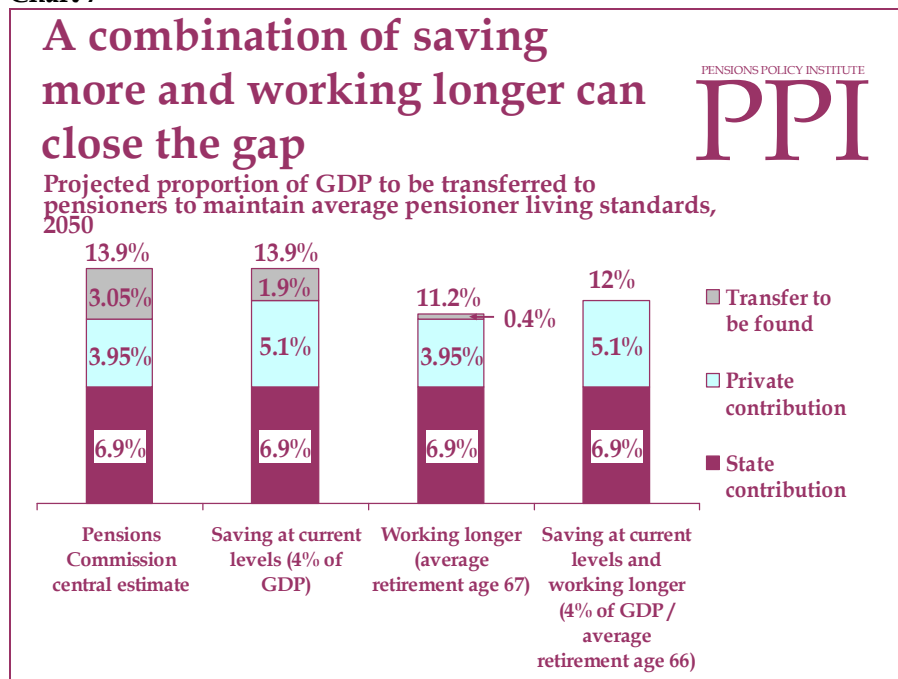
Without an increase in state spending on pensions both a levelling of private saving and working longer would be needed

If state spending on pensions remains as projected, closing the gap in resources transferred to pensioners by using only one of saving more or working longer in isolation is not feasible (Chart 7).

- Contributions to private pensions would need to increase above today's contribution level, as opposed to the Pensions Commission's central assumptions of a fall in contributions. Even if contributions continued at today's level³⁴ (the highest level assumed by the Pensions Commission) then, on average, pensioners would still be relatively poorer in 2050 than they are today.
- The average retirement age would need to rise from 63.8 to above 67 to close the gap completely through working longer.

But a combination of maintaining private pension contributions at current levels and increasing the average retirement age to 66 could close the gap.

Chart 7³⁵



³³ Pensions Commission (2004). Ideally this analysis would be carried out looking at changes in employment rates rather than average retirement ages, as for many people retirement is not a clear cut process. Increases in combinations of part-time working and taking pensions are likely to make it difficult to measure the age at which people 'retire'.

³⁴ Assuming contributions of 4% of GDP per year, compared to the current level of 3.8% per year

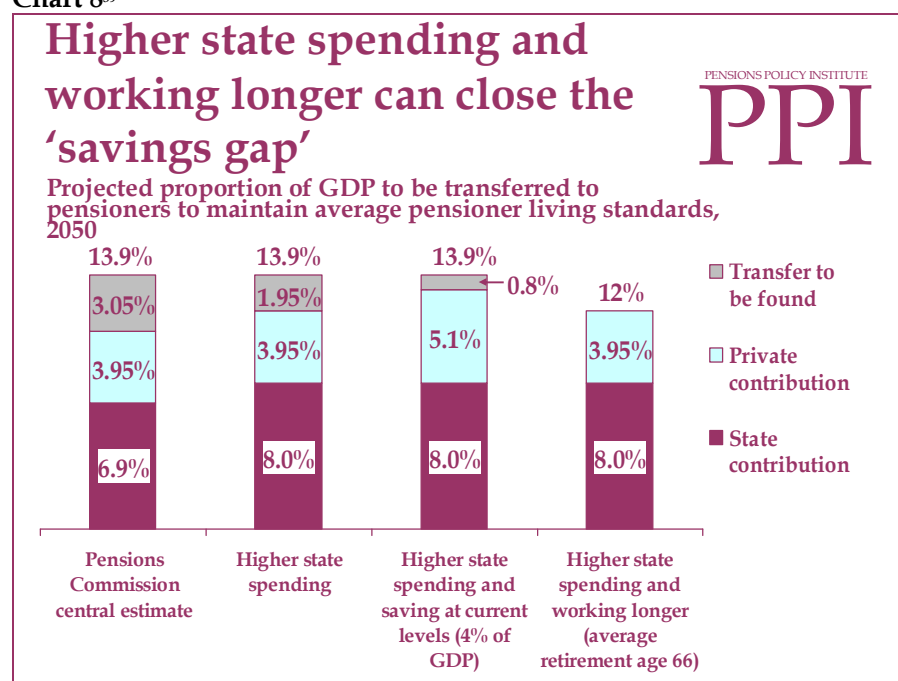
³⁵ PPI analysis based on Pensions Commission (2004)

A combination of more spending on state pensions and working longer could close the 'gap' even if private saving does fall as predicted

Although there is likely to be a limit on how much state spending on pensions can increase, any increase would reduce the transfer of resources needed to be found from saving more and working longer. If state spending could be increased to around 8% of GDP by 2050 (for example by introducing a Citizen's Pension at the level of the Guarantee Credit³⁶), it becomes more plausible that **either** saving more **or** working longer could avoid pensioners becoming poorer on average³⁷ (Chart 8).

- Maintaining contributions to private pensions at today's levels (rather than falling) would still not transfer enough resources to avoid pensioners being poorer on average, but the gap to be filled by increasing saving or working longer would be less than 1% of GDP.
- If retirement ages increased in proportion with life expectancy to reach age 66³⁸, even with falling contributions to private pensions enough resource would be transferred to avoid future pensioners being poorer on average than today's pensioners.

Chart 8³⁹



³⁶ See for example O'Connell (2004 CPNZ), NAPF (2004)

³⁷ This chapter analyses the impact of saving more, working longer and higher state spending in aggregate, but does not look specifically at how changes in saving, working and state pensions would impact on different types of individuals (for example, women and low earners). While there are obvious implications for policy, an in particular which policy response would be most appropriate for different parts of the population, such an analysis is beyond the scope of this short paper. This issue will be covered in other seminars in this series.

³⁸ Pensions Commission (2004) page 46

³⁹ PPI analysis based on Pensions Commission (2004)

Incentives to work longer and save more are important parts of the policy mix that could be used to prevent future pensioners being relatively poorer on average than today's pensioners. But incentives for working and saving need to be considered in the context of what could plausibly be delivered by state pension reform.

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