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Retirement saving and pension reform

The UK experience

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The retirement saving issue

- Do people save enough for retirement?
  - It depends how you define ‘enough’
  - And how you define ‘retirement saving’

- If people *don’t* save enough is this because..
  - Incentives are ‘wrong’
    - Incentives encourage people not to save at all (e.g. by doing so, they forgo public benefits)?
    - Or in the ‘wrong’ assets?
  - People are myopic, inconsistent etc etc

In the UK context….

- Income security from combination of social security and private pension benefits
- What expectations from social security in future?
- Combined programme in UK has delivered income security until now…
- …without social security ‘crisis’ of many other European countries
- (Despite, or because of) constant reforms to UK programme

The frequency of policy revisions…

“This is our New Insurance Contract for pensions. This Contract will deliver the security we all want, now and for the future.”

DSS, Green Paper, 1998

“Pensions policy has to be for the long term. If we want people to plan for the future, stability in the framework of pensions policy is a key component.”

DWP, Green Paper, 2002

“These reforms set the direction for the long-term future of pensions and retirement savings. They will create a system that is coherent, comprehensive and which will stand the test of time”

DWP, White Paper, 2006

Next reform 2010?

Trajectory of UK social security I

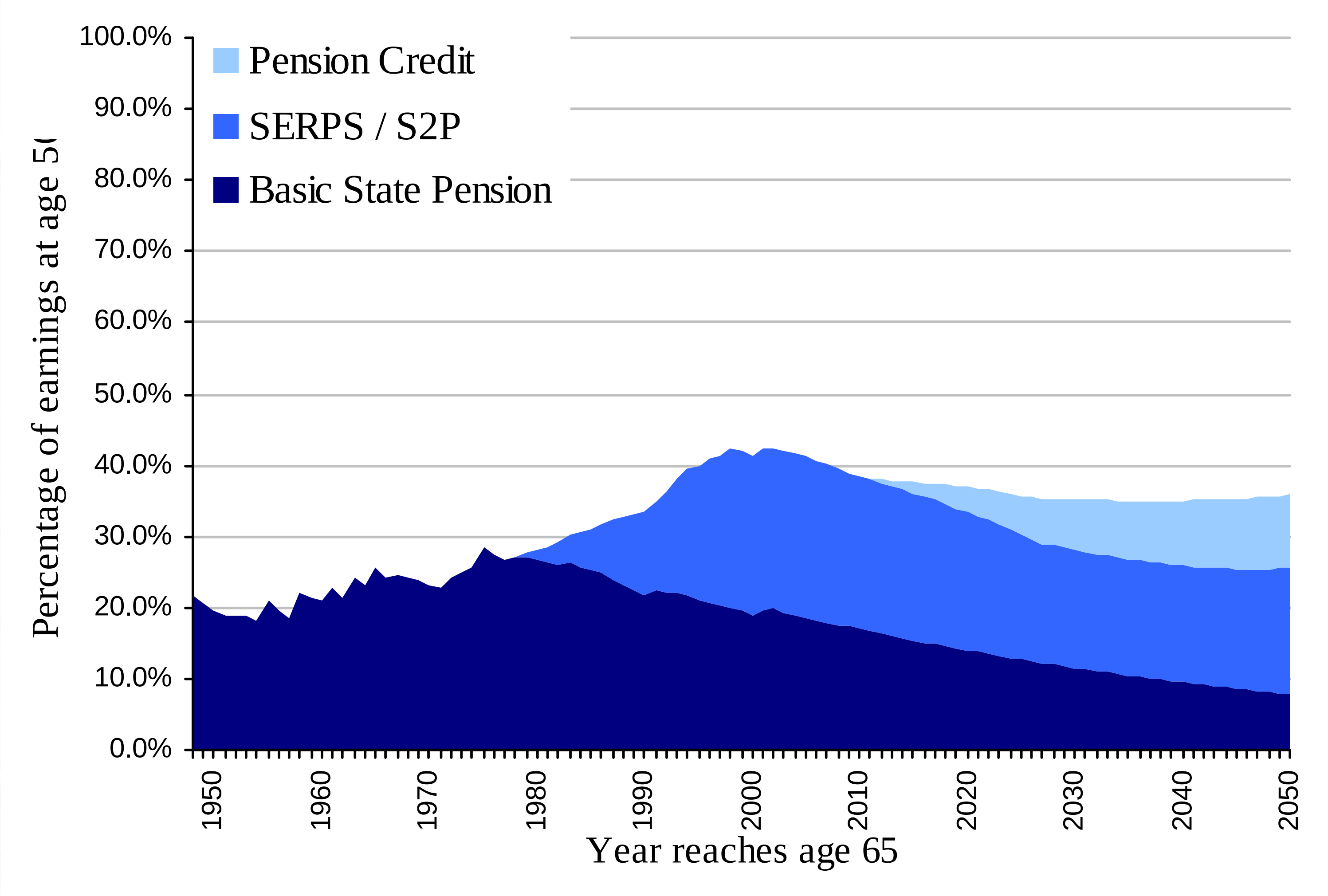
- Three components to programme (like Canada)
  - A flat contributory benefit (Basic State Pension)
  - An earnings-related contributory benefit (SERPS/S2P) since mid-1970s
  - An income-tested component (now MIG/Pension Credit)

Trajectory of UK social security II

- (unlike Canada!?)
- The shares of different components in total retirement income have changed
- The earnings-related component has been cut back since the mid-1980s
- The income-tested component has been enhanced since late-1990s
  - Indexed to earnings not prices
  - ‘taper’ on outside income reduced from 100%

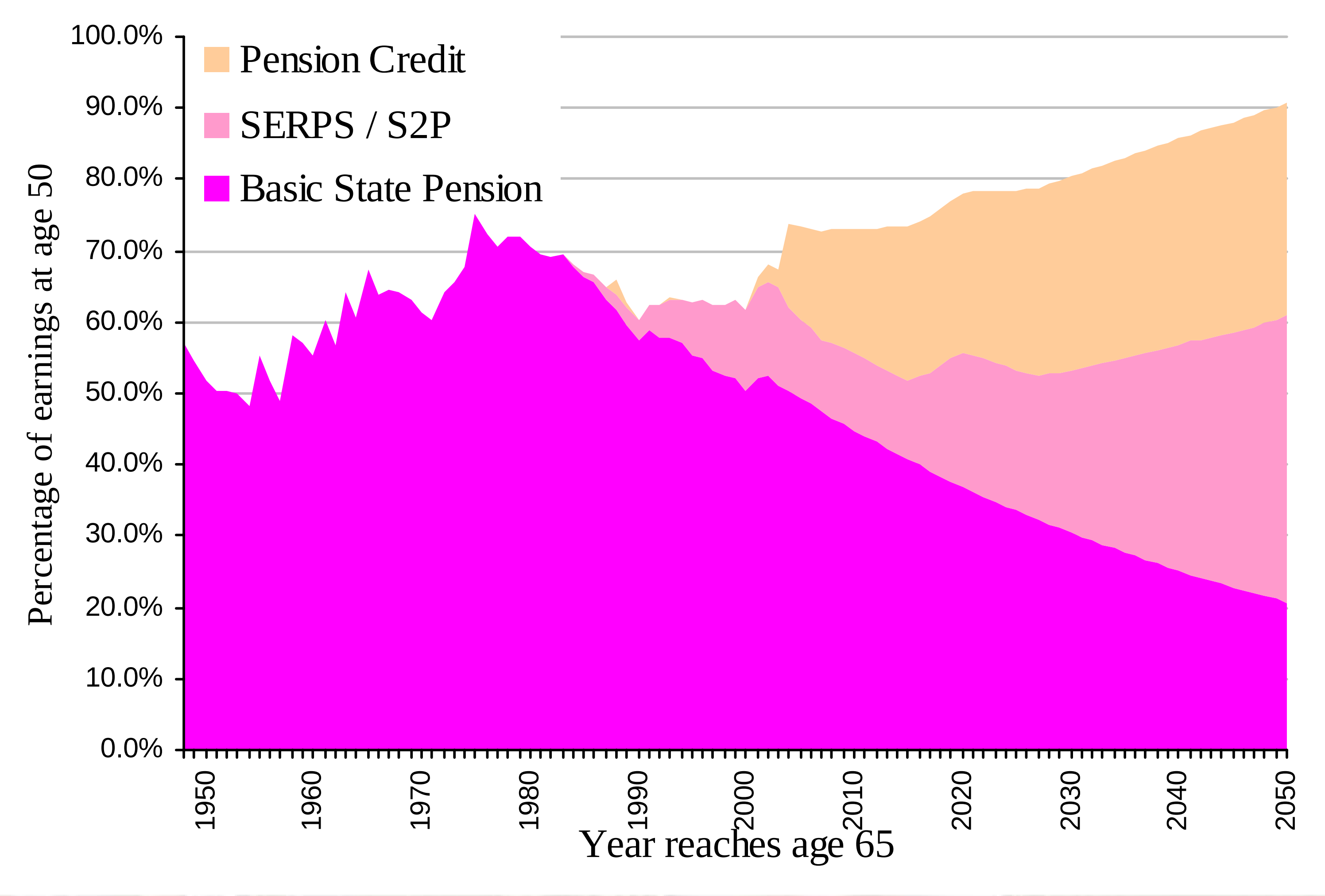
What the UK's public programme pays:

to someone on median male earnings retiring at t



What the UK's public programme pays:

to someone on median female earnings with career break retiring at t



Security from public pensions?

- Strongly ‘redistributive’ (within generations)
- Many families will want to supplement public benefits with private retirement resources
- Growth of income-testing v. decline of pension from contributory programme
- 2006 reform will stabilise share of contributory benefits – earnings indexation

UK retirement saving I

- For all but low earners, social security alone is not enough for retirement security
- People should save voluntarily in private pension plans
- A UK feature: workers can opt out of part of the social security programme (SERPS/S2P) into a private pension (as well as joining both)

UK retirement saving II

- **Reform Strategy**: increase fraction of workforce opting-out of earnings-related benefits (SERPS/S2P):

  (opting out implies forgone payroll tax revenues to government in return for lower future spending)

  – In the mid-1970s, DB company pensions could opt out.

  – In the late 1980s DC plans could opt out and *Personal Pensions* introduced

  – In the late 1990s *Stakeholder Pensions* introduced

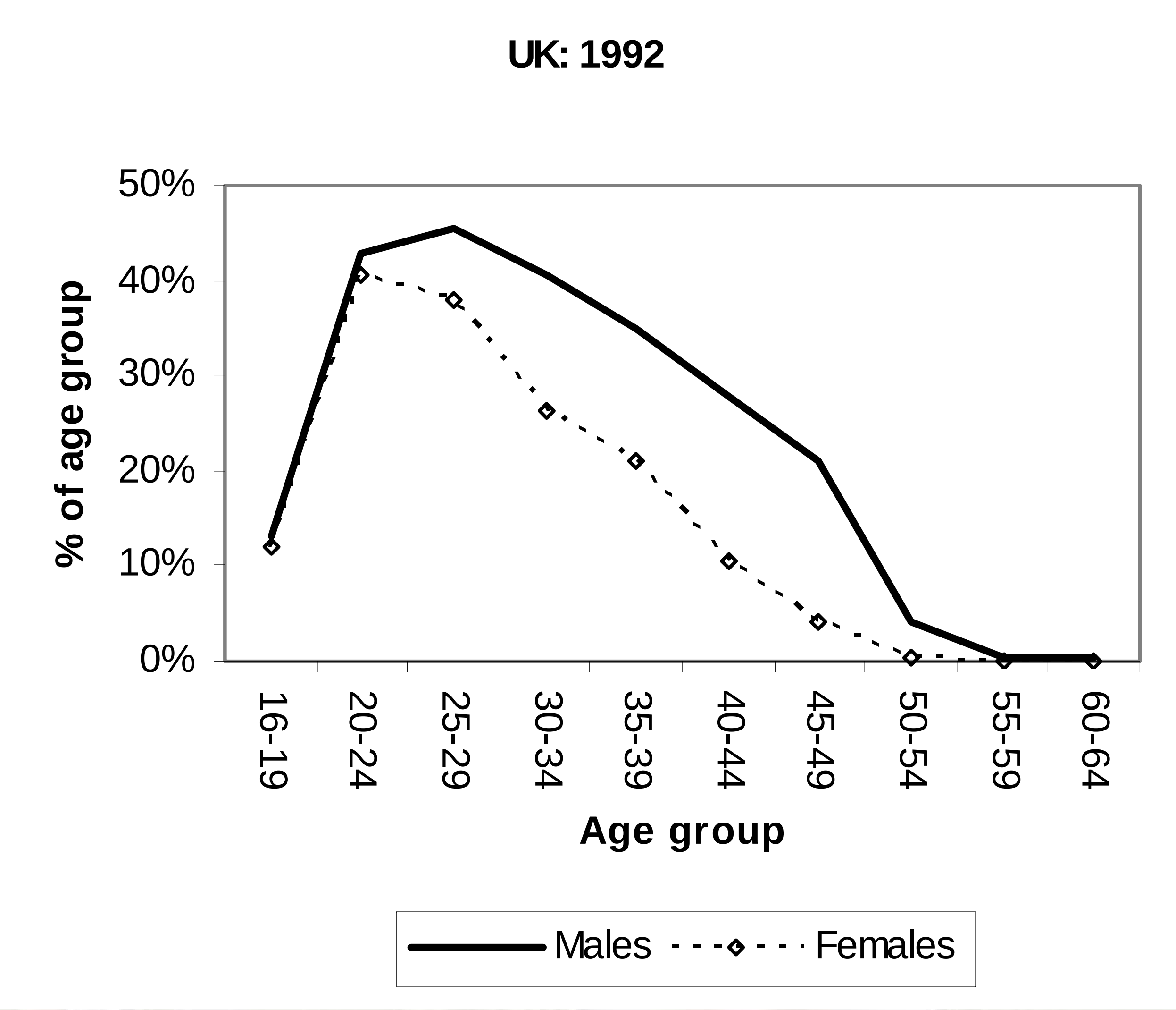
Why all these reforms?

- Perception that previous reforms haven't 'worked':
- In what sense?
  - Outcomes not what were expected by policy-makers
  - 'Too many' people opted for Personal Pensions ('mis-selling' etc; government castigated by NAO)
  - 'Too few' people opted for Stakeholder Pensions (coverage by private pensions fell, 'target group' unaffected etc.)
  - ∴ (the story goes..) Voluntarism a failure – people are myopic/time inconsistent and need more 'steering' e.g. 'auto-enrollment'
- Let's evaluate these arguments…

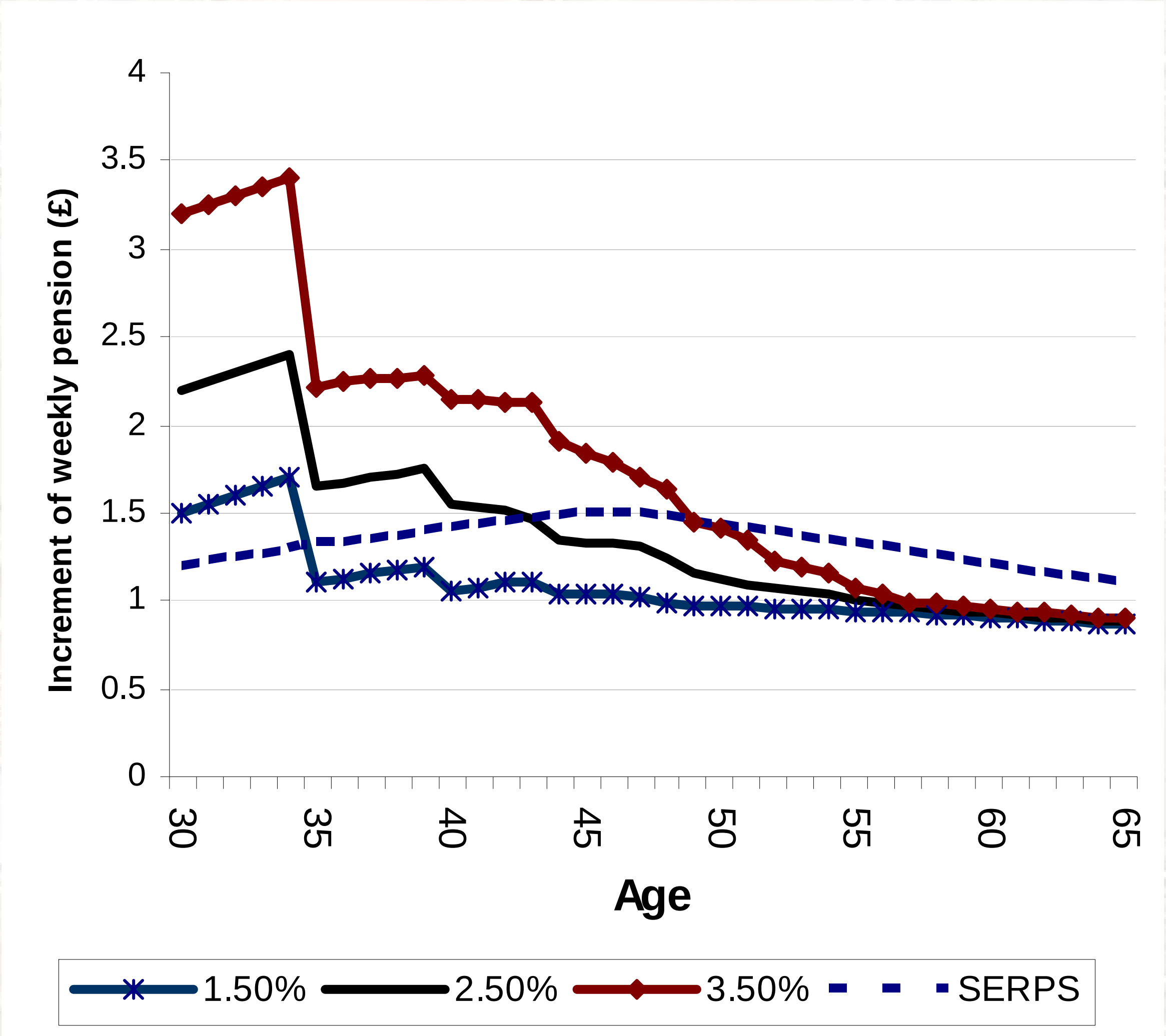
Personal Pensions (introduced 1988)

- Individual contracts with insurance companies to provide an annuity from accumulated fund
- Individuals opting for Approved Personal Pension (APP): contracted-out rebate of 5.8% of salary + an extra incentive payment of 2% of salary + tax relief = 8.46% of salary, deposited by DSS in their APP account instead of in social security system.
- DSS forecast ½ to 1½ million 'optants' – in first year, 6 million!
- Cost to taxpayers – cost of rebates in first 5 years: £9.3 billion. Saving of public pension payments: £3.4 billion (NAO).
- High administrative charges.
- Obviously a poor policy but what does it tell us about household behaviour? – incentives vary across households…

Take-up of Personal Pensions by age-group



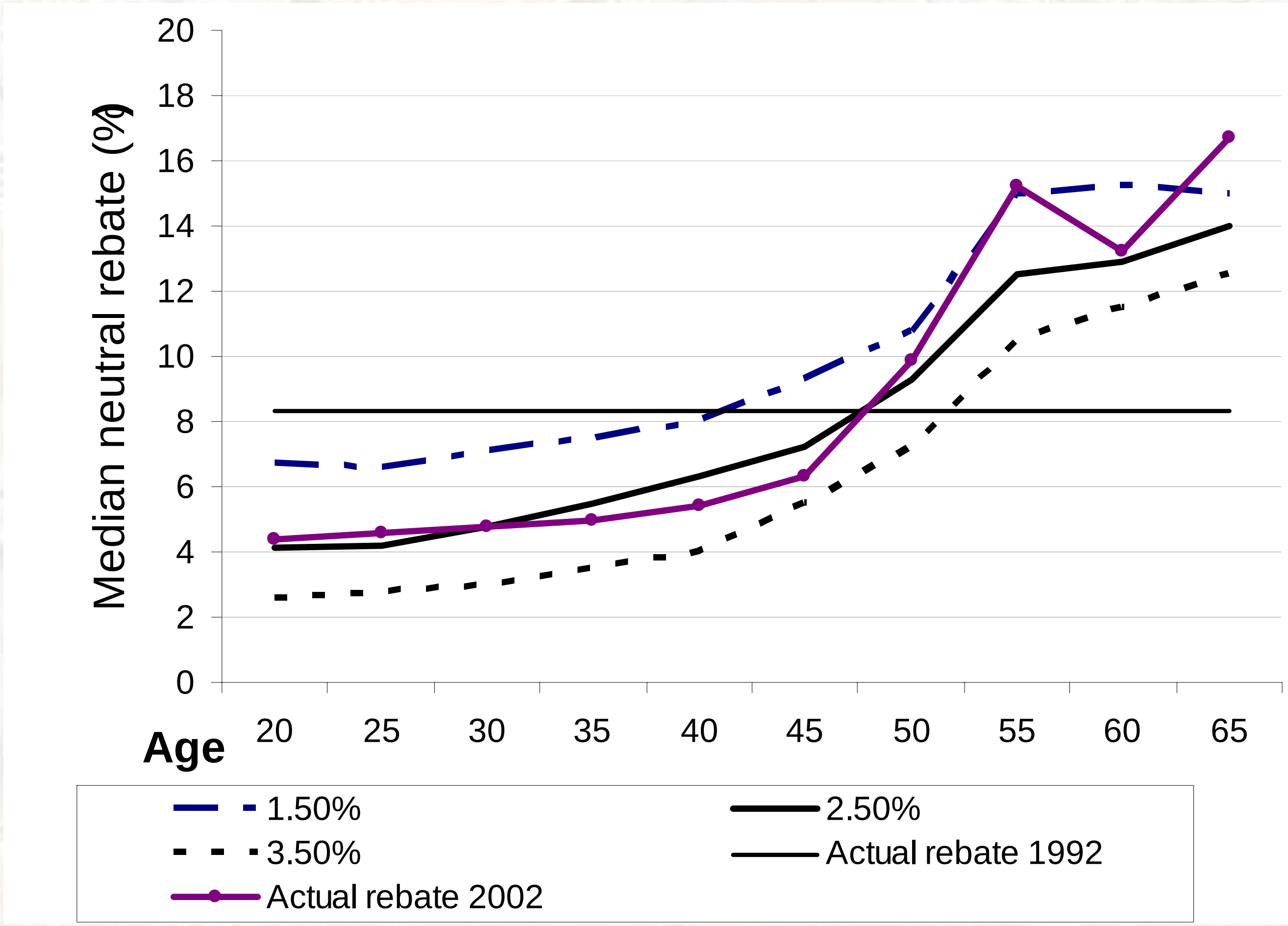
The incentive for 30 year old in 1988 to opt into Personal Pension (and revert later to SERPS)



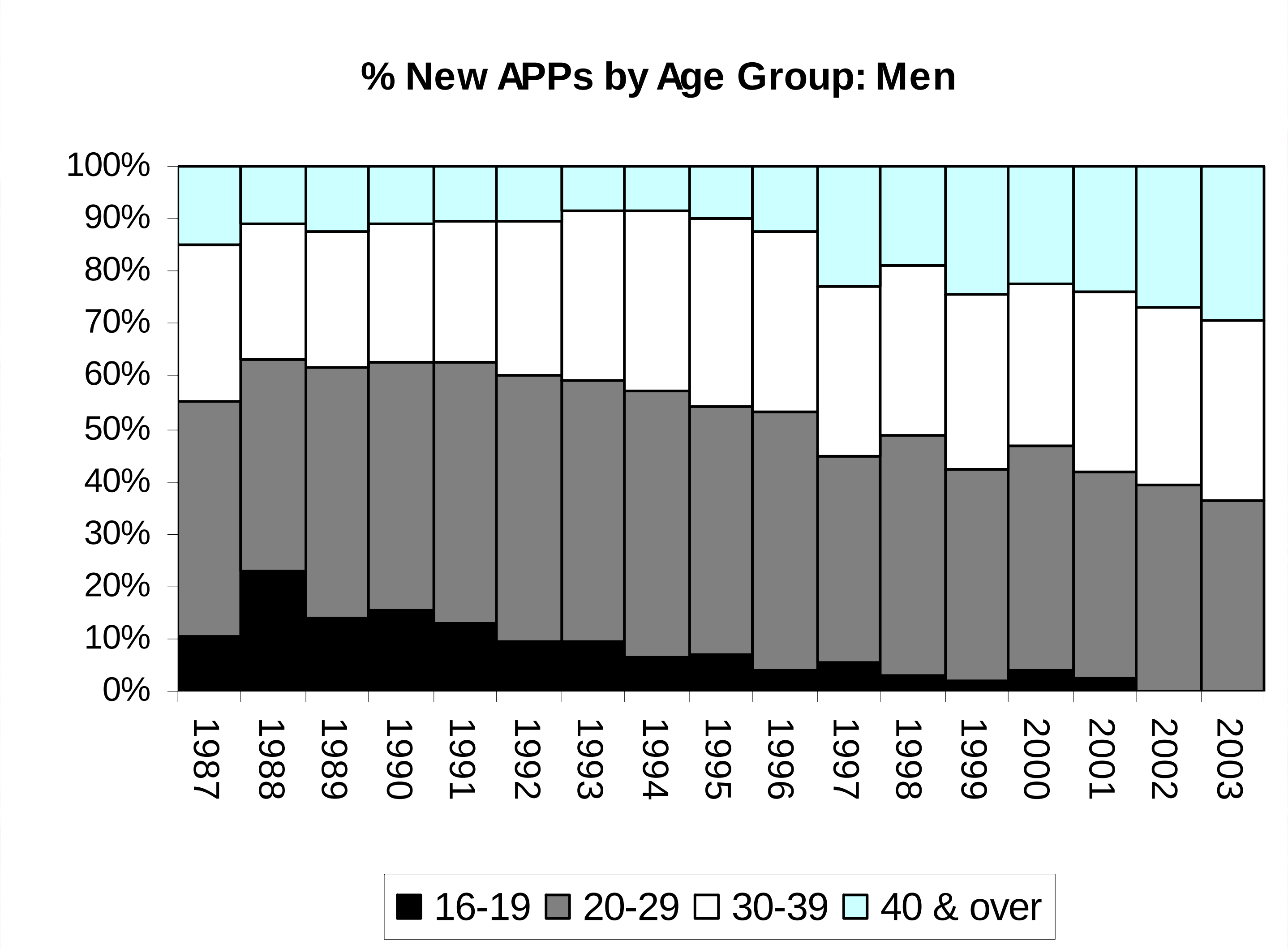
The Reform of Approved Personal Pension incentives *(introduced 1997)*

- The rebate incentives were biased towards young people in practice – a policy intention??
- For reasonable expectations of rates of return, we can calculate the rebate at each age that would just induce opting out (i.e. avoid intramarginal subsidies)
- This was calculated at IFS (and elsewhere) in mid-1990s. The government was persuaded to introduce age-related rebates in 1995 legislation (coming into force in 1997).
- Unlike 1988, this was evaluation-based policy.

Age-related contracted out rebates: calculated & actual



And age shares of new optants changed accordingly…



Did Approved Personal Pensions increase retirement saving?

- Did APPs increase saving?
- Initially, almost certainly not:
  - The enhanced return on contracted-out rebates (relative to remaining in SERPS) induced a *wealth* effect.
  - Once intramarginal subsidies disappeared in late 1990s, ‘extra’ saving component of APP contributions increased (evidence from admin data)

Stakeholder Pensions

- Introduced **2001** – New Labour’s response to rethink Personal Pensions
- Same principle as PPs but all firms 5 or more employees must offer a SP nominated-provider (however employees were not ‘auto-enrolled’)
- Ceiling on admin. charges and other simplifications.
- Nevertheless take-up was disappointingly low.

The government announced a target group for Stakeholder Pensions:

- **"People on middle incomes want to save more for retirement but current pension arrangements are often unsuitable or expensive. Our new secure, flexible and value-for-money stakeholder pension schemes will help many middle earners to save for a comfortable retirement."** (DWP Green Paper, 1998)

- 'Middle earners' defined in Green Paper as those earning £9k to £18.5k *(subsequently rising with real earnings)*
- 'High earners' (i.e. above £18.5k) assumed to have a pension. 'Low' and zero earners to be better off in state scheme i.e. SERPS/S2P

Coverage of private pensions by pension type and by level of earnings

Pension coverage by type of pension and earnings band
1999/00 to 2002/03

Panel B: All individuals of working age

Year	*1999*	*2000*	*2001*	*2002*	*Δ99-02*
Coverage by earnings band	%	%	%	%	%
Zero	3.4	3.6	3.5	3.5	+*0.1*
Low	34.0	34.2	35.6	35.2	+*1.2*
Medium	68.2	66.9	67.3	65.5	*–2.7*
High	86.2	85.4	84.6	83.8	*–2.4*
Self-employed	46.2	46.1	46.0	43.1	*–2.9*

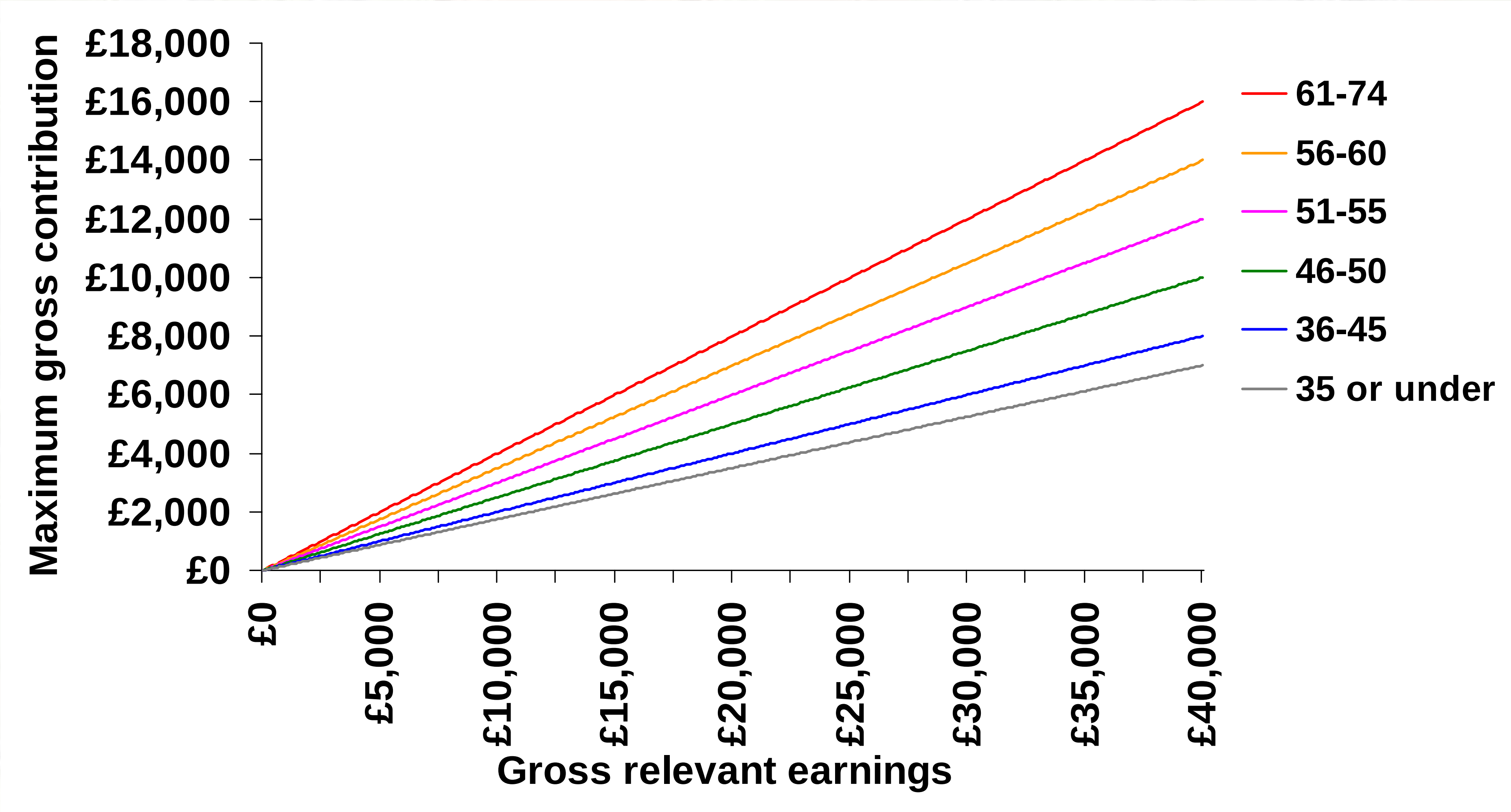
Source: own calculations, Family Resources Survey 1999/00 to 2002/03. 'Working age' is defined as age 16 to state pension age (65 for men, 60 for women).

Overall coverage change around –1.0%

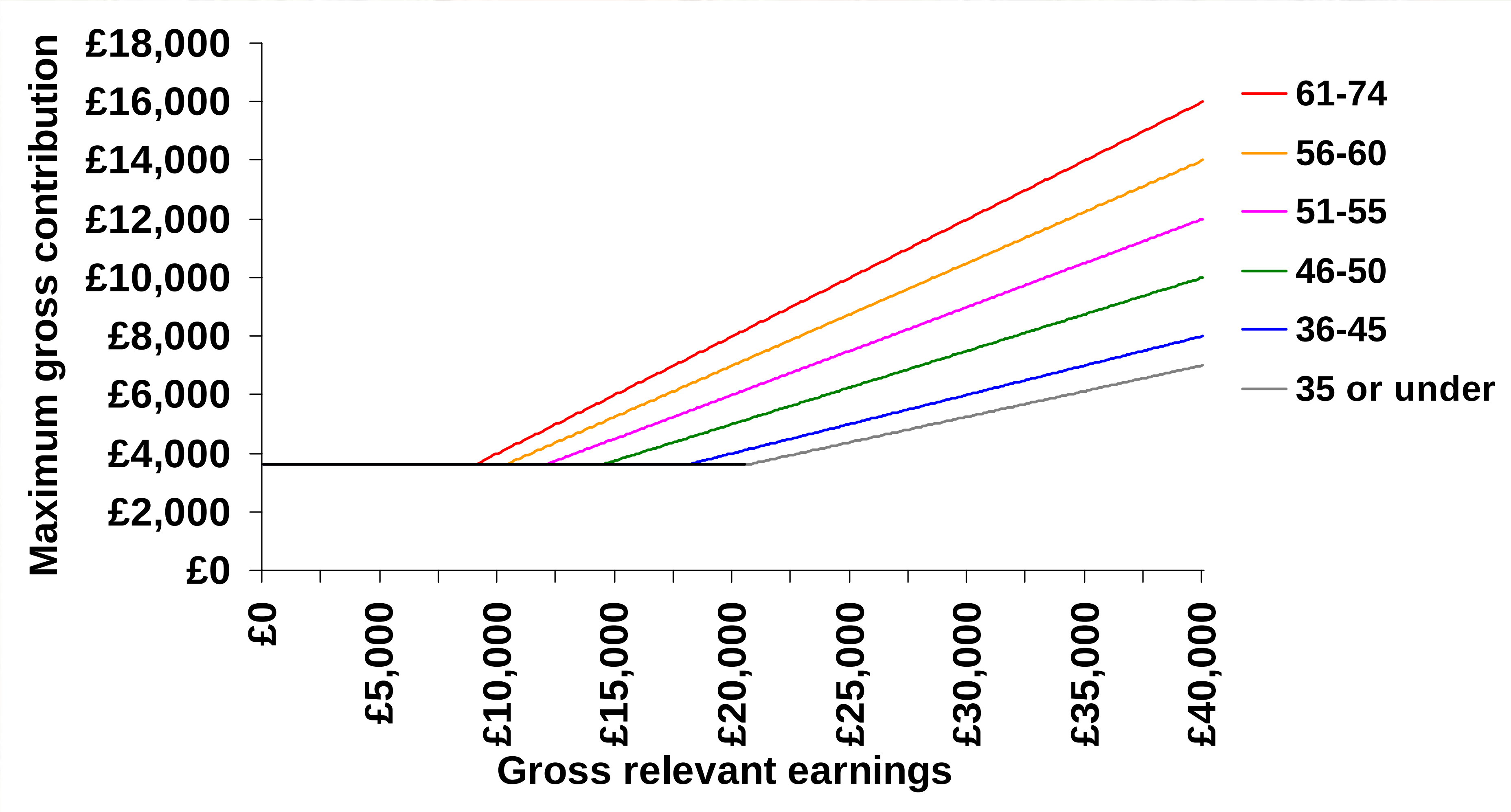
We model formally the changes in take-up of private pensions by earnings group..

- Assume the 'control' (unaffected) group is the 'high income' group. Use a treatment model & a multivariate approach. It's a non-linear model so the 'common trend' assumption is applied to the value function. The standard errors are bootstrapped.
- The *only* significant effect is on *low* earners, where the SP reform is associated with a rise in coverage of **3.6 ppts.**
- There is *no* effect on middle earners.
- When we allow for partners' earnings: the only significant effect is among low earners with a high or middle earning partner: a rise in coverage of **5.2 ppts.**
- So something else is going on…..

Tax reliefs by age on personal pensions pre-2001



Tax reliefs by age on personal pensions post-2001



Effect of reform of tax limits

- Treatment effects:

Had a limit increase:	2.4ppt (0.9ppt)*
Had a limit increase and zero earnings:	0.6ppt (0.3ppt)*
Had a limit increase and positive earnings:	3.3ppt (1.4ppt)*

(*standard errors in brackets, estimated by bootstrapping with 1,000 repetitions*).

- In fact the SP reform ‘worked’ through change in tax reliefs – allowed better-off families to shift retirement tax reliefs to minimise tax bill.

“The changes will also make it easier for partners to contribute to each other’s pensions, again within the overall contribution limits, should they choose to do so.” (DSS, Green Paper, 1998*,* p.63)

Summary on Stakeholder Pensions

- At first sight, a failure:
  - Overall coverage fell (but is this surprising?)
  - Coverage fell among target group (middle earners)
  - Coverage rose among low and even zero earners, especially with richer spouses
  - This a result of associated change in tax reliefs?
  - This fits with people responding to ‘true’ incentives, not the headline….

Interpretation

- Divergence between ‘headline’ policy predictions and outcomes for both Personal and Stakeholder Pensions
- These often adduced to be failures of individual rationality:
- Would give rationale for greater mandating and direction of retirement saving e.g. ‘auto-enrollment’.
- But *given ‘real’ incentives in place*, individual responses to these problems seem to accord with ‘rationality’ (despite bad advice e.g. on ‘mis-selling’ of personal pensions).
- Misinterpretation by policymakers of incentive changes and outcomes may have led to excessive reform.
- 2006 reform??

Conclusion

- Public programme has provided income security, especially to low income groups
- Changing composition of social security spending – now reverting to contribution-based provision.
- This has led to several interventions to enhance retirement saving
- These have often ‘worked’, but policies not always ‘thought out’ by policy-makers
- We need less emphasis on individual ‘irrationality’ in retirement saving and more on good policy design!