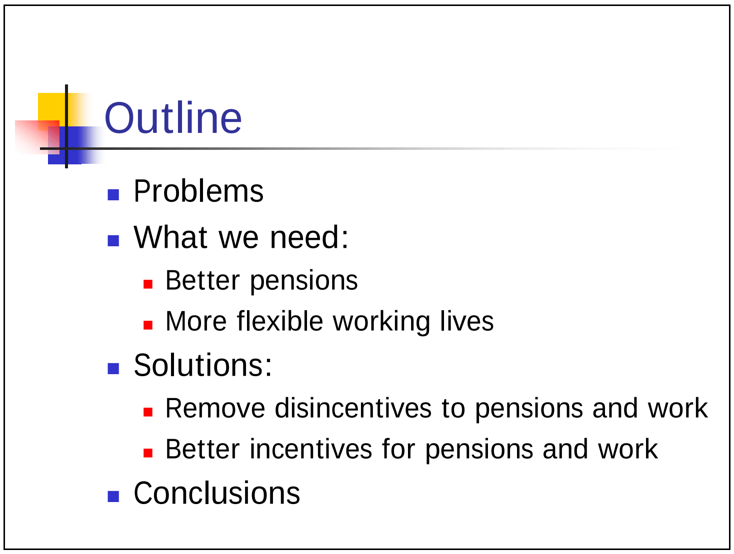
SPEECH TO THIRD AGE EMPLOYMENT NETWORK CONFERENCE – 10/10/02

'MAKING PENSIONS AND PENSIONERS WORK WELL'

Good morning everyone. .As you can see, I'm going to be talking about pensions. Pensions are an important part of this conference discussing issues of retention and employment of older workers. But they are only one part. Yes, we need to make pensions work better, but, as the title of my talk today suggests, I believe we also need to make **pensioners** work better too!



I don't have much time this morning, so I won't be able to go into things in too much detail, but this is the outline of the thoughts I'd like to share with you.

First, I'll discuss what I think the problems we face are. I'll talk about what we need – and that will cover both improving the way pensions work – they need to be much more flexible – but also that they need to be able to fit in with more flexible working practices too.

Then I'll suggest some possible solutions for you to think about. These will focus on getting rid of all the disincentives we have, which put people off putting money into pensions and working at older ages, plus improving the incentives that we offer. Then finally, a few conclusions.

Problems

- People not saving enough
- Retiring too early - not working enough
- Risk of poverty
- Waste of resources
- Lower long-term economic growth
- WE ALL LOSE

So what are the problems? There are so many problems associated with today's subject that it is hard to know where to start. Essentially, it is not just a matter of people saving too little, people are also working too little. There is a great risk that they will end up in poverty and this is a huge waste of resources – paying people not to work. Ultimately, this must lead to lower economic growth in the longer term, so that, if we don't do something about it , all of us will be losers.

We Need Better Pensions

- State pension falling
- Confidence in pensions collapsing
- Private pension saving not enough
- Increased reliance on means testing
- State system increasingly complex

We need better pensions. We all know that the Basic State Pension in the UK has been declining as a % of average earnings. It's the lowest by far of any EU country. Until recently, though, people had put plenty of money into private or occupational pensions, to make up retirement income to a more decent level. But, after all the scandals and problems, people have been losing confidence in pensions and private pension saving is not going to be enough to support most people in their retirement in future. They will be likely to end up in poverty and to have to rely more and more on means tested benefits in our very complex and confusing system of State support.

Can't Get Bigger Pensions From Smaller Contributions

- Rising longevity
- Longer time in education
- Trend to earlier retirement

These imply

- Less time contributing into pension
- More time living on pension
  - Financially unsustainable

A fundamental problem with pensions today is that they are having to last too long. They were never designed to be paid for 30 or 40 years. Pension policy has fallen way behind the advances in longevity and health status. People are also spending much less time than they used to in the labour force. More people go on to higher education and the last couple of decades have witnessed a consistent trend to earlier and earlier retirement. Companies used their pension funds as a way of hiding the costs of industrial restructuring. The funds were in surplus and the cost of paying people generous early retirement benefits could be conveniently hidden from company accounts by using the pension funds, instead of paying redundancy benefits. This has meant that effective retirement ages have been falling and people are retiring in their 50's, so they are spending less and less time contributing to their pensions. But, as they are also living longer, they are spending more time trying to live on those pensions. Someone who started contributing in their mid-20's, who then retires in their mid-50's, will have contributed for 30 years. If they live into their 90's, these 30 years' of contributions will need to last someone for 40 years. It's financially unsustainable. You can't get big pensions from small contributions.

But just saving more into a pension is unlikely to be enough to sort out this problem.

More Flexible Working Lives

- Falling birth rate
- LFP of older workers falling
- Size of labour force reduced
- Labour shortages
- Lower long-term economic output
- Waste of resources
- High social and economic cost

We need people to work longer too. There are fewer young people as a result of the falling birth rate, fewer older people are working and this obviously means less people are going to be available to work. In 20 years time, the real demographic problem will hit and, if policies don't change, there are bound to be serious labour shortages. This means that economic output will fall below potential, it is a waste of resources and the UK economy will suffer in both economic and social terms.

We have got to change the way we think about what are currently referred to as retirement and pensions.

Retirement
- a 'Process' not an 'Event'

- Change social attitudes - gradual/phased withdrawal
- Part pension/part work - current rules prevent
- No fixed retirement - flexible band
- Reward longer working life
- This is a BENEFIT of social/medical advances

We should think of retirement as a 'process', rather than an 'event', or a 'journey,' rather than a 'destination'. We're hearing lots about this during today's sessions. Changing social attitudes, to encourage gradual retirement, cutting down from full-time work, to part time work and perhaps living on part pension, if extra income is required. The current Inland Revenue rules don't allow people to draw a pension and stay working with the same employer – this must change.

I don't agree with the idea of just raising the pension age from 65 to some other age, like 67 or 70. We need to think about a flexible band of retirement ages. A one size fits all policy is not really appropriate in this day and age. We can account for individual differences. If people want to work longer, they should ultimately receive a bigger pension and I really believe that most people do want to stay at work. They value the income and the company of colleagues, the feelings of usefulness and structure to their lives. But they don't want to work at the same pace as they did when they were in their 30's, 40's or 50's. They would like to work less hours, part time, maybe retrain for less stressful roles, mentoring, job sharing and so on.

This could be thought of as a whole new phase of life, that just couldn't exist before. The period after full-time work and before what used to be called retirement. This would be a tangible benefit for people, of the advances in society and medical treatment. But, of course, people do still need to save to support themselves better if they will be living longer. So why don't they save enough at the moment?

Remove Disincentives - Why People Don't Save Enough

- Risks/difficulties of saving are greater than the risks/difficulties of NOT saving
- Very low savings among low income groups
- Poverty does not explain low saving levels
  - lack of access
  - complexity of products
  - lack of sufficient incentive
  - lack of information/education

Well, I think we have so many disincentives in place, it's not so surprising that saving levels are falling. People now feel that the risks and difficulties of saving are actually greater than the risks and difficulties of not saving. In particular, lower income groups save very little, but studies suggest that poverty itself doesn't explain low saving levels. There are many other problems, generally focussing on the complexity of the current system and people's lack of financial education.

Why Don't People Save?

General Barriers:

- Psychological inhibitors
  - apathy/inertia/boredom
- Complexity of system
- Lack of education
- Lack of understanding
- Lack of confidence
  - scandals
- Not willing to pay for advice

Barriers for Poor:

- Savings trap in means testing
- Pension credit
  - tax 40%+
- Perception of security from benefits system/ Social Fund
- 'Social exclusion' in advice
- Tax relief discriminates against poor

This slide shows some of the main barriers to saving for people in the UK today. There are general ones that affect just about anyone, shown in the left hand column. These are sometimes psychological barriers, savings are boring, I can't be bothered to think about saving, it's too difficult to understand, why should I worry now. Or confidence issues – I don't trust financial companies, there have been lots of scandals, I don't want to part with my money. And there are also particular barriers which affect the lower income groups especially, shown in the column on the right. Pension credit is a big problem, for example. It is very sensible to help today's pensioners but, if nothing is changed, this policy will be a major deterrent to younger people and is likely to prevent them from saving, especially for those on middle/low incomes. If people might be in the pension credit zone when they retire, they could still lose their savings pound for pound and will certainly be taxed on them at 40% at least. So why bother putting money into a pension at all?

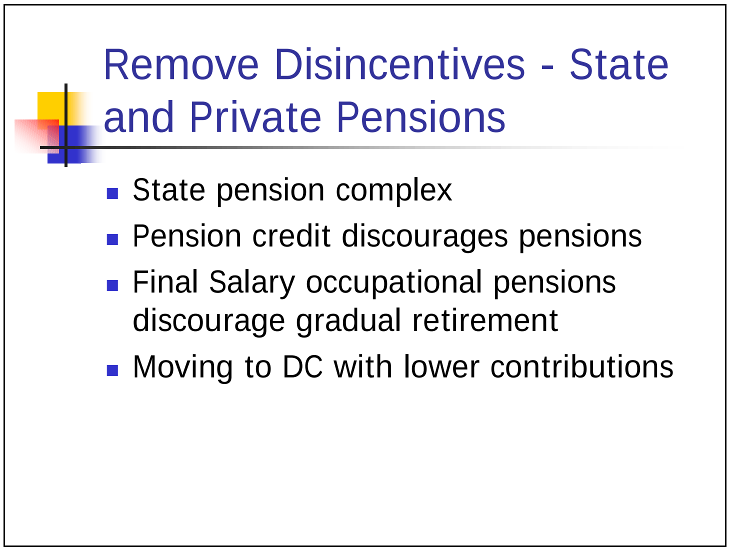
It is also very important that people should start saving from as early an age as possible, to have time to build up enough funds to live on.

Contributions Needed to Achieve a Pension of Two-Thirds of Final Salary

Age when starting pension contributions	Required contributions as % of salary	Maximum contributions permitted by current legislation (% of salary)
25	10.9	17.5
35	16.8	17.5
40	21.7	20
50	40.8	25
55	64.1	30
60	129.8	35

assumes male retiring age 65, salary increases 3% per year, investment growth 5% pa

This slide shows estimates from the Economic Journal of the amount that people would need to save to achieve what is often considered to be a decent level of pension. As you can see, unless you start young, if these estimates are correct, anyone starting after age 40 needs to save about 22% of their salary. But Inland Revenue rules only allow them to put in a maximum of 20%. If you start at older ages, the amounts you need to save are so huge, it is unrealistic to expect anyone to do this. There is clearly a problem here and saving more is only part of the answer.



We also have other disincentives in place. The complexity of the current system often defies belief and as I've already mentioned, pension credit discourages people from saving in a pension.

Final salary occupational pension schemes are a real problem, if we want to move to a system of gradual retirement. It is much more expensive to employ an older worker in a final salary environment than younger workers. So employers who have final salary pension schemes, which is mostly the larger companies, if faced with the choice of employing a worker over 50 with the same skills as a younger one, or even with better skills, would find it much cheaper to take on the younger person. I believe the impact of final salary pension schemes on employment of workers over age 50 has been seriously underestimated and we need urgently to examine how to address this effect.

I am certainly in favour of companies moving away from final salary pensions. They are old-fashioned, they really became popular in the late 1970's as a means of coping with high inflation and, given the increases in longevity and maturing of the schemes, the costs have become too uncertain and onerous for employers to bear. The trend to DC schemes is not a bad thing per se, but the real problem is that employers are using the move as an excuse to cut contributions. They should not really be allowed to get away with this so easily. It's an effective pay cut.

But even if we remove all these disincentives, I don't believe we will solve the problem.

Improving incentives - Encourage higher savings

- Encourage higher and more regular savings
- Allow more flexibility of pension withdrawal
- Incentivise employers more
- Improve financial education
- 60/40 to 40/60 for pensions
- Tax relief unfair

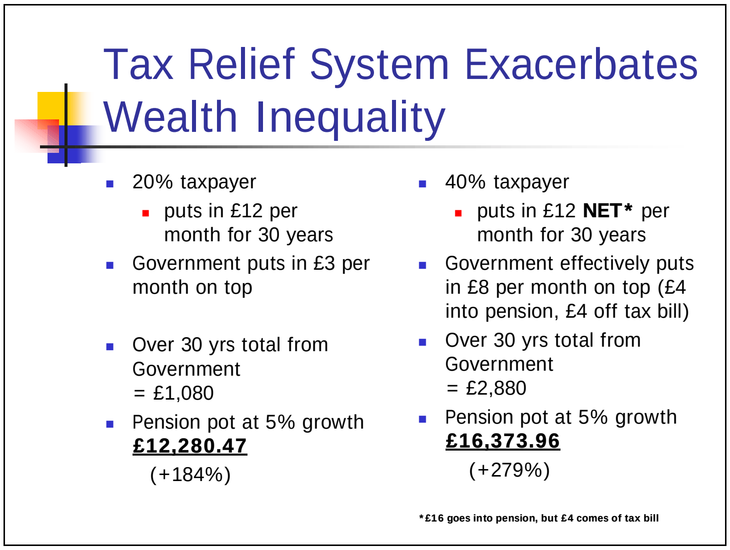
I think we need to offer better incentives too. If we want to encourage people to save more, we should allow them more flexibility in how they withdraw their pension. To be able to take some of it to live on and still work part time with their existing employer. To be able to draw on it, perhaps, while they are looking for work at older ages. We need to offer employers better incentives to put money into pension schemes for their workforce, We also need to improve people's level of financial understanding and knowledge. Government wants to move from a situation nowadays where 60% of retirement income comes from the State and 40% from private sources, to one where 40% is from the State and 60% from private means. But the only real incentive offered for people to put money into their private pensions is tax relief. As I will show you, I believe tax relief is not the right way to incentivise most people. It is unfair, lacks transparency and flexibility and is actually very inefficient as a means of targeting the middle and lower income groups, who need most encouragement to save.

Cost of Tax Relief

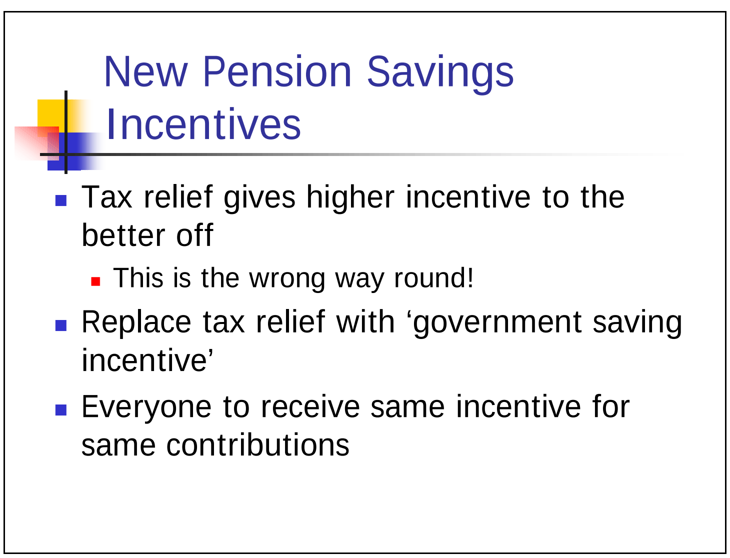
- Spend around £14bn pa
- Half to top 10% of taxpayers
- Quarter to top 2.5% of taxpayers
- Is this sensible? Is this fair?

We spend around £14bn a year on tax relief for pensions alone, even more if we include all the other forms of savings which are tax-favoured but half of this pension tax relief money goes to the top 10% of taxpayers and quarter of it goes to the top 2.5%. These are people who would probably save anyway and it is hard to believe that they are the ones that need the highest incentive.

Using tax relief could also make the inequalities of wealth in retirement worse. In fact, inequality among over 65's has become worse since 1997.

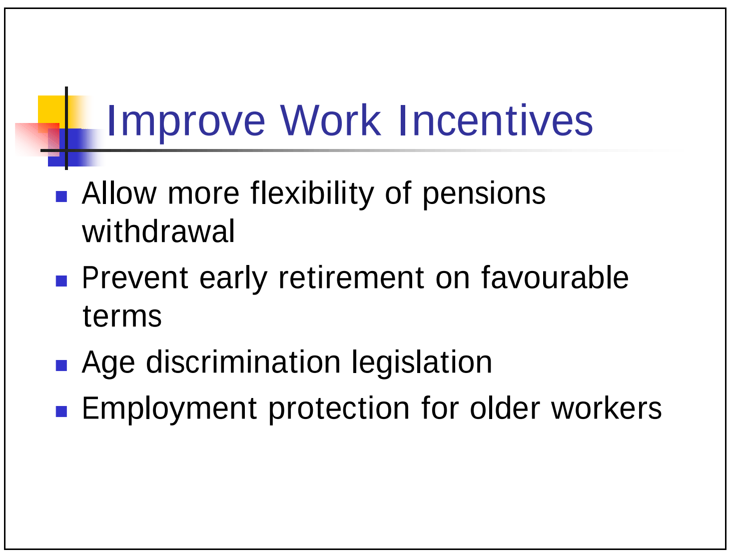


These figures show how unfair tax relief can be. Take two people, both save an effective £12 a month into their pension, both invest their fund for 30 years and both get an investment return of 5% a year. One pays tax at the lower rate (which I've assumed is 20% to make the maths easier!) and one pays tax at the higher 40% rate. The lower rate taxpayer receives tax relief of 20% which amounts to a total of £1,080 over the 30 years. The higher rate taxpayer receives a total of £2,880 from Government in tax relief over the period. Because the higher rate taxpayer has more to invest, her pension pot grows to over £16,000 by the time she retires, but the lower rate taxpayer who put in the same amount each month and earned the same investment return, will only end up with just over £12,000!

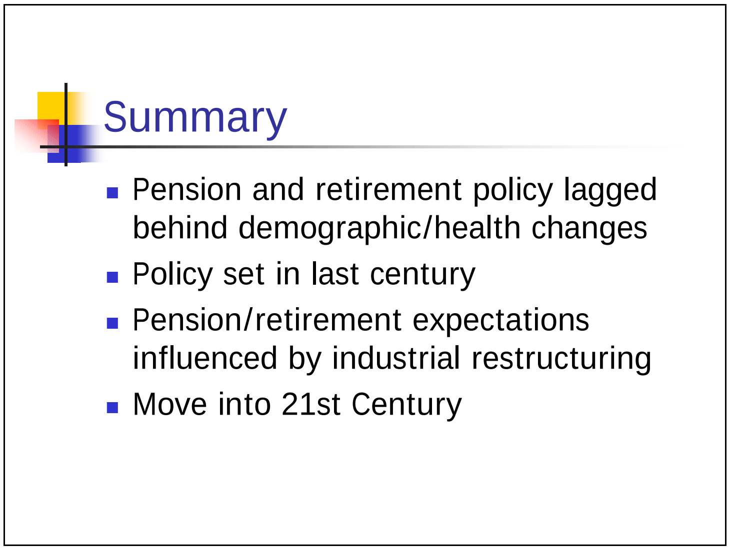


I think we need a new system of incentives for pensions (and savings), which does not give the highest incentive to the better off. I propose that we should replace tax relief with a system of matching payments or ‘government savings incentives’ where everyone receives the same amount from the Exchequer, for the same level of pension contributions. The Sandler Review suggested that this would be a better system than tax incentives, and I believe that such a scheme would be much fairer and could offer much more meaningful incentives to lower income groups to actually put money into pensions. A 22% top-up is just not enough to make it worth people’s while to lock their money away for such a long time.

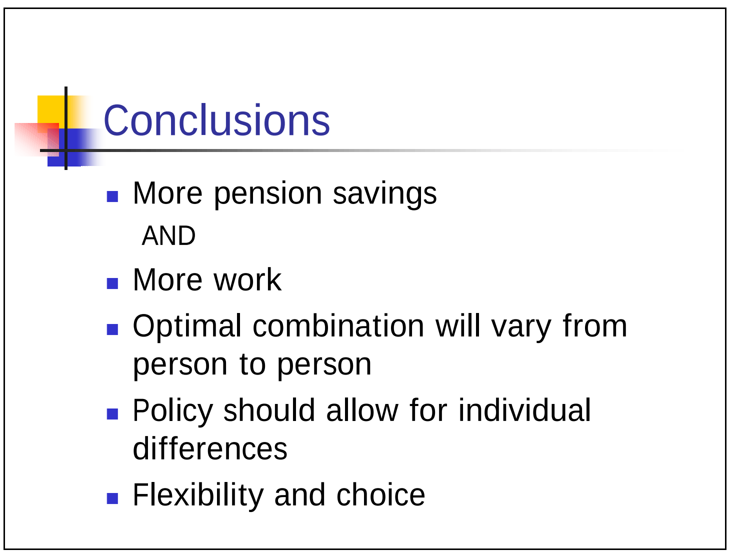
Policy has so far concentrated more on the supply side of pensions, rather than the demand side. Government has focussed on offering people cheaper pension products, simpler products and better information, but, unless you get them to want to buy a pension, the policy won’t work. We’ve seen this with stakeholder pensions. They are a great idea – a simple, cheap and flexible product – but the target group are just not interested enough in buying them.



Of course, we also need to improve the incentives for people to stay at work longer. Allow greater flexibility of pension withdrawal, perhaps make it much harder for people to take early retirement on the kind of favourable terms that they have been offered in past years. Again, we need to work on the demand side, not just the supply side, to help create more job opportunities, also on a part time basis, for older workers. I would like to see age discrimination legislation introduced soon and proper employment protection rights for older workers, like those for everyone else.



In summary, I believe pension and retirement policy is light years behind the changes in demography and health status we have enjoyed in the past half century. The industrial restructuring of the latter part of the 20th Century is over and has left a dangerous legacy of expectations about early retirement and large pensions, which are completely unrealistic. We need to move policy into the 21st Century.



In conclusion,

Yes, people do need to save more for their retirement, but they also need to be enabled and encouraged to work more too – for all our sakes. The optimal combination of savings and work will be different for each person, there should not be a 'one size fits all' policy. People should have a degree of choice about how much they can afford to work or not to work as they get older. We need more flexibility and more choice and this will help both pensions and pensioners to work well in the years to come.