

RETHINKING RETIREMENT: Dr. Ros Altmann responds to the Tomorrow Project's recent report *The Opportunity of a Lifetime: Reshaping Retirement*

(Photo, hopefully from RA's website)

Ros Altmann is a pensions and investment expert, investment banker and economist, advising the pensions industry on policy and strategy.

Before going into the City, she was an academic, working and publishing on the topics of UK pension policy, occupational pension provision, poverty among the elderly and retirement. She worked and published in the UK and at the National Bureau of Economic Research Pensions Program at Harvard University. She has a Ph.D. degree in Economics from L.S.E. and was a Kennedy Scholar at Harvard.

Introduction

The Tomorrow Project report *Opportunity of a Lifetime* deals excellently with many of the major issues faced by Western societies in dealing with demographic changes in coming decades. These pose huge challenges, whose implications Governments will ignore at their peril.

The Tomorrow Project report discusses the two principal features of any solution to the problem of financing an ageing population – rethinking retirement and improving lifetime savings levels (or pensions). As regards retirement, *The Opportunity of a Lifetime* suggests that there are two options – postponing retirement or reshaping retirement. My own view is that we need to abandon the current concept of retirement altogether and change the way we think about organising people's lives. The report correctly assumes that individuals will have to work till older ages and discusses the issues of retirement and savings in depth, providing a very interesting analysis of the issues. However, just saving more will not ensure that individuals have sufficient income to support themselves at a comfortable level for long periods of inactivity. Certainly, encouraging savings is important at various stages of people's lives and moving beyond pensions to think about savings over the whole lifecycle is required. However, this alone will not remove the risk of poverty and long term economic decline which our present system entails.

Retirement and Pensions

The Tomorrow Project analysis recognises that the UK does have a 'pensions crisis'. Pension policy has become outdated and confidence has collapsed. One of the fundamental issues that people must now wake up to is that saving in a pension plan will not provide decent pensions for the majority of the population. Most people simply cannot save enough to finance a decent lifestyle for 25 or more years of retirement. This will only really be possible for the top 10-20% of earners and is financially unsustainable for the majority of the population.

Pension policy was designed in the middle of the last century, when people were spending at least two-thirds of their lives working and pensions only needed to last 5 or 10 years. Nowadays, we spend about half our lives working and individuals are generally unable to start saving until older ages than in the past. In addition, as the numbers of older people rise sharply, with fewer younger workers, there are likely to be labour shortages in the future. To have so many members of the population not working implies increasing poverty, social unrest and long-term economic decline. It is a waste of resources and is not healthy for the individuals themselves. Those retiring in their 50s often become bored in their 60s. Why pay them not to work?

However, just postponing retirement is unlikely to be a suitable option. Moving from one arbitrary age to another would still fail to account for individual differences or provide the necessary flexibility to allow political acceptability. Furthermore, most people have already retired before state pension age anyway.

Reshaping retirement: a whole new phase of life to be grasped

Retirement should be a 'process', rather than an 'event', a 'journey', rather than a 'destination'. Individuals could have a whole new phase of life that previous generations never envisaged; gradual and flexible retirement, letting people benefit from modern improvements in working practices, longevity and health status. The Tomorrow Project envisages 'liquid lives' with more 'vertical stratification' of work and study. My vision is slightly different, but is along similar lines. I think we could plan our lives to have a first full time career, as now, but then expect to move to less stressful, less demanding, less time-consuming work at later ages, if people want to.

This new phase of life is available to most people. They can remain economically active, but not at the same stress levels as before. Such flexibility can be encouraged in different ways: reducing working hours, mentoring, training younger colleagues, job sharing, or retraining for another type of work altogether. Instead of the standard three phases of life which exist now – early years education, then full time career, then retirement – there would be a new phase of life at older ages. This might be called the 'COOL' phase (Challenges Of Older Life!), as individuals reduce their working hours, but do not stop altogether and still find time for other interests. In other words, retirement of the future should not be along the lines of 'retirement postponed' but more along the lines of 'retirement reshaped' (or even abandoned altogether!)

This is a positive message. There is more to working life than one full time career. Society has achieved such radical changes for women. Some thirty years ago, it was thought impossible for mothers with young children to find work easily. It was said that employers would not want to offer flexible hours, time off for child care, school holidays and so on, but nowadays the majority of mothers with children under five in the UK are working. We must consider how to achieve this for older workers too. Employers are starting to value an age diverse workforce, especially as the service sector expands and heavy manual labour falls.

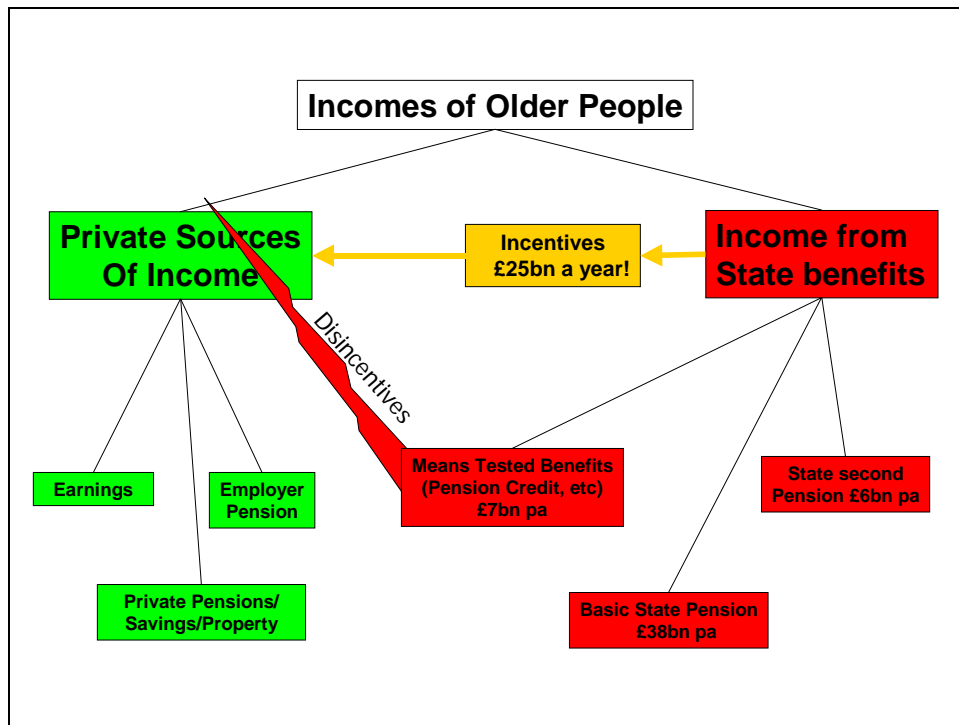
So, where does pension policy fit in?

Even with a new concept of retirement, people still need pensions, or some other form of savings, to supplement earnings. Pension policy is designed to improve incomes of older members of society but unfortunately, at the moment, most sources of old age income are declining. Future retirees will not have enough to live on comfortably. Some joined up radical thinking is required. The Tomorrow Project report discusses a possible scenario of 'more of the same' with the Government just tinkering with the State pension system and raising the State pension age. I do not believe this is a realistic option.

Diagram 1 shows the possible sources of income in later life: This can either come from private means, or from the State. Unfortunately, all private sources of potential income for older people have been falling in recent years. In particular, employer pension coverage has declined dramatically since the mid-1990's, with employer contributions being cut significantly and movement from defined benefit, to defined contribution pension arrangements, as discussed in the Tomorrow Project report. In addition, the overall savings ratio has fallen and debt levels have increased.

Furthermore, the levels of State retirement income (Basic State Pension and Second State Pension (S2P/SERPS)) have also fallen in the past few years. The only other element of support is, therefore, means tested benefits, which have grown rapidly. This Government has introduced a means tested top up element to the State pension system (Pension Credit) which offers all those who are eligible, an above poverty-line income. The problem with this policy is that it is undermining private pensions and interfering with the incentive to save. Well over half the over 60s are now eligible for means testing and the proportion is expected to grow to over three quarters of older people by 2050. This implies that most people will be penalised for any pension savings they accumulate, since the Pension Credit calculation reduces pension income by *at least* 40% and sometimes by 100%. A summary of the current situation is shown below.

Diagram 1



UK State Pensions are too low

UK pension policy has been based on the idea that the private sector can fill the gap between a very low level of state spending and the need for decent pensions. As Diagram 1 shows, the Government spends £25 billion a year on incentives to encourage private pension provision (in the form of tax relief and National Insurance rebates to private pensions), but the policy is not working well, since over half the population is not on course for adequate pension. A more sensible alternative would be to clarify and improve State pensions, preferably by ending contracting out and joining Basic State Pension with State Second Pension, to provide an above poverty-line basic minimum pension. Private provision can then be built on top.

Encouraging more private provision

The Tomorrow Project report suggests that policymakers will face a choice between compulsion – forcing individuals and employers to contribute to pensions - and radical change. I do not believe that compulsion is an optimal solution. There are several problems with compulsion. Firstly, the level of savings required over a working lifetime would be too high for most individuals (over 15% of earnings would need to be contributed). More importantly, there is no conclusive evidence that compulsion leads to a rise in overall levels of saving – many people switch from other forms of saving or take on extra debt to make up for the increased pension contributions. In addition, the impact on the economy of a sudden surge in savings would be negative and this is likely to be viewed as a tax and would be politically unpopular.

The report's second suggestion of encouraging more people to save, using a 'lifetime savings account' vehicle, is more appealing. If this were coupled with a re-design of

the savings incentive system and a state pension which provided basic poverty-line payments for all those over, say, 75 or for all those who have worked and contributed to national insurance for over, say, 50 years, then the savings element of old age support could be voluntary. If individuals were happy with a poverty line existence, they need not save and can live on state support or continue working part time to earn some extra income in later life.

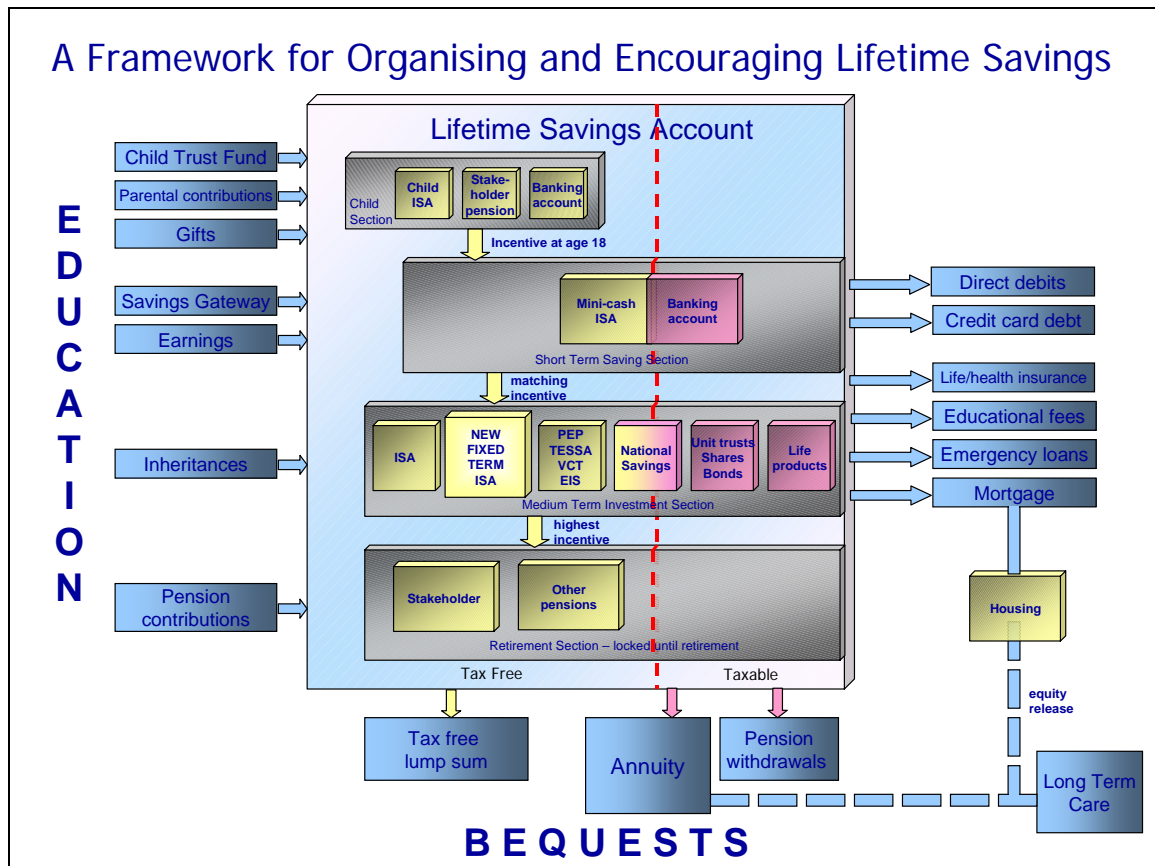
Lifetime Savings Account could encourage higher lifetime savings

The Tomorrow Project describes the introduction of a Lifetime Savings Account, which I have described in detail elsewhere¹. To increase saving levels, individuals could be encouraged to save in other forms, not just pensions. For example, they could save in medium term or shorter term vehicles first, with a lower level of Government incentive than for pensions, but then receive higher incentives if they transfer this money to pensions later. Furthermore, those who will be caught in the means test of Pension Credit would be better advised not to put money into a pension, because they could lose at least 40% of their pension income, or even all of it, as the rules currently stand. In fact, this problem of means testing rendering pensions 'unsuitable' for most people, is another reason why compulsion is impossible in the current environment. As the Tomorrow Project report points out, we also need to improve financial education, so that people can better understand why and how they should save.

The Lifetime Savings Framework can address these issues. It could look after all of an individual's financial needs in one wrapper, providing a 'one-stop shop' to manage savings throughout their lifetime. It could also include education and advice. Diagram 2 shows a possible outline of such an account.

Diagram 2

¹ See, for example, Ros Altmann 'Encouraging Savings Through the Lifecycle', Journal of Financial Services Marketing, June 2003, Volume 7 Number 4. for a detailed discussion of the Lifetime Savings Account.



Having discussed the main aspects of the Tomorrow Project report, and the important reforms to retirement and pensions policy which it suggests, I would like to conclude by outlining briefly the challenges which any such reforms imply for the future.

Challenges for the Future

Challenges for the Individual

Individuals need to re-think how they organise their lives. The idea of leaving the labour force completely at any particular age is outdated. More modern, less physically demanding labour practices, coupled with improving health status, mean that individuals can work for far longer and keep contributing to the economy and their own welfare. Why plan to stop working at any particular age?

Challenges for Government

The State pension system requires urgent reform. If individuals are truly to be encouraged to save, the system of means tested support for the majority of the elderly must be re-thought. The Government must also encourage more flexibility in the labour market, age discrimination legislation and lead social thinking on working longer, but not full time.

Challenges for Employers

Employers can facilitate more flexibility of employment for older workers, to attract and retain older staff as the number of younger workers falls. Employers also need to think carefully about how to keep pension costs under control. Defined benefit pension promises have become too expensive, but moving to defined contribution often entails a significant reduction in employer contributions, which should be explained to staff. It is likely that pension issues will become an increasingly important part of overall pay negotiations and employers need to be prepared for this.

Challenges for Financial Services Companies

Designing pension vehicles which consumers find attractive and the possible provision of lifetime savings vehicles for middle Britain poses a huge challenge, but could be extremely rewarding for any companies which succeed.

Summary

The Tomorrow Project report offers extremely useful insights and analyses of the vital aspects of retirement and pensions policy for the future. I believe that it has provided a really useful framework for consideration of these issues, covering both radical and less controversial scenarios which will inform the debate for the future.