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Towards a 'balanced' approach to pensions reform? Individuals, the state and employers in the restructuring of post-retirement income in the UK

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Towards a ‘balanced’ approach to pensions reform? Individuals, the state and employers in the restructuring of post-retirement income in the UK

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Abstract

This paper tests the feasibility of individual saving as a solution to the pensions crisis and, heeding the Pensions Commission's call for a 'balanced' approach to the UK's problems, investigates the effect on individual savings rates of changes in state and occupational provision: ie the re-introduction of the Basic State Pension earnings link and a return to an average pension contribution of 8 % for those employers currently providing occupational pensions. The paper is based on a series of micro-simulations of the pension entitlements of a selection of illustrative 'risk biographies', which are founded upon a critique of similar calculations undertaken by the DWP and Pensions Commission.

The paper shows that:

1. The introduction of typical risks (eg care responsibilities, unemployment, early retirement) to individual life biographies, and the use of an adequacy standard based on relative poverty, significantly increases the rate of saving required to secure an adequate income in retirement in comparison with the savings rates outlined by the DWP and Pensions Commission.
2. A relatively small change in the current policies of the state and some employers has the potential to make the prospect of an increased reliance on individual savings a more feasible prospect.
3. Greater intervention by the state and/or employers would nevertheless be required to cater for those with greater periods out of the workforce and/or working in sectors uncovered by occupational provision.

The Problem with UK Pensions

As it currently operates the UK pension system will be able to guarantee an adequate pension to fewer and fewer citizens over the next fifty years. The Government-appointed Pensions Commission, for example, predicts a 30% decline in the incomes of the average pensioner relative to average incomes between now and 2035 if existing public pension policies and private savings rates remain unchanged, (2004: 12). This is a frightening prospect given that the situation today is far from ideal: while for some pensioners the present might be characterised as a ‘golden age’, more than two million of their fellow retirees are in poverty (DWP 2005: 2). A substantial increase will be required in the amount of national income put aside for retirement just to maintain the current unsatisfactory position, given the predicted relative rise in the number of older people in the population. Much more will be needed to ensure future pensioners a poverty-free retirement.¹ In short, the problems with the UK pension system are distributive as well as demographic.

The Pensions Commission, which was established in 2002, has been assigned the task of assessing the main problems with the current British pension regime and recommending reforms. Constituted of academic experts and high ranking practitioners, its first report clearly stated that three main options are available for rectifying this problematic situation:

1. Taxes could be increased to boost state provision
2. Levels of private savings could increase
3. More people could work for longer (2004: 12)

The Commission intimated that it favoured a ‘balanced’ approach based on all three options (2004: 20). But, what combination of the three options constitutes a balanced approach? In this regard, there are indications that so far as post-retirement income is concerned the Government is moving towards a proposal that will focus primarily on individual saving, perhaps with a compulsory component. These indications are: Labour’s past shyness towards policy proposals that explicitly involve significant costs to industry; its emphasis on private savings in its earlier responses to the pensions debate (DWP 2002), and its consistent refusal to substantially increase the level of universal state provision. Thus, David Blunkett, the Secretary of State for Work and Pensions told the BBC’s *Today* programme seven days after the last election: ‘I haven’t ruled out the issue of some sort of means of ensuring that *people* do save.’ (quoted in Tempest 2005; emphasis added).

Against this background, this paper will consider the feasibility of compulsory individual saving as a solution to the pensions crisis. On the basis of new research, undertaken using a simulation model constructed as part of the EU-funded six country study², it will

¹ By poverty, we mean relative poverty operationalised as 60% of median income. We use this term interchangeably with social exclusion, although we recognize that there are other non-income based dimensions to this concept. See Hills and Stewart (2005: 14-16).

² “Private Pensions and Social Inclusion in Europe” 5th Research Framework of the EU. Jan 2003-October 2005. P. Bridgen T. Meyer, University of Southampton.; B. Riedmüller, M. Willert, Free University of Berlin; P. Calza Bini; Institute of Research on the Dynamics of Social Security; B. de Vroom, D. Bannink,

indicate the types of contribution levels that citizens with lower incomes and disrupted working lives would have to pay under a compulsory scheme to receive an adequate pension in retirement. These calculations and findings differ from similar work done by the DWP (2002) and Pensions Commission (2004). This paper argues that both bodies have under-estimated the level of savings required for those on lower incomes because of unrealistic assumptions regarding citizens' life courses and entitlements to pension benefits.³ Indeed, the paper will conclude that for many citizens private savings would only be able to provide a retirement above the poverty line by substantially and unreasonably reducing their current gross income. The paper will thus suggest that any move towards compulsion only becomes financially feasible⁴ if its introduction is accompanied by steps to increase support from employers and/or the state. It justifies such increases on the basis that the projected role of both is currently set to decline, and finally shows how changes in state and employer provision could be used to make individual savings rates more manageable.

The DWP, the Pensions Commission and saving

Since early in its second term, New Labour has come under pressure with regard to its pensions policy. Criticism from within the labour movement about the declining value of the state pension in relation to wages (TUC, 2002) has been accompanied by more general charges that the Government bears a major responsibility for the gradual demise of defined benefit occupational pensions (see Bridgen/Meyer, 2005, forthcoming). The Government has responded by releasing a Green Paper, *Simplicity, Security and Choice* (2002), which details a number of reforms to the pension and savings system, and by establishing the Pensions Commission.

With regard to the former, the major focus of the Government's attention has been private saving. The Green Paper (DWP 2002) accepted the view that citizens are under-saving (Oliver Wyman 2001) but, true to voluntarist principles, argued that 'given the right opportunities, people will plan ahead sensibly' (2002: 33). Government's role, it suggested, is to ensure that the obstacles preventing people from doing this are minimised or removed. A series of reforms relating to the tax regime for UK pensions (HM Treasury and Inland Revenue, 2002) and the transparency of financial services sector (Pickering, 2002; Sandler 2002) have been designed to address these problems. These build on the 1999 stakeholder reform which was designed to address problems of coverage by facilitating greater access to supplementary pensions for those in small companies and on low pay. They have been implemented as part of the Pension Act 2004.

As part of this general policy approach, the DWP identified levels of savings that various individual biographies with full public pension entitlement would need to reach to obtain certain income thresholds in retirement. In this regard, the DWP first highlighted, on the basis of panel data, 3 million employed and self-employed people earning over

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³ The Pensions Commission is quite open in accepting that its calculations are based on optimistic assumptions (see 2004: chapter four)

⁴ This leaves aside of course the question of *political* feasibility.

£10,000/year who ‘could be seriously under-saving’, and a further 5-10 million people ‘who might wish to alter their savings behaviour’(2002: 157). On the basis of its own calculations, the details of which were largely unspecified, the DWP suggested that if the ‘slight’ under-savers ‘increased their savings rates by around 1% to 2%, and this was matched by their employers’ (2002: 157), then many of this group would be saving enough. Those earning £15,600/year (ie £300/week), it suggested, require to save 10% of their gross earnings to achieve a replacement rate of 66% on retirement (2002: 28). No savings figure was specified for the serious under-savers.

The Pensions Commission addressed the issue of savings rates in its first report released in 2004. This was intended to provide a fact-based description of the existing situation upon which debate could take place. The Commission’s approach to savings rates was broader and more detailed than that of the DWP. It identified the rates required for a range of income groups to ensure an ‘adequate’ income in retirement, assuming entitlement to the basic state pension and the State Second Pension (S2P), and also broke these figures down on the basis of current age⁵ and the age at which saving started. Thus, for example, a 25-34 year old male⁶ employee earning £21,250 per year who started saving in a personal pension at 25 would, according to the Commission, requires savings of 9% of their gross earnings throughout their working life to ensure an ‘adequate’ retirement income at 65 (2004: table 4.10, 156); this rate would rise to 14% if saving was delayed until 35 (2004: table 4.9, 155). The results for this and other income groups and savings’ starting ages can be seen in tables 1 and 2.⁷

Replacement Rate %	Income	Age today			
		25-34	35-44	45-54	55-64
80	£9,000	n/a	0	2	7
70	£13,500	n/a	12	10	9
67	£21,250	n/a	14	12	11
60	£32,500	n/a	14	12	10
50	£50,000	n/a	13	11	10

Source: Pensions Commission (2004): Table 4.9: 155. Amended to reflect 3.3% rate of return for personal pensions

⁵ The lower savings rates for older cohorts reflects the declining generosity of the state system and rising life expectancy (see Pensions Commission, 2004: 154).

⁶ That the person is male is reflected in the assumptions made by the Pensions Commission about annuity rates. See footnote 8.

⁷ The assumptions on which these calculations were based are detailed in chapter four of the Pensions Commission report and appendices C, F and G.

Table 2. Required Contribution Rates to a Personal Pension for a Male Employee Starting Saving at 25 and Retiring at 65: Assuming Contracting-In to SERPS/S2P

Replacement Rate %	Income	Age today			
		25-34	35-44	45-54	55-64
80	£9,000	0	0	2	5
70	£13,500	7	7	7	6
67	£21,250	9	9	8	7
60	£32,500	9	9	7	7
50	£50,000	9	8	7	6

Source: Pensions Commission (2004): Table 4.10: .156. Amended to reflect 3.3% rate of return for personal pensions

The implications of the DWP's and Pensions Commission's findings do not seem too serious for some current workers, given that the average contribution currently paid by workers into an occupational pension is 4.7% (IDS 2004: 200). In particular, the DWP's suggestion that some individuals only need to increase their saving by a total of 2 to 4% including an employer contribution suggests that an adequate income in retirement is easily within their grasp. Likewise, some of the Pensions Commission savings rates detailed in table 2 do not look too intimidating. However, for other workers, the implications seem more problematic: savings levels of between 9% and 14% (depending on the age at which saving starts and rates of return) to achieve the specified replacement rates at 65 would impact quite severely on employees' gross income. Certainly, savings of this scale would be substantially greater than those which currently takes place among workers with access to DC provision. In 2000, less than 10% of active members of these schemes had a combined employee/employer contribution rate of more than 10% (Pensions Commission, 2004: 155 and 157).

Yet, even these quite high levels of savings are likely to be an underestimate: the calculations undertaken by the Pensions Commission and DWP can be questioned on three accounts: The first concerns adequacy: what should the threshold for an "adequate pension" be? We argue that the limits set in the existing calculations are too low if the aim is poverty prevention for citizens on low wages. Secondly, when measuring whether hypothetical individuals cross these thresholds, to what extent should we assume that the person has other means of income, such as Pension Credit or access to his or her spouse's entitlements? In contrast to the DWP and the Pensions Commission our position is to suppose neither. Thirdly, how should the working lives of hypothetical individuals be modelled in order to illustrate possible social problems in retirement? We reject the use of a "standard biography" with uninterrupted full-time employment and argue that typical social risks such as unemployment, care responsibilities or forced early retirement because of redundancy should be made transparent in calculations of this kind. In the following, we will explain in more detail why we arrived at these diverging assumptions.

A critique of the DWP's and the Pension Commission's assumptions

Setting an adequate minimum pension level

The DWP and the Pensions Commission assume that an acceptable pension level should be based on the extent to which retirement incomes replace the level of the last wage. However, they differ about the appropriate replacement rate, especially for lower paid

workers. The DWP proposes ‘[b]enchmark replacement rates’ of between half and two-thirds’ (ie 50% to 66%)(2002, annex 4, para, 7). The Pensions Commission suggests a sliding scale in relation to income with the threshold of the lowest paid set at 80% (2004: 143, See Table 3).

The basis for the DWP’s benchmarks are average replacement rates in the current pensioner population but, as the DWP itself acknowledges, this threshold does not necessarily measure adequacy; it merely reflects ‘the majority of individual desired outcomes’ (2002: annex 4, para, 7). By its own admission, therefore, the DWP’s savings rates are not built on any of the standard income-based measures of social inclusion, such as 60% median wage. They would thus not necessarily guarantee the individual in question a retirement free from relative poverty.

The Pensions Commission is more ambitious in this respect. It chooses a sliding replacement rate scale for its calculations (see table 3), with higher replacement rates for those on lower pay, because: ‘Lower income people may need a higher consumption replacement rate to be assured of what society considers a minimum acceptable standard of living’ (2004: 134). However, despite this greater concern for social inclusion of the lower paid, the Pensions Commission does not go so far as rejecting replacement rates altogether in favour of a recognised poverty line. Its failure to do this is a reflection of the philosophical underpinnings of the Commission’s approach (2004: 129). In this regard, while the Commission explicitly rejects a neo-liberal approach to pension provision, it also rejects an egalitarian social democratic approach that aims to prevent relative poverty for all. Rather, its principal justification for state pension provision above a safety net minimum is market failure caused by information deficiencies⁸ and externalities⁹ (see also Barr, 1998). On this basis, the Commission takes the view that ‘government should ensure that people make provision which they would consider adequate for their retirement’, a view it operationalises on the basis of ‘international comparisons, time trends, analysis of expenditure patterns, actual replacement rates observed today and people’s stated expectations and preferences’ (2004: 130). For this reason, when it comes to relative poverty prevention the Pensions Commission’s approach is still problematic, notwithstanding its greater readiness to acknowledge the risks of social exclusion, because considerable social risks are not addressed sufficiently. Even if we assume that citizens on lower incomes achieve the more generous replacement rates of 70 or 80%, they are still likely to get pensions that are below 60% of median wages. Thus, for example, our calculations show that a 70% replacement rate for someone earning £13500 throughout their working life (See Pensions Commission, 2004: table 4.6, 152) would result in an income on retirement 27 percentage points below the 60% median income threshold.¹⁰ If the avoidance of social exclusion is the main criterion, therefore, only savings rates based on standard income-based relative poverty thresholds, are sufficient.

⁸ The Commission speaks of an ‘inherent imbalance between customers and providers’ in the field of pensions (2004: 129).

⁹ For example, the social costs caused by insufficient occupational pensions which are then met by the state, via means-testing (2004: 129).

¹⁰ The assumptions on which this calculation is based are detailed in Appendix A.

Pre-retirement Earnings	Replacement Rate %
<£9500	80
£9500-£17499	70
£17500-£24999*	67
£25000-£50000	60
£50000+	50

*Includes median wage of £21250
Source: Pensions Commission, 2004: 143

Calculating other possible sources of retirement income

The second area where the assumptions made by the DWP and Pensions Commission might be questioned relates to the other sources of income retired people may have after they finish work. In this regard, the DWP reduced its replacement rate by 5% for a fifth of future pensioners on the basis that they would have 'significant non-savings assets', such as ownership of property (2002, Annex 4: 157).¹¹ Moreover, in undertaking its assessment of 'retirement under-saving' it looked at 'the total level of savings in a partnership' rather than individual saving (2002, Annex 4: 156). However, the DWP itself accepts there are important problems with releasing housing assets to provide income in retirement (2002: 90-91). The Financial Services Authority, for example, has recently raised the issue of the mis-selling equity release products by the financial sector (FSA 2005). Basing savings assessments on partnerships is also problematic because research findings show that couples do not necessarily pool and share their resources in a harmonious fashion and specifically that the "breadwinner" does not always distribute "his" resources equally (Pahl 1998; Graham 1987). The assumption of equally shared savings also runs counter to a clear social trend towards individualization, expressed for example by the steadily rising yearly divorce rate over recent decades (ONS, 2005). The European Union and British governments have made forceful political statements pledging to protect citizens against the social risks this trend has brought with it (Council of the European Union 2003: 96-97; DWP 1999).

The Pensions Commission bases its research on individuals (2004: 158) and makes no allowance for non-pension savings assets. However, when calculating the savings low-income individuals require on top of their public pension entitlements to hit the replacement rate thresholds, it recognises the means-tested Pensions Credit on a par with other post-retirement income (2004: Appendix G, 1-5). This means that anyone who, with the addition of Pension Credit, surpasses their replacement rate target is considered to have sufficient protection in retirement, and no need to save. Thus, for example, the Commission concludes that those with lifetime earnings of £9000 per year do not need to save to achieve an 80% replacement rate, because this level would already be exceeded by the Pension Credit (2004: 151-156). This assumption can be questioned on ethical and practical grounds with respect to social inclusion. Ethically, many commentators would

¹¹ Precisely how this reduction was incorporated in the calculations is not made clear in the Green Paper

regard any notion of inclusion based on receipt of mean-tested benefits as unacceptable, given their stigmatising and intrusive effect (eg Help the Aged, 2002). Practically, the problem is one of take-up: with one third of those entitled to Pension Credits not claiming, it clearly cannot be relied upon to lift all of those on lifetime earnings of £9000 above the 80% replacement rate threshold (DWP, 2004). On this basis, the savings rates deemed sufficient by the Commission to achieve adequate pensions for citizens on lower income must be questioned: if means-tested benefits are excluded, as we would argue they should be, these savings rates jump sharply.

Modelling hypothetical individuals

The final area where the approach of the DWP and Pensions Commission might be questioned concerns the illustrative biographies used to assess required savings levels. In this regard, both calculate their savings rates on the basis of very simple working life biographies characterised by continuous employment, stable wage and savings levels. However, as the Commission recognises, neither model picks up transparently the experience of those who have broken savings patterns and/or lower entitlement to the Basic State Pension and the State Second Pension on retirement (2004: 158). Such occurrences are more likely to be experienced by individuals on incomes significantly below average, who are more likely to encounter breaks in employment, periods of part-time work and a more variable wage trajectory (Dickens/Gregg/Wadsworth: 2000: 98). Many of these citizens are women (Ginn, 2003).¹² These individuals would obviously have to earn more during their periods of full-time work than those with unbroken full-time work trajectories to achieve the same total lifetime earnings. Thus, for example, our calculations suggest that someone with a constant working life income in relation to the average wage whose yearly pay in 2004 was £13500 will achieve a similar level of lifetime earnings to an individual whose annual earnings were £700 above this level in 2004 but who experiences a five year absence from the workforce.¹³

A more transparent and relatively straightforward way of illustrating the experience of such citizens, and thus the experience of a large number of women workers, is by including breaks in employment and variable wage rates in the calculation method.

Savings rates for 'risk biographies'

The critique outlined above of the approach taken by the Pensions Commission and the DWP informs the savings calculations undertaken in this paper. These seek to indicate the savings levels required by a more diverse range of individuals - 'risk biographies' - than those considered by these two bodies. The calculations include details of the savings required to surpass standard relative poverty thresholds and assume that individuals have no post-retirement income beyond their own *individual* non-means tested pension entitlement. In calculating the pensions of these biographies, wherever possible similar

¹² The Pensions Commission does however make some allowance for gender by including lower annuity rates in a couple of its calculations (2004: 155-56).

¹³ The assumptions on which this calculation is based are detailed in Appendix A.

assumptions (about rates of return, annuity rates etc.) have been made to those which informed the Pensions Commission calculation (see Appendix A).¹⁴

In this regard, a group of seven risk biographies has been constructed, using the Pensions Commission model of an individual with 44 years of uninterrupted employment on a median wage as a base, but incorporating various social risks typical for post-industrial society which such an individual might experience during their working life. It is not claimed that these seven biographies are representative; they are merely illustrative, as, of course, are those of the DWP and Pensions Commission.¹⁵ However, they do indicate more explicitly and transparently the significant effect deviations from standard working life trajectories can have on the savings rates required to enjoy a socially inclusive retirement.

All of our risk biographies, each of which has been given a name, were 18 in 2003 and start saving at 25. They are all able to claim a state pension on their 65th birthday - on the first day of 2050 – after a 44 year working life and, with the exception of those who are self-employed for periods of their working life, are contracted-in to the State Second Pension (S2P) during years of employment. Further details of the risk biographies are as follows:

1. David – the qualified full-time worker

He is in full-time work throughout his working life during which time he consistently earns the median wage.

2. Tessa - The unqualified worker and mother

While in paid employment, she has a mixture of full-time and part-time work and consistently earns 70% of the median wage or slightly below. She takes a total of four years out of the labour market due to child care responsibilities.

3. Margaret – the qualified worker and mother/carer

She earns more than Tessa (ie the median wage when employed full-time), but experiences 16 years of part-time work and is absent from the labour force for 8 years due to caring

4. Tony – the qualified intermittent worker

When in full-time employment he earns the median wage, but experiences a total of eight years out of the labour force.

5. Gordon - the unqualified worker

He works full-time throughout his working life but earns less than David (around 65% of the median wage).

6. Stephen – the unqualified intermittent worker

He earns the same as Gordon, but experiences four years of unemployment and leaves the workforce at the age of 62 due to redundancy.

7. Jack – the unqualified small business entrepreneur He is always in full-time work and earns the median wage. However, he is self-employed from age 30

¹⁴ We have chosen to use the Pension Commission's calculations as the model for our calculations rather than the DWP's because the former provided a fuller description of their methods.

¹⁵ For a discussion of the strengths and weaknesses of micro-simulation as a tool for assessing pension systems see Bridgen/Meyer (2003) and Johnson/Rake (1998).

Our results on the basis of this approach are fully comparable with those of the Pensions Commission (see table 4). For example, our qualified breadwinner David is almost identical¹⁶ with the Pensions Commission biography, who in 2004 earns the median wage of £21,250, who starts saving at 25, achieving a rate of return of 3.3%, and retires at 65, after a working life of 44 years (2004: Table 4.10¹⁷, 156). According to the Pensions Commission, this hypothetical individual requires a 9% savings rate to achieve a total gross replacement rate of 67%. This is also true for David.

	Summary	Target Replacement Rate	60% median wage
David	Median wage	9	7
Tessa	FT/PT, carer, 70% of median	12	18
Margaret	PT/FT, extended carer, median	18	16
Tony	Median wage, unemployed	13	11
Gordon	65% of median wage	7	13
Stephen	65% of median w., unemployed	11	19
Jack	Median w., self-employed	13	11

Source: Our calculations. Assumptions detailed in Appendix A.

Our results show that by introducing typical risks like care responsibilities, unemployment, early retirement and self-employment to our biographies, the amount of money they need to save during times of economic activity to make up for times of inactivity increases sharply. This can be demonstrated by comparing our full-time worker David with everyone else. The savings rate of Tony for example, who earns the same as David while in work, but experiences a total of eight years out of the workforce, jumps from David's 9% to 13%, if he wants to reach the Pensions Commission's target replacement rate for his income level (ie 67% of his last wage).

The savings rates required by both these individuals to reach 60% of the median wage (i.e. the relative poverty line) are also worthy of note. David's savings rate of 7% appears quite manageable, given the current 4.7% average employee contribution to occupational schemes (IDS 2004: 200). However, Tony is in a more precarious position; he requires 11% to pass the 60% median threshold. Thus, even if the adequacy standard for those on median wages is lowered from that set by the Pensions Commission, individuals from this group who experience periods of self-employment or disrupted working lives still face savings rates significantly above those currently paid by most employees.

¹⁶ One important difference is that David's working life starts in 2003 and thus his pension simulation is based purely on the current pension regime.

¹⁷ Figures amended for 3.3% real rate of return.

The situation for Jack, our small business entrepreneur, is a little different. His earnings trajectory is similar to David's, but because of his self-employment Jack does not receive the S2P and would thus have to save 4 percentage points more of his gross earnings per year to gain the same replacement rate. However, this increased savings rate is, in theory, offset by the fact that he pays less in national insurance contributions. Jack should find it easier than Tony to save the additional amounts required to keep himself out of poverty in retirement. In reality, however, we know that self-employed people often do not save at the rates required. In 2002-2003, for example only approximately 43% of self-employed men and 35% of women were contributing anything to a private pension scheme (Pension Commission, 2004: 91).

The examples of Gordon and Stephen illustrate the problem of using replacement rates as an adequacy threshold for those on lower incomes. Gordon has a very similar working life trajectory to one of the biographies used by the Pensions Commission. This individual is between 25 and 34 today and earns £13,500. He starts saving at 25 and retires at 65 (Pensions Commission, 2004: see table 4.10, 156). Both this individual and Gordon would require to save 7% of the gross income to achieve the Pensions Commission's target replacement rate for this level of income (ie 70%). This does not appear too problematic. However, if Gordon's target retirement income is considered in relation to the relative poverty line of 60% median income the picture does not look so bright. His required savings rate almost doubles to 13%. Stephen's situation is even more bleak. His more disrupted working life means that he can only achieve a 70% replacement rate by saving 11% of his gross income, but even saving at this level our calculations suggest would only provide him with an income 27% below the relative poverty line.

Tessa and Margaret find themselves in a similar situation to Gordon and Stephen but for different reasons. Their working life trajectories give a transparent indication of the effect on savings calculations of gender. Tessa's wages vary above/below 70% median income and she experiences a disrupted working life due to caring responsibilities. Margaret is paid more (i.e. the median wage when in full-time employment) but has a more disrupted working life. Nevertheless, the biographies of both are within the current government's target group of individuals who should increasingly become reliant on private saving (DWP, 1999).¹⁸ On the basis of their working lives, both Tessa and Margaret are faced with savings rates substantially greater than current levels of saving. Tessa would have to save 12% to achieve a replacement rate of 70%; Margaret would need 18% to hit the target replacement rate for her income (ie 67%). These savings rates would seem unlikely, but even if Tessa achieved her target she would still not secure an income above the relative poverty line at the start of her retirement. To rise above relative poverty on retirement, she would have to save a further 6% of her gross income. This is because a 70% replacement rate is lower, given her low income, than the 60% median wages threshold.

¹⁸ Their lifetime earnings equate to those of someone with a starting wage close to £13000 and a regular yearly income thereafter that does not alter as a percentage of the median wage.

A More Balanced Approach

The results of our research strongly reinforce the view of the Pensions Commission that a better balance needs to be reached in relation to the UK's pension problems. Our calculations show that such a balance cannot be achieved via the Government's apparently preferred route of individual savings alone. If this path was taken, many citizens on lower wages facing the standard social risks of contemporary society would have to save at levels that are likely to be considered unrealistic, just to avoid relative poverty.

It is thus necessary to examine more closely the possible role of the other actors - employers and the state - that can help to create a better balance.¹⁹ The Pensions Commission identified both as potential contributors to a solution.²⁰ However, what could the nature of their contribution be? In the following, we will demonstrate the consequences for the savings rates of our six hypothetical biographies of a simple assumption: that both, employers and the state go back to the level of support they were prepared to guarantee in the past. If a sense of balance and burden sharing is really to be the principle upon which reform is founded, we will argue that this represents a reasonable minimum contribution from these sources.

Thus, with regard to employers we assume a commitment among those who offer occupational pensions to the average level of contributions made to defined benefit schemes in 2003 – ie 8% - for all their scheme members (DWP 2004: 93; see also IDS 2002:13). With regard to the state we calculate the impact of a re-instated earnings-link for the basic state pension (broken in the early 1980s) from 2003. On this basis, we show that while such turnaround would not solve all problems of pensioner poverty, it would make private savings for many of our “risk biographies” much more feasible and therefore achieve a better savings balance overall. Before discussing our calculations we will give a brief overview of what we mean by a withdrawal of employers and the state in public and occupational pensions since the mid-1980s, and explain on this basis the level to which we hypothetically raised the current contributions of the state and employers in our revised simulations.

State pensions

Between 1974 and 1980 the Basic State Pension rose in line with earnings. However, worried by a pensions “time bomb” and ideologically committed to rolling back the state the Conservative Government decided to cut this earnings link. Since then the Basic State Pension has generally risen in line with prices.²¹ This is a significant explanation for the predicted fall in pensioner incomes up to 2030 and beyond outlined above. Because of

¹⁹ The Pensions Commission included a raised pension age in their list of reform options. While this would undoubtedly reduce savings rates, we have not simulated the impact of such a step on savings in this paper, because we believe that such increase would exacerbate problems of equity (see Shaw *et al.*, 2000). Pensioners with manual jobs have a shorter life expectancy and would therefore be disadvantaged in comparison with non-manual workers. Besides, widespread forced early retirement would leave those concerned no option but to claim state benefits while waiting for their pensions.

²⁰ Provided we assume that the “private savings” it refers to in the catalogue of reform options summarized at the beginning of this paper is understood to include savings made by companies.

²¹ The current government is committed to increasing the BSP by inflation or 2.5% whichever is higher.

the inflation-link the Basic State Pension has fallen from a peak of nearly 20% of average earnings in the early 1980s to 15% in 2001. If current trends continue it will be worth just 7% of average earnings by 2050 (Brooks et al: 2001). This decline started from a very low base in comparison with most other European nations.²² Thus, the UK is one of the few countries in the industrialised world that is predicted to spend little more on state pension provision as a proportion of national income as its elderly population rises (Pensions Commission, 2004: 144).²³ In other words, the average pensioner will receive a smaller state pension in relation to GDP in the future than they are receiving today. As a result, someone on average lifetime earnings who is wholly reliant on state provision is likely to have an income marginally above means-testing when they retire but fall below it soon after (Rake/Falkingham/Evans, 2000). This low public pension level is also the reason why our risk biographies above would have to save a lot to protect themselves from relative poverty. We therefore justify our decision to simulate a return to the earnings-link of public pensions on the basis of the current very low public spending, compared with other countries as well as over time. To finance this change, the UK state would still be spending less on public pensions as a proportion of GDP in 2050 than many EU countries are spending on state pension provision today (Attansio *et al*, 2004).

Occupational Pensions

If the state seems committed to reducing its responsibility for financing retirement, so too do employers. Over the last 50 years retirees who have had consistent access to occupational provision (and coverage has peaked at around 50%), have been provided with very generous pensions (Bridgen/Meyer 2005, forthcoming). However, in recent years the occupational sector has been undergoing a significant structural change with important implications for the retirement incomes of future pensioners. Defined benefit schemes that previously dominated the occupational pensions landscape even in the private sector are becoming an increasingly rare feature of provision for new workers, with 41% of private sector companies operating a DB scheme changing to a DC scheme for new members within the past two years (CBI/Mercer 2004: 13). This change has been accompanied by a reduction in employer contributions; on average, private sector employers contributed 8% of a worker's payroll to open DB schemes in 2003 but only 5% to an open DC scheme (DWP 2004: 93; see also IDS 2002:13;). Besides, in leaving DB schemes employers no longer take on the commitment to balance their pension fund in order to meet contractually guaranteed pension levels. Thus, employees have to carry a greater risk because benefit levels for DC schemes are determined by stock and annuity market performance. As a consequence of these changes the expected benefits likely to accrue to employees are set to fall substantially over coming years (Bridgen/Meyer 2005, forthcoming).

²² Even in countries, such as Switzerland and the Netherlands, where the private sector is given a large role in pension provision, the state-provided first pillar is much more generous. In the Netherlands, for example, the basic state pension in 2003 was 44% of average wages, while in the UK it was less than 16% (Our calculations based on Eurostat wage data).

²³ The Pensions Commission suggests that government expenditure on pensioners of normal retirement age will rise from 6.1% of GDP today in to 6.9% in 2050, but this includes council tax and housing benefit, and pensioners' call on Attendance Allowance and Disability Living Allowance. The cost of pension benefits alone (including Pension Credit) will rise from 5% to just under 6%. If Pension Credit is excluded, the cost remains about static. (See Pensions Commission, 2004, Appendix F: 165)

Employers have attributed this change to the increasing complexity and rising costs of running DB schemes, with the cumulative pension scheme deficit in the private sector standing at £100 billion in 2004 and total employer contributions to DB schemes forecast to double between 2001-2006. These pressures have been intensified by regulatory changes such as the FRS17 accounting standard that requires companies to record the net surplus or deficit of the schemes assets and liabilities (CBI/Mercer 2004: 14). However, even if we consider that employers switched to DC schemes to curb the long term rising costs of DB pension funds this does not explain why employer contributions to the new DC schemes have fallen. This suggests that employers are less willing to play the role in pension provision that they have played over the past 40 years.

Against this background, in our simulations below we will assume that all employers who offer occupational schemes return to the level of contributions they made in 2003, and that these contributions will be to defined contribution schemes, i.e. financially predictable. We justify our decision on the basis that if the main risk factor for employers – the long term costs of db schemes – has been removed, they can be expected to return to contribution levels they were willing to pay until very recently and which many still pay today.

A balanced approach - Revised savings rates for risk biographies

As the revised savings calculations of our risk biographies show (see tables 5 and 6), the changes assumed above to the state and occupational pension provision would certainly make the contributions expected of individuals more feasible. With an employer contribution of 8%, none would have to save more than 6% of their gross earnings to reach the Pensions Commission’s replacement rate targets and only one – Stephen - would have to pay more than 5% to achieve the 60% median income threshold. He would have to pay 7%

	Summary	Target Replacement Rate	With Employer Contribution*
David	Median wage	7	0
Tessa	FT/PT, carer, 70% median	7	0
Margaret	PT/FT, extended carer, median	14	6
Tony	Median wage, unemp.	10	2
Gordon	65% median.	4	0
Stephen	65% median, unemp	7	0
Jack	Median, self-employed	11	3

* Assuming employer contribution of 8 % if required
Source: Our calculations. Assumptions detailed in Appendix A.

Table 6: Savings Rate (%) of Life-Time Income Required to Achieve 60% Median Income for Individuals Starting Saving at 25 Reformed

	Summary	60% Median	With Employer Contribution*
David	Median wage	6	0
Tessa	FT/PT, carer, 70% median	14	6
Margaret	PT/FT, extended carer, median	12	4
Tony	Median wage, unemp.	8	0
Gordon	65% median.	9	1
Stephen	65% median, unemp	15	7
Jack	Median, self-employed	9	1

* Assuming employer contribution of 8 % if required
 Source: Our calculations. Assumptions detailed in Appendix A.

In summary, these findings suggest that a relatively small change in the current policies of the state and some employers has the potential to make the prospect of an increased reliance on individual savings a less frightening prospect. Given that many employees, as has been seen, already pay 4.7% of their gross income (IDS, 2004) into occupational pension schemes, the savings rates indicated seem less problematic than those outlined in table 4.

However, important problems would still remain. The first concerns those individuals represented by the examples of Stephen and Tessa.²⁴ They experience the most disruption in their working life biographies and, as a result, would still fall substantially short of the relative poverty line on retirement even with the changes to state and occupational provision outlined above. However, one important consolation with regard to Stephen and Tessa is that as a result of these changes the retirement income of both is brought close (or equal) to their Pensions Commission target replacement rate. As was suggested above, such a result is not consistent with an approach guided by egalitarian social democratic principles (ie it would not provide security against relative poverty) but it is consistent with the more limited goal that guides the Pensions Commission. However, if workers such as Stephen and Tessa are to be assured of a income on retirement above the relative poverty line it is clear that more would have to be done by the state and/or employers.²⁵

The second problem is the current coverage of occupational provision. These changes involve a relatively small (if any) increase in employer contributions for companies that currently provide occupational pensions to all of their workers.²⁶ However, those

²⁴ Margaret also falls short but by a more manageable amount, particularly given her higher level of earnings.

²⁵ A increase in the retirement age as an alternative would be likely to most disadvantage (of our six biographies) workers such as Stephen and Tessa given their biographies are consistent with lower class positions.

²⁶ They have more significant implications for those companies that currently only cover some of their workers.

companies that currently provide no occupational provision would be left entirely unaffected, with serious implications for the retirement income of their workers. If these workers²⁷ are to be protected against relative poverty on retirement the contribution of the state and/or employers would have to be greater than the 'minimum' level we have outlined.

Conclusion

The main aim of this paper was to test the feasibility of compulsory individual saving as a response to the current problems with the UK pension system. The paper has done this by undertaking a series of micro-simulations of the pension entitlements of a selection of illustrative 'risk biographies', constructed on the basis of a critique of similar calculations undertaken by the DWP and Pensions Commission. In this regard, the approaches of the DWP and Pensions Commission were shown to be open to question to varying extents on the basis of their assumptions about: adequacy; non-pension forms of income; and the modelling of individual life biographies

Using these micro-simulations, the paper has suggested that many individuals would have to save significantly more than the savings rates outlined by the DWP and Pensions Commission if they are to secure an income in retirement above the relative poverty line. Because of the limitations of individual saving, and on the basis of the Pensions Commission's call for a 'balanced' approach, the paper considered the possible contribution of the state and employers. On this basis, it amended the simulations, assuming the re-introduction of the Basic State Pension earnings link and a return of average employer occupational pension contributions to 8 %.

Such changes are just one possible way in which a balanced approach could be operationalised. Good arguments can be made for other approaches (see for example Pension Reform Group, 2001; TUC 2002; CBI 2004), and it is clear also that some commentators regard an increase in the state pension age as a necessary part of such a balance (eg CBI 2004). Arguably, however, the proposals we have included in our amended savings calculations are the minimum that could be expected of the state and employers consistent with the notion of 'balance'. On this basis, the paper has shown that relatively small improvements in the contribution of the state and employers would make the prospect of compulsory savings significantly less intimidating as a means of lifting more UK citizens out of relative poverty in 2050 than are currently projected. Even so, more would need to be done to cater for those with greater periods out of the workforce and/or working in sectors uncovered by occupational provision.

Notwithstanding the problems with individual savings identified here and elsewhere, the present government seems likely to resist even these minimal steps towards a more balanced pensions' settlement. However, the findings of this paper are clear: without a concomitant increase in the commitment of employers and the state, an compulsory increase in the savings of individuals will be very difficult to defend on the basis that it

²⁷ These will include some who have working life biographies similar to Stephen and Tessa and are thus doubly disadvantaged.

represents a fair balance between the responsibilities of the state, employer and individual.

Appendix A: Assumptions used in Calculations

Age:	18 in 2003
Working life:	44 years (Pensions Commission, 2004: 150-156)
Age at which saving starts:	25 years (Pensions Commission, 2004: Table 4.10, 156)
Years of saving:	40 years (Pensions Commission, 2004: 150-156)
Scale of Saving:	Same proportion of earnings during every year of saving (Pensions Commission, 2004: 150-156)
Inflation:	1.9% - based on UK government (CM5677, 2002) and EU (www.ecb.int/mopo/html/index.en.html) assumptions.
Earnings:	2% above inflation (DWP, 2002: 159)
Rate of return:	3.3% real (including charges)(Pensions Commission, 2004: Appendix C)
Annuity rate:	Male: 5.3% Female: 4.7% (highest index-linked single life annuity for a healthy individuals aged 65 available on 1 August 2005: Pensions Commission, 2004: Appendix G. Source: The Annuity Bureau. Available at: http://www.bureaux ltd.com/tab/rates_current.aspx)
State Pension System:	Steady state. Basis State Pension up-rated by 2.5% per annum (DWP, 2002)
Entitlement to state pensions:	Contracted-in to S2P (Pensions Commission, 2004: 150-156)

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