



A better private pension system is possible

✓ **As the government prepares to launch the long-awaited next phase of its pensions review, the Institute for Fiscal Studies (IFS) has unveiled its own comprehensive set of proposals aimed at securing better retirement outcomes for future generations. IFS senior research economist, Laurence O'Brien, explains**

The government is expected to launch the second phase of its pensions review in the coming months, examining whether working-age people are saving enough for retirement and how policy should change to improve outcomes for future generations of retirees.

The review is, in many ways, long overdue. Despite significant policy success following the seminal work of the 2002-2006 Pensions Commission, the world has changed significantly over the past two decades, and there is a wide range of risks facing the future retirement incomes of today's working-age generations. Policymakers cannot afford to be complacent.

Fortunately, as we await the commencement of the government's review, we at the Institute for Fiscal Studies (IFS) have been working on our own review of the UK pensions system over the past two years. Our work has not only assessed the outlook for future generations of retirees but also provided concrete policy recommendations and a credible blueprint to improve the UK pension system.

The outlook for private-sector employees is at best mixed. Our analysis suggests that, on current trends, a significant minority of DC pension savers

are on track for a significant drop in living standards when they retire. Exactly how many people are under-saving depends on various factors, including investment returns, how many people will own their own home by the point they retire, and whether you include the income of someone's partner and any potential future inheritances. While these factors change the numbers somewhat, the big-picture conclusion remains the same: Many private-sector employees are on track for retirement incomes that will make it hard to match the living standards they enjoyed in working life.

More saving therefore needs to be done. And, for employees, reforming automatic enrolment would be the most natural way to achieve this.

But more saving comes at a cost. Higher employee pension contributions mean lower take-home pay during working life. While this will be fine for many, others are already struggling with low levels of disposable income today. Higher employer pension contributions would increase employer costs at a time when these have already been hit by the recent rise in employers' National Insurance contributions and the minimum wage. And there is good evidence that higher employer contributions ultimately lead firms

to reduce wage growth, at least in the medium run, again hitting take-home pay. Finally, any increase in saving into a private pension would mean a reduction in government tax revenues, since private pension saving is tax-advantaged. The government could be forgiven for finding this slightly off-putting given the tight fiscal constraints they are currently facing.

In the face of these constraints, our recommended reforms to automatic enrolment are intended to strike a balance between the benefits and costs of increased saving, while being realistic about how and when changes should be implemented.

Our first recommendation is to increase default minimum total pension contributions, particularly for middle and higher earners. This would increase contributions at those parts of people's careers when they can most afford it. One way to achieve this, which we model in our report, is to increase the default minimum total contribution rate to 10 per cent of a new qualifying earnings band (£9,000 to £90,000) for those earning more than £10,000 per year.

Second, employer pension contributions should become near universal for employees, so that even more people benefit from building up a private pension. We suggest employers should have to make a contribution worth at least 3 per cent of pay for all employees, except those earning less than £4,000 per year (to prevent very small pension contributions) and those in the first three months of their job. This would prevent employees from losing out on a part of their remuneration – their employer pension contribution

– if they want to opt out of making an employee pension contribution, for example for affordability reasons.

We also recommend that eligibility for automatic enrolment should be expanded from the current age range (22 to state pension age) to encompass all ages from 16 to 74. This age range expansion would, together with our other recommendations, bring an extra 1.5 million employees into workplace pension saving. Finally, to future-proof the system, all the thresholds in the system should be uprated in line with average earnings growth in the economy.

Together, this package of reforms would boost the future retirement incomes of low- to middle-income people by almost 15 per cent, while also protecting the take-home pay of low earners. In contrast, abolishing the lower limit of qualifying earnings, so that automatic enrolment contributions start from the first pound – as set out on legislation passed under the previous government – would hit the take-home pay of lower earners the hardest.

We therefore think this package is the right next step for automatic enrolment. However, that does not mean it should be implemented immediately given

the economic constraints. Indeed, the contrasting reaction from employers to the recent, and sudden, increase in employers' National Insurance contributions, and the initial gradual introduction of automatic enrolment highlights the benefits of a phased approach. Promptly announcing reforms along the lines we propose, but only implementing gradually starting several years thereafter, would therefore be a sensible way forward.

Self-employed

Of course, these proposals would not help the self-employed, who are not covered by the current system of automatic enrolment as they have no employer to enrol them into a pension.

The outlook for this group is, if anything, even more concerning than for employees. Only around one-in-five self-employed workers are currently saving into a private pension, compared to almost half back in the late 1990s. In this time, pension saving has been made much easier for employees due to automatic enrolment, but there has been nothing like the same policy effort for the self-employed. This needs to change.

We propose that self-employed

people should be able to make an active choice about their level of pension contributions when filling out a self-assessment tax return, with HMRC then diverting contributions into a private pension for them. This could be taken further by a form of automatic enrolment at the point of self-assessment, but it should be very easy to opt out within the process as pension saving will not be the right for option for many self-employed people, especially if they are just starting their own business. Either of these options would facilitate pension participation for the self-employed and would represent a significant improvement on the status quo.

Together, these recommendations would help workers have larger pension pots by the time they reach retirement. However, as DC pensions grow in importance, so does the risk that people make unwise decisions on how to draw them that they live to regret. People should have more support when deciding how to manage their wealth through retirement. While freedom to choose should remain, default products should steer people towards solutions that will be right for most people – such as those that provide flexibility earlier in retirement, and an annuity at older ages to provide protection against living longer than expected.

We hope that our recommendations will inform, and be taken up by, the government's review, which needs to bring about decisive policy action to address the risks facing today's working generations.

The sooner this happens, the more generations of workers will benefit from policies to improve their future retirement outcomes. Our IFS recommendations provide a set of policies to achieve these goals, providing a blueprint to improve the retirement prospects for workers across the UK.

**Written by IFS senior research economist,
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