Summary
- UK retirees receive an average of 24 per cent of their annual salary through state pension payments, ranking it the lowest amongst developed countries.
- However, there are other factors to take into account, including the supportive occupational pension sector and tax relief on contributions.
- Many industry experts have called for reform of the state pension system in the UK, notably on the triple lock and state pension age.

The bigger picture

The OECD has ranked the UK's state pension as the lowest in the developed world as a percentage of average earnings, but is there a bigger picture to consider? Jack Gray investigates

The UK's state pension (SP) aims to provide a safety net to workers across the country. However, it is widely accepted that it is not enough on its own to retire comfortably. In its current guise, those who have paid 35 years of National Insurance contributions receive the full SP of £179.60 a week when they reach SP age, which is currently 66.

The most recent data from the Organisation for Economic Co-Operation and Development (OECD) shows that this equates to 24 per cent of average earnings, the lowest in the developed world.

Although this has led to criticism by some, it is important to consider all the factors that contribute to an individual's retirement. Some countries may have a higher SP, but few have a private and occupation pension sector that is supportive as the one in the UK.

Out with the old

In 2016, the UK moved to the 'new' SP, which aimed to simplify a complex system to help the public plan their retirement and create a fairer structure. LCP partner, Steve Webb, who was Pensions Minister during the development of the new SP, says it was introduced to "deal with a number of failings of the old system".

Alongside the complexity, these failings included the interaction with means testing, which could result in those with a small private pension not being better off than if they had just a SP. Webb also points to the abolition of the State Earnings Related Pension Scheme (Serps) and contracting out as positives.

Although the reforms aim to simplify the SP, Aegon pensions director, Steven Cameron, notes that this will not be achieved until all those who had entitlement under the old system have reached SP age.

He also explains that "many" workers built up a "significant" additional amount through Serps, which meant that even those not in a workplace scheme could save enough for a comfortable retirement.

"Future generations in the new SP, many of them will receive less than they would have received under the previous two-tier structure," Cameron adds. "While I get the reason for the change, I wouldn't say it was without its drawbacks."

However, it could be argued that auto-enrolment will create a new Serps-like system, whereby savers will have saved a second income to the SP.

In with the new

While the new SP is seen as an improvement by most, it is not immune to criticism. "The SP is an incredibly valuable part of the retirement ecosystem in the UK and is playing its part in helping boost the retirement income prospects of millions of people," says Canada Life technical director, Andrew Tully.

"However, the SP is far from generous, with the onus really lying on individuals to take personal responsibility to save if they wish to enjoy their retirements."

AJ Bell senior analyst, Tom Selby, adds that while the SP is a good foundation, it only provides a basic standard of living and puts the UK alongside Lithuania and Mexico in terms of generosity, according to the OECD.

"At the other end of the spectrum, countries such as Austria and Italy boast an income replacement rate via mandatory state benefits of over 90 per cent," he notes.

Some cohorts benefited from the change, as Webb explains: "One group who benefits, on average, is women. For example, if you take time out of paid work to bring up a young child, which on average is more likely to be a woman, you have as much SP rights for that year as a year running a FTSE 100 company.

"The other group is the self-employed. Under the old system, their National Insurance they paid accrued them a basic SP but not Serps. Whereas a year of self-employed National Insurance contributions builds you up a year of the new rate."

The bigger picture

Despite the 'basic' standard of living provided by the SP, it is important to understand the additional factors that contribute to a comfortable retirement. A large occupational pension sector, with savers automatically enrolled once they earn a certain amount, helps plug the gap. Additionally, the UK has relatively generous tax relief on pensions.

"If you compare the UK, where we have a big occupational pension sector, with a country where the SP is very high, they will tend to have a much smaller occupational sector," explains Webb. "What matters is the total income, not just the bit that comes from the government. Through tax relief particularly, there is a lot of public money that goes into bolstering the 'second pillar'."

Selby agrees, adding: "The private pillar of UK retirement provision is strong when compared with other countries, with savers benefiting from both matched contributions via automatic enrolment and pension tax relief at their marginal rate.

"Savers also benefit from a huge choice of pensions, with a wide range of providers offering different services at different prices."

Other benefits of living in the UK include access to Pension Credit to top up SP income and the NHS, which can remove the need to plan for most medical expenses later in life.

Room for improvement

While improvements have been made, there are still issues to address. People are living longer and the population is ageing in general, resulting in an affordability issue whereby less workers are supporting more retirees.

"The SP age in the UK is in the process of being pushed back, with an increase to 67 due by 2028 and 68 potentially as early as 2039," says Selby.

"In the private sector, defined benefit provision has also been dramatically scaled back over the past two or three decades, with employers running for the hills amid spiralling costs and rising life expectancy."

Although most agree, and hope, that Covid-19 is unlikely to cause a long-term decline in life expectancy, it has put the triple lock in the spotlight. The triple lock is assessed each year and increases SP payments by whichever is highest out of earnings growth, inflation or 2.5 per cent.

"If national average earnings growth is going up because lots of low earners are losing their jobs, is that the basis on which you should be granting pensioners an increase?" asks Cameron.

"If there's a big boom in consumer spending and inflation rockets up for a little while, is that the best way of year-on-year determining SP increases? What I would like to happen is to smooth out the triple lock and we look at experiences over three years rather than one year."

Another issue is the disparity in life expectancy between the most deprived and affluent areas, leading to concerns that having a set SP age leaves those with lower life expectancy with fewer years of benefits.

"A *[downwardly]* flexible SP age with a small actuarial reduction is something that I'm really supportive of," says Cameron. "I think that giving people some flexibility is a good thing, as long as you help them make those choices. If we keep increasing the SP age, there are people who are in heavy manual occupations and other stressful jobs who it becomes increasingly difficult for to keep working."

However, Webb notes that this could benefit those who can afford to take an early SP more than others, while Selby warns that it could present cashflow problems for the Treasury if there is significant demand.

Most appear to believe that reform is needed, but how to proceed with those reforms could be a contentious issue.

Written by Jack Gray