The self-employed retirement crisis: Is it time for policy reform?

Saving for retirement is a daunting challenge when you're self-employed and many are alarmingly unprepared. Policy-makers need to consider flexible solutions to attract self-employed participation

Summary
- Despite auto-enrolment driving progress for workplace pensions, self-employed pension savings are lagging, with just one in five earning over £10,000 contributing to a pension.
- A lack of policy focus on the self-employed has led to lower savings rates than in the late 90s; 60 per cent paid into a pension in 1998, compared to just 22 per cent by 2022.
- Auto-enrolment could boost participation levels, but the practicalities are complex because the self-employed don't fall under the PAYE system.
- The tax-return system could be utilised to promote pension saving with options including automatic enrolment into a pension or Lifetime ISA. Any new system would need to include an opt-out mechanism.
- A redesigned Lifetime ISA could be an attractive option for the self-employed. Policymakers could consider reducing the exit penalty and expanding the age limits to boost flexibility and participation.

The past 12 years have brought significant progress for workplace pensions. Thanks to auto-enrolment, participation levels have soared and millions more are now on track for a more comfortable retirement income. However, the outlook for Britain's 4.24 million self-employed workers is starkly different.

Low pension saving

Many self-employed workers face an uncertain financial future hampered by low pension savings. According to the IFS *Pensions Review,* published in September, just one in five earning more than £10,000 pay into a pension, compared to over four in five employees. Alarmingly, 55 per cent of self-employed workers are on track to have no private pension at all in retirement and will be completely reliant on the state pension.

Even those saving into a pension often make inadequate contributions. Many self-employed workers contribute the same amount for many years, failing to adjust their contributions to keep pace with inflation.

"Pension saving among the self-employed has dipped in recent years for several reasons," explains Hargreaves Lansdown head of retirement analysis, Helen Morrissey. "First of all, they aren't covered by auto-enrolment and variable earning patterns can also make them less likely to want to tie up their money until the age of 55. This can set back their retirement planning, with the most recent data from Hargreaves Lansdown's Savings and Resilience Barometer showing that only 22 per cent of self-employed households are on track for a moderate retirement income compared to 45 of employed households."

While self-employed workers often struggle with pension savings, many do accumulate wealth in other ways, such as property or business assets. However, wealth can vary significantly, with a quarter having less than £10,000 in total assets.

Lack of policy focus

Worryingly, despite these challenges, there's a distinct lack of policy focus on boosting retirement savings for the self-employed.

Speaking in September, Institute for Fiscal Studies research economist, Laurence O'Brien, said: "Successive governments have put great effort into establishing automatic enrolment for employees to make it easier for them to save for retirement and have done so with much success. In contrast, the self-employed are left to their own devices. People who spend a long time in self-employment are all too often on course to be reliant on their state pension, some modest other savings, and potentially a partner's pension or an inheritance to provide for them in retirement."

Interactive Investor CEO, Richard Wilson, agrees that the self-employed are disadvantaged due to lack of policy focus. Commenting at the launch of a recent report on self-employed pensions, he said: "The self-employed are essential to our nation's competitiveness yet they are at a disadvantage when it comes to saving for their future. This isn't right and needs to change – largely due to a lack of focus from policymakers to have failed to address the unique challenges faced in saving for retirement when you work for yourself."

With no new incentives, it's perhaps not surprising that self-employed pension saving has plummeted since the late 90s, contrasting with the upward trend for employees. For self-employed workers earning over £10,000, 60 per cent paid into a pension in 1998, compared with just 22 per cent in 2022. The majority of this slump happened between 1998 and 2012, with participation levels stagnating since that date.

Auto-enrolment

To combat declining participation rates, harnessing the power of automation could significantly boost retirement savings for the self-employed. But the practicalities are complex because self-employed workers fall outside the PAYE system.

One proposed solution is to leverage the tax return system to promote pension saving. Institute for Fiscal Studies senior research economist, David Sturrock, remarks: "The government could either get the self-employed to make an active choice over whether to save into a pension or Lifetime ISA (LISA), or enrol them automatically into a long-term savings plan, which they could opt out of. Either way would reduce the hassle and cost that self-employed people face when looking to save for retirement."

IPSE senior policy adviser, Fred Hicks, agrees that automation is crucial, but emphasises that flexibility is essential to boost participation. "The biggest issue for the self-employed is inertia. When you're running a business, taking the time to fully engage with saving for retirement is just one of many competing priorities. This is where a form of automatic saving – one that's more flexible than automatic enrolment for employees – could make a big difference for the self-employed."

"Fifty-five per cent of self-employed workers are on track to have no private pension at all in retirement"

Beyond pensions

With a radical shift in behaviour needed, policymakers may require a two-pronged approach. In addition to automation, they may need to consider redesigned financial products, tailored to the self-employed, alongside traditional pensions.

The reality is that pension saving can be challenging to the self-employed due to their need for easy access to emergency cash savings. Hicks comments: "Locking money into a pension can feel difficult when you need to maintain a cash buffer in the event a client pays late or defaults."

Given the importance of flexibility, one potential option is to redesign the LISA as an alternative pension for the self-employed.

Morrissey says: "We believe the LISA could play a role in bolstering this group's financial resilience. The 25 per cent government bonus on contributions of up to £4,000 per year acts in the same way as basic rate tax relief on a pension with any income taken tax free. You can also access the money early in times of need, subject to a 25 per cent exit penalty. It could be a great solution for self-employed people paying basic rate tax. For those paying tax at higher rate their pension will likely remain the best option due to the tax relief on offer."

Nevertheless, LISAs would need some tweaks to make them more attractive, says Morrissey. "The 25 per cent exit penalty not only removes the effect of the government bonus but also a slice of your hard-earned savings. To mitigate this we have called on government to reduce the penalty to 20 per cent as it did during the pandemic and this could encourage more self-employed to opt for a LISA."

Hicks agrees that a revamped LISA could encourage retirement savings, but raises concerns about the age limit of 39. "The low age limits on opening and contributing to a LISA are locking the majority of today's self-employed population out of a product that might otherwise be ideal for them," he explains.

Morrissey also criticises the low age limit and adds: "Given that many people go self-employed later in life, the ability to open and contribute to LISAs until the age of 55 would open this product up to many more people."

Pension review

With Labour's pensions review underway, it could be an opportune moment for policymakers to address the challenges faced by self-employed retirement savers. The government announced in July that the second phase of its review, which is due to start later this year, will: "Consider further steps to improve pension outcomes, including assessing retirement adequacy".

Interactive Investor senior personal finance analyst, Myron Jobson, says: "It's vital that policymakers consider the self-employed as part of their pensions review. Business owners and self-employed workers are a key part of our economy but at the moment many are facing poor retirement outcomes. Recently, pensions policy has rightly focused on workplace pensions, but it's time to bring self-employed workers into the spotlight."

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