REPORT BY THE
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Government interventions to support retirement incomes

Key facts

£250bn

is the amount government spent in 2011-12 on supporting older people and encouraging saving for retirement

10.7m

is the number of people aged between 22 and state pension age DWP estimates are not saving enough to achieve the pension income they want or expect in retirement

2.6%

is the increased proportion of Gross Domestic Product (GDP) that the Office for Budget Responsibility projects government will spend on pensions and pensioner benefits in 2061-62

£39 billion net amount of tax and National Insurance contribution relief government provided in 2011-12 to encourage saving in pensions

8 million people are expected to save for the first time or save more because of automatic enrolment into workplace pensions

1 per cent increase in GDP that government expects (within six years) from a one-year extension of working lives

Summary

1 People are living longer and looking after an ageing population presents a major challenge to government. The state is ultimately liable for providing a basic income for the elderly and meeting certain health and care costs. Government spending on state pensions, other financial support, and health and social care for older people has increased substantially over recent decades to £250 billion, 16 per cent of Gross Domestic Product (GDP). Life expectancy is continuing to increase and the working age population is not currently saving sufficiently for retirement. As well as being a current pressure, an ageing population presents a growing risk to public finances.

2 This report examines what actions government has been taking since the Pensions Commission reported in 2006 to mitigate this risk and how effectively it is being managed. It is intended as an overarching report to inform Parliament ahead of more detailed value-for-money reports on specific government actions. The report examines interventions that affect current and future retirement incomes, including: state pensions and benefits for older people; encouraging saving for retirement; and, extending working lives. We report on social care insofar as it affects retirement incomes and incentives to save. Public service pensions, on which we have reported earlier, and health spending on the elderly lie outside the scope of this report. We plan to carry out more work on adult social care in the future. We cover:

- the risks to public finances of an ageing population (Part One);
- the challenges government faces with its initiatives to manage this liability of the state (Part Two); and
- managing the uncertainty (Part Three).

Key findings

The risks to public finances

3 There are significant future consequences for the taxpayer as people live longer and are likely to be more dependent on the state to look after them. There are four factors which place increasing demands on the public purse and need management:

- **People are living longer and spending longer in retirement.** Between 1981 and 2010, life expectancy at age 65 increased from 14 to 21 years for men and from 18 to 23.7 years for women. The Office for National Statistics (ONS) estimates that by 2050 it will have reached 25.8 years for men and 28.2 years for women (paragraph 1.3 and Figure 1).
- **People can expect to spend more than two-fifths of their remaining years from age 65 in poor health.** In July 2011, the Commission on Funding of Care and Support reported that three-quarters of 65-year-olds will need social care before they die, with a half likely to face care costs of up to £20,000 and a tenth costs of over £100,000 (paragraphs 1.4 and 1.5).
- **People need to save more for retirement, but are saving less.** The Department for Work & Pensions (DWP) estimates that 10.7 million people, two-fifths of the working age population, are not saving enough to achieve the income they want or expect in retirement (paragraphs 1.9 and 1.10).
- **The proportion of working age people in private sector workplace pension schemes fell between 2002 and 2011 from 47 per cent to 33 per cent and individuals' annual saving in pensions fell by nearly a fifth.** Most private sector employees will receive defined contribution pensions that will be typically much smaller, and less certain, than people with private pensions have received in the past. Defined benefit schemes have mostly been closed to new entrants over the last few years (paragraphs 1.11 to 1.13 and Figures 5 and 7).

4 Government spending on the state pension and pensioner benefits has risen substantially since 1990 and is projected to rise further by 2061. Spending on the state pension and pensioner benefits increased from 5.5 per cent of GDP in 1990 to 6.9 per cent in 2011-12 in part because of the growing pensioner population but also because of increased spending per capita on pensioner benefits and pensions. The Office for Budget Responsibility (OBR) projected, in July 2012, that this spending will rise by a further 2.6 percentage points of GDP, to 9.5 per cent by 2061-62 (paragraphs 1.7 and 1.8 and Figures 3 and 4).

There are challenges with existing initiatives to manage this problem

5 **Governments have been implementing a programme of reforms to help mitigate the potential liability to the state from the ageing population.** The programme has been informed by a substantial evidence base and recommendations of the 2002 to 2006 Pensions Commission and involves three key elements (paragraphs 2.2 and 2.3 and Figure 8):

- **State pension reforms.** Government has increased spending on the basic state pension by uprating it from 2011 by the best of average earnings growth, inflation or 2.5 per cent ('triple lock'). And from 2016, it plans to introduce for new pensioners a single-tier pension set at a level above the level of basic means-tested support for pensioners. This is intended to improve incentives to save and reduce the proportion of pensioners who receive means-tested benefits (paragraphs 2.5 to 2.7).
- **Encouraging saving for retirement.** Between 2012 and 2018, all eligible workers are being automatically enrolled into workplace pension schemes, but with the right to opt out. DWP estimates that this will lead to eight million employees newly saving £11 billion a year (in 2012-13 earning terms) and that by 2050 it will increase aggregate private pension incomes by £5 billion to £8 billion a year (in 2011-12 earning terms) and reduce government spending on income-related benefits to the retired by £0.9 billion (paragraphs 2.9 to 2.12).
- **Extending working lives.** Government has raised future state pension ages to among the highest in the developed world and abolished the default retirement age. It has also extended the right to request flexible working to all employees. DWP projects that each one-year extension in working lives increases GDP by 1 per cent, improves the government's budget balance by 0.6 per cent of GDP and raises a person's private pension income by 10 per cent (paragraphs 2.13 and 2.14).

6 **The success of encouraging saving through automatic enrolment of employees into a pension will depend on the responses of individuals, pension providers and employers.** Automatic enrolment is an innovative approach informed by analysis that has identified inertia as a key factor in savings decisions. Its success will depend on the proportion of employees who remain with schemes and the incomes they receive when they retire. This will depend on the level and duration of contributions, scheme charges and investment performance. DWP and The Pensions Regulator have been working with the pension industry to improve the quality and transparency of defined contribution pensions, but people's confidence in them has been low and declining. In its November 2012 consultation paper on *Reinvigorating Workplace Pensions* DWP has suggested amalgamating schemes and asking employers to take on some investment risk. Implementation of automatic enrolment began in October 2012 and employee opt-out rates have been lower than expected, at between 5 per cent and 20 per cent according to early indications to DWP from the largest employers (paragraphs 2.16 to 2.20 and Figure 12).

7 **Many individuals find it difficult to plan for their retirement.** The shift to defined contribution pensions has transferred financial risk from employers to individuals. To prepare effectively for retirement, people need to make complex decisions about how much to save, in what fund, and what annuity to choose. They also need a good understanding of what income they are likely to receive when they retire, from the state and private savings. Currently, people have poor awareness of state pension ages and their likely retirement incomes and government recognises that many individuals will need to increase their levels of saving if they are to achieve the retirement incomes they need to be less reliant on the state.. The Money Advice Service leads on government activities to improve the UK's financial capability, working to improve the effectiveness and provision of financial education, to enable people to understand and manage their finances better. Spending on financial capability has more than doubled since 2006, but so far there is limited direct evidence of impact on outcomes (paragraphs 2.21 to 2.25).

8 **Tax incentives have not been successful in encouraging overall saving for retirement.** Government provides tax incentives to encourage saving for retirement through pensions because it recognises that pensions are less flexible than other forms of saving. The net cost to government of tax and National Insurance relief to encourage pension saving doubled in real terms to £40 billion in the nine years to 2010-11. Around three-fifths went to higher rate taxpayers, but there has been little evidence of positive impact on overall saving. From April 2011, government placed new limits on the amount of relief available. This helped reduce the annual cost to government by 2 per cent in 2011-12 (paragraphs 2.26 and 2.27 and Figure 13).

9 **Government is working to change employers' attitudes towards training and employing older workers to influence the extent to which working lives are extended.** Government has increased the incentives for working longer through raising future state pension ages and enabling people to increase the weekly amount of their state pension by claiming it at a later date. It has also addressed some barriers to extended working through abolishing the default retirement age, extending flexible working and allowing people to claim part of their private (but not state) pension while continuing to work. The average age at which people leave the labour force has been rising and DWP projects it will continue to rise, although less rapidly than the state pension age is to rise. Government has no formal published strategy to influence employers and its spending on communications has been scaled down since 2006, with its focus shifting to working with employer stakeholders (paragraphs 2.28 to 2.31 and Figure 14).

Managing the portfolio of interventions and uncertainty

10 Government does not view the interventions that influence retirement incomes as a portfolio with clear responsibility for delivering the intended outcomes. DWP and HM Treasury have strategic lead on the main interventions that influence retirement incomes, but a variety of departments and public bodies, and local authorities, have some involvement. There is no overarching programme or single accountability. Many of the interventions have complex interactions with each other and with other policies and objectives. Some of these interactions extend widely, including home ownership, long-term care funding, quantitative easing, and consumer credit and debt (paragraphs 3.2 to 3.4 and Figures 15 and 16).

11 Without a whole system view, there is a risk that individual, but co-dependent interventions may not be effective in increasing saving for retirement. There are a number of areas where we have identified potential risks:

- Individual interventions are managed separately without adequate consideration of their impact on the overall objective of increasing retirement incomes.
- The Treasury leads on overall savings strategy and tax treatment of pension contributions and DWP on workplace saving, but there is no overall accountability for saving for retirement.
- DWP research suggests that the overwhelming majority of people who save under automatic enrolment can expect to end up better off in retirement than if they did not save, although incentives to save in pensions are diluted for those on low incomes and renters by the interaction with means-tested benefits on retirement. The single-tier pension will improve incentives for those on low incomes who are not renters.
- Differing tax treatments, indexation and eligibility rules for older person benefits add to complexity and risk sending confusing signals.
- Three regulators have oversight of pension providers but they have no common framework for assessing risk and measuring performance.
- Seven public bodies inform the public about pensions and saving for retirement but, outside the automatic enrolment programme, there is no overall strategy or mechanism to make sure they work seamlessly together (paragraphs 3.5 and 3.6 and Figure 17).

12 Efficient allocation of resources is difficult because government does not know the relative costs and benefits of different interventions. Impact assessments provide insight into the distribution of expected benefits between government, individuals and employers but not comparative cost and benefits. But recent programmes, such as automatic enrolment, have been better at identifying critical success factors, measuring baselines and developing evaluation strategies (paragraphs 3.7 to 3.9 and Figure 18).

13 Long-term costs for government remain highly uncertain. The actual residual liability on the state created by lack of saving for retirement is not known and will be reliant on a number of factors. It depends on trends in healthy life expectancy, inflation, GDP growth, investment returns, migration, and house ownership and on outcomes on saving and extended working (paragraph 3.10).

14 Government has developed mechanisms to manage some of these uncertainties but current projections on income-related and condition-related expenditure may be too optimistic. Government is managing affordability and sustainability through a variety of reforms and policies, including regular reviews of future state pension ages, with the potential to adjust the indexation of benefits. In November 2012, DWP projected that government's spending on income-related and condition-related benefits on pensioners will fall by 1.3 percentage points of GDP between 2011-12 and 2061-62 to 0.6 per cent of GDP in 2061-62 despite it expecting that the number of pensioners claiming condition-related benefits will double. In March 2013, DWP projected that government spending on state pensions and pensioner benefits will rise as a proportion of GDP between 2011-12 and 2061-62 by only 1.2 percentage points: far below OBR's forecast of 2.6 percentage points in July 2012. These projections may be too optimistic given trends in house ownership, private pension income and the numbers of older people with physical and mental health conditions (paragraphs 3.11 to 3.13 and Figure 19).

Conclusion

15 Government is implementing a series of measures to help reduce the liability on the state arising from people living longer and under-saving. It is doing so within the constraints of a challenging fiscal position. By increasing the future state pension age, introducing automatic enrolment into workplace pensions and making changes to the state pension the government is expecting to reduce the potential long-term spending liability of supporting people in their retirement. The interaction between these policy changes and other interventions is complex. To maximise effectiveness and mitigate perverse effects, government could benefit from taking a more holistic view of its portfolio of interventions, how they interact and their relative costs and benefits to ensure they are being managed coherently. This should be done in a proportionate way that enables DWP and the Treasury to take a central overview and provide clear accountability for the interventions that contribute to the aim of increasing retirement incomes.

16 The value of the UK state pension, as a proportion of pre-retirement earnings, has historically been low compared to other developed countries and projections for future spending on state pensions and pensioner benefits (as a share of GDP) may prove too optimistic. To manage this risk, government needs to be more active and effective in:

- influencing individuals to save more;
- working with employer stakeholders to influence those employers who have negative attitudes towards older workers;
- enabling people to financially plan effectively for retirement; and
- influencing pension providers to improve their schemes' transparency and value for money.