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Public Economics
Lecture

@TheIFS

Pension saving in the UK



Economic
and Social
Research Council

Introduction



- Pension saving is one of the most common forms of saving among people
- Also a form of saving that governments intervene in
- Topics today:
 - Why do people save for retirement, and why does government intervene in pension saving?
 - How does the UK government intervene, and how and why has that changed over time?



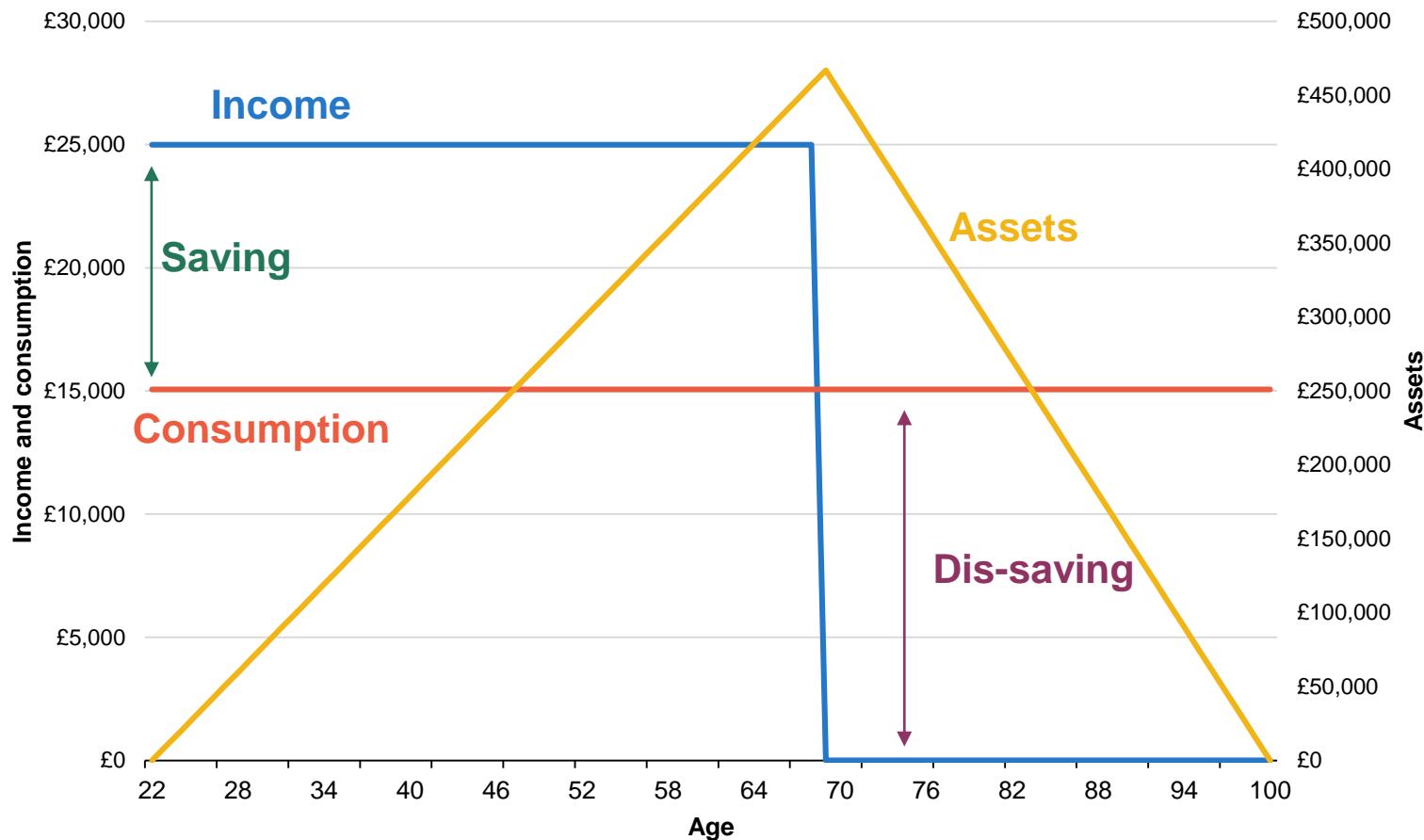
Pension saving

Why save in a pension?

- Life-cycle model
 - People facing a trade-off between saving and consumption
- Assumes people are fully informed and there are no market distortions

Life cycle model

Consumption smoothing and longevity risk



Why save in a pension?

- People save in order to smooth consumption
 - Save during working life to be able to maintain a level of consumption in retirement
- People may want to insure against longevity risk
 - An annuity provides a fixed income stream that enables steady levels of consumption until end of life

Why does the government intervene?

- Number of biases, information asymmetries and other distortions → people may not behave in the way that the model assumes
 - Behavioral biases
 - Present bias
 - Inertia
 - Inaccurate assessment of risk and uncertainty
 - Lack of financial literacy
 - Market failure due to asymmetric information
- The government may also want to intervene for redistributive purposes

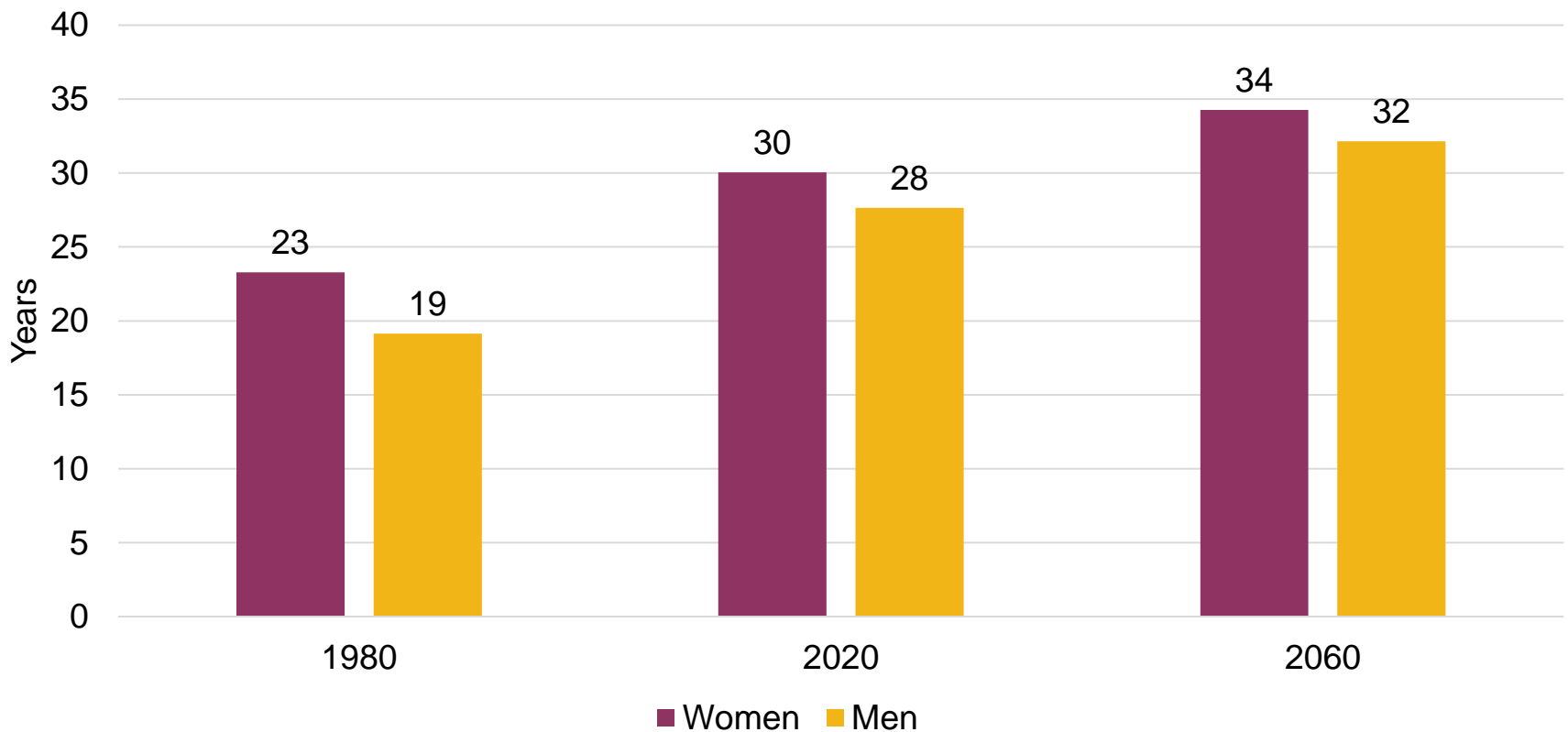


UK pension system and recent changes

Demographic change

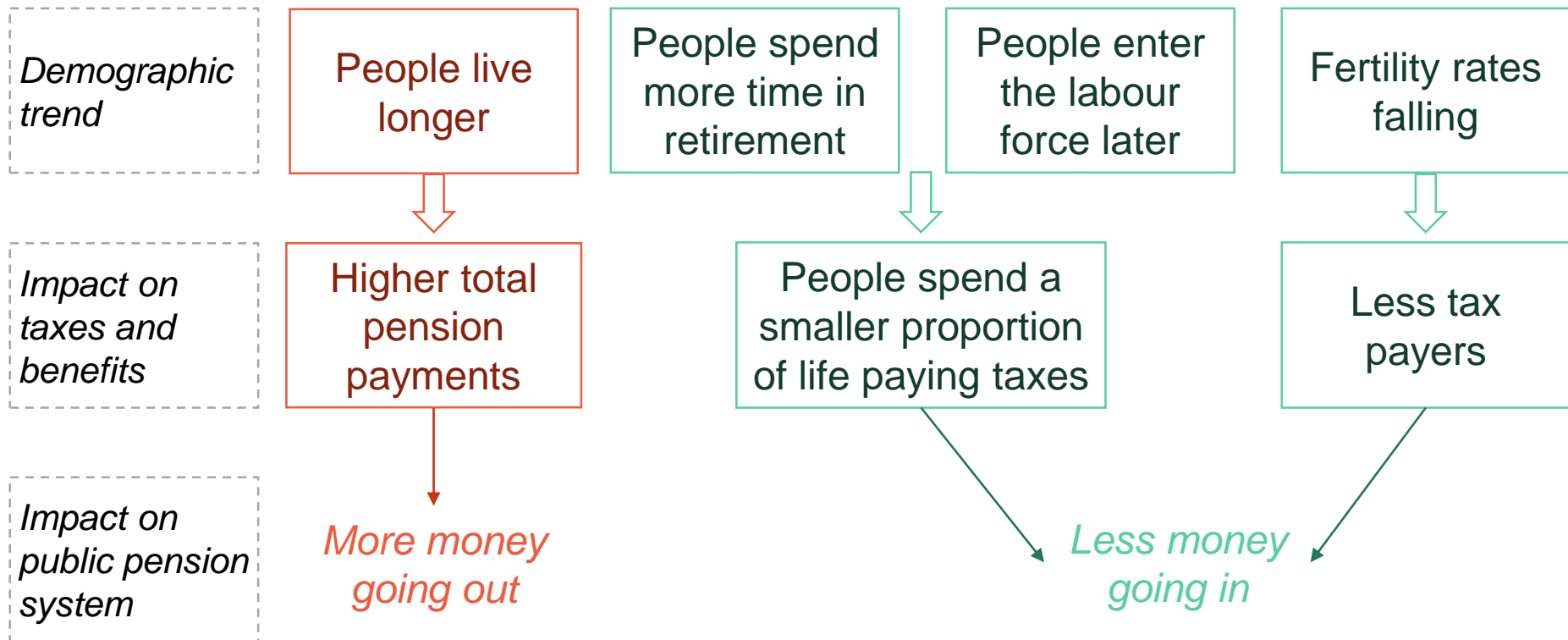
Ageing population

Life expectancy at 60, by year that turn 60



Source: ONS

Public pension system sustainability



Pension system trade-offs

How to ensure sustainability of a pension system?

- More social insurance
 - Higher contributions
 - Trade-off:
 - Labour market distortions
 - Moral hazard
- Less generous benefits
 - Incentives for private pension saving

UK pension system



State provision complemented with private saving

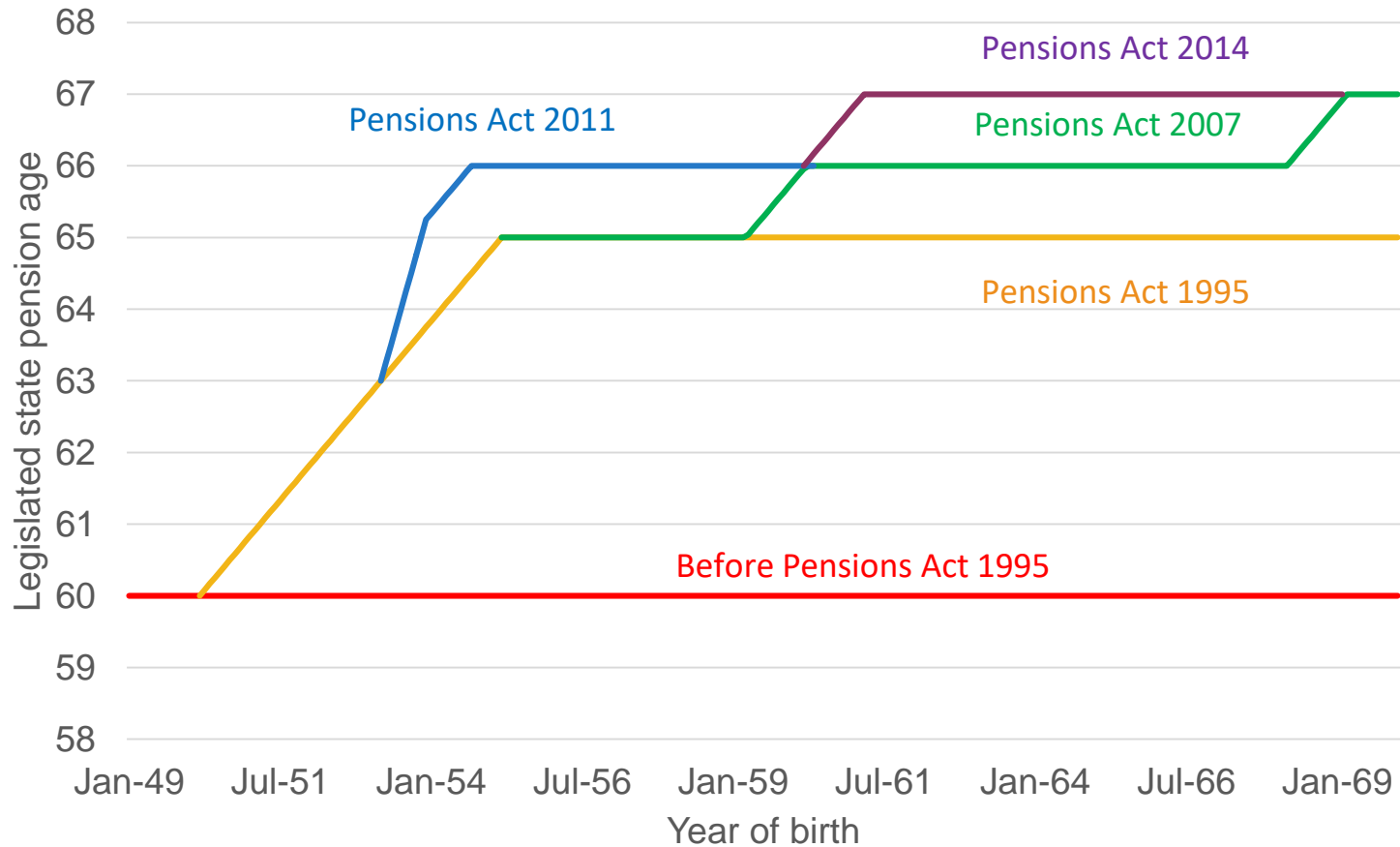
- State pension
 - Flat rate (£172.5 / week in 2020/21)
 - Pay as you go
- Employer pension
 - Defined benefit
 - A set income in retirement, usually defined by earnings and time spent in scheme – risk sits with employer
 - Defined contribution
 - Employee and employer contribute into a pension fund, value evolves according to the investments – risk sits with employee
- Other saving

UK pension system

Changes in recent times – state pension

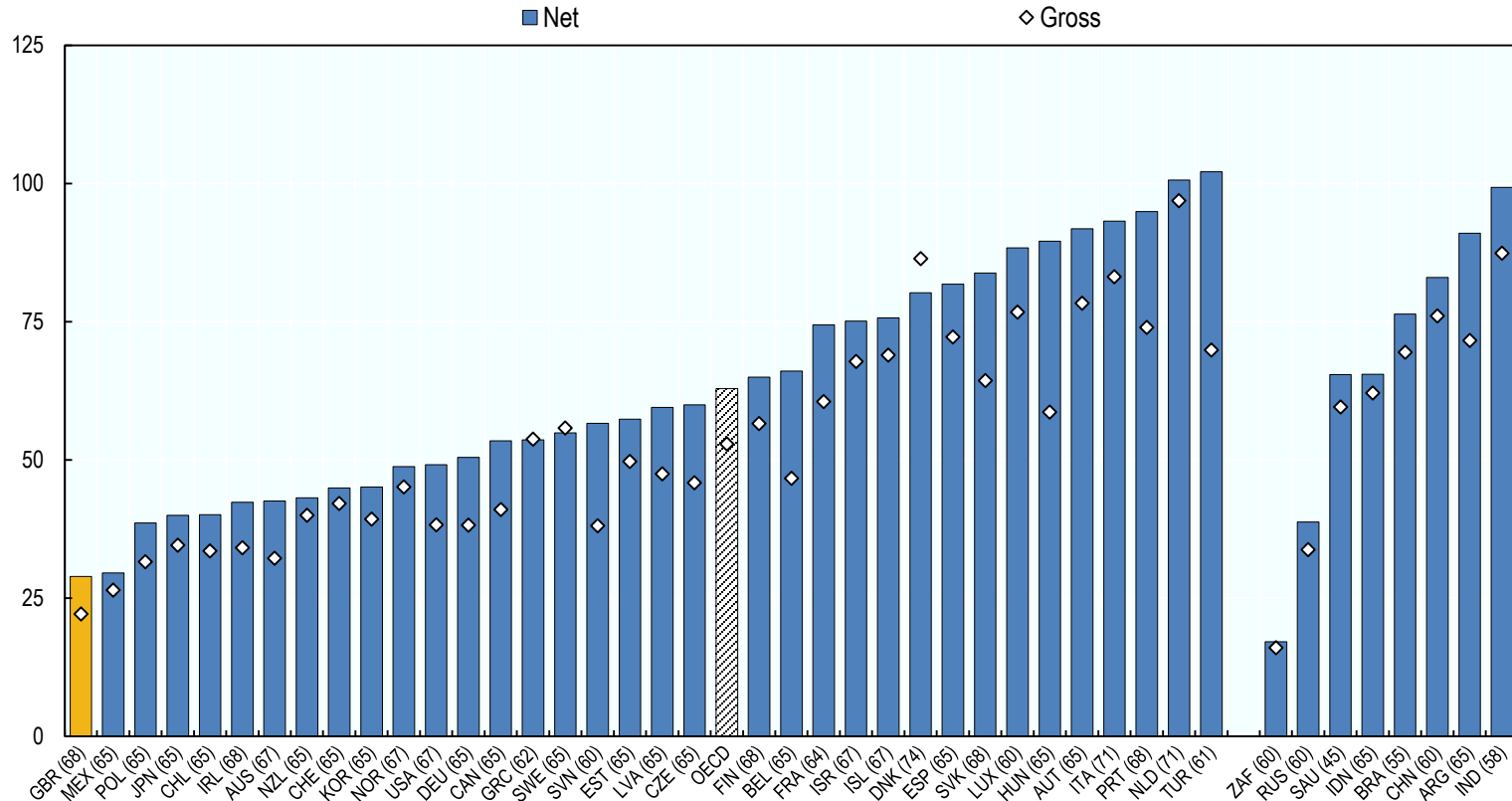
- State pension less generous
 - New (flat rate) state pension
 - Increases in state pension age (age at which people can start receiving state pension)

Changes in women's SPA



UK pension system

OECD net pension replacement rates: Average earners



Source: OECD (2017) <http://dx.doi.org/10.1787/888933634021>

UK pension system

Changes in recent times – employer pensions

- Defined benefit schemes much less prevalent
- More focus on defined contribution schemes and individual responsibility
- Transfer of risk and responsibility to individuals
 - → government intervention needed



Policy responses to transfer of risk

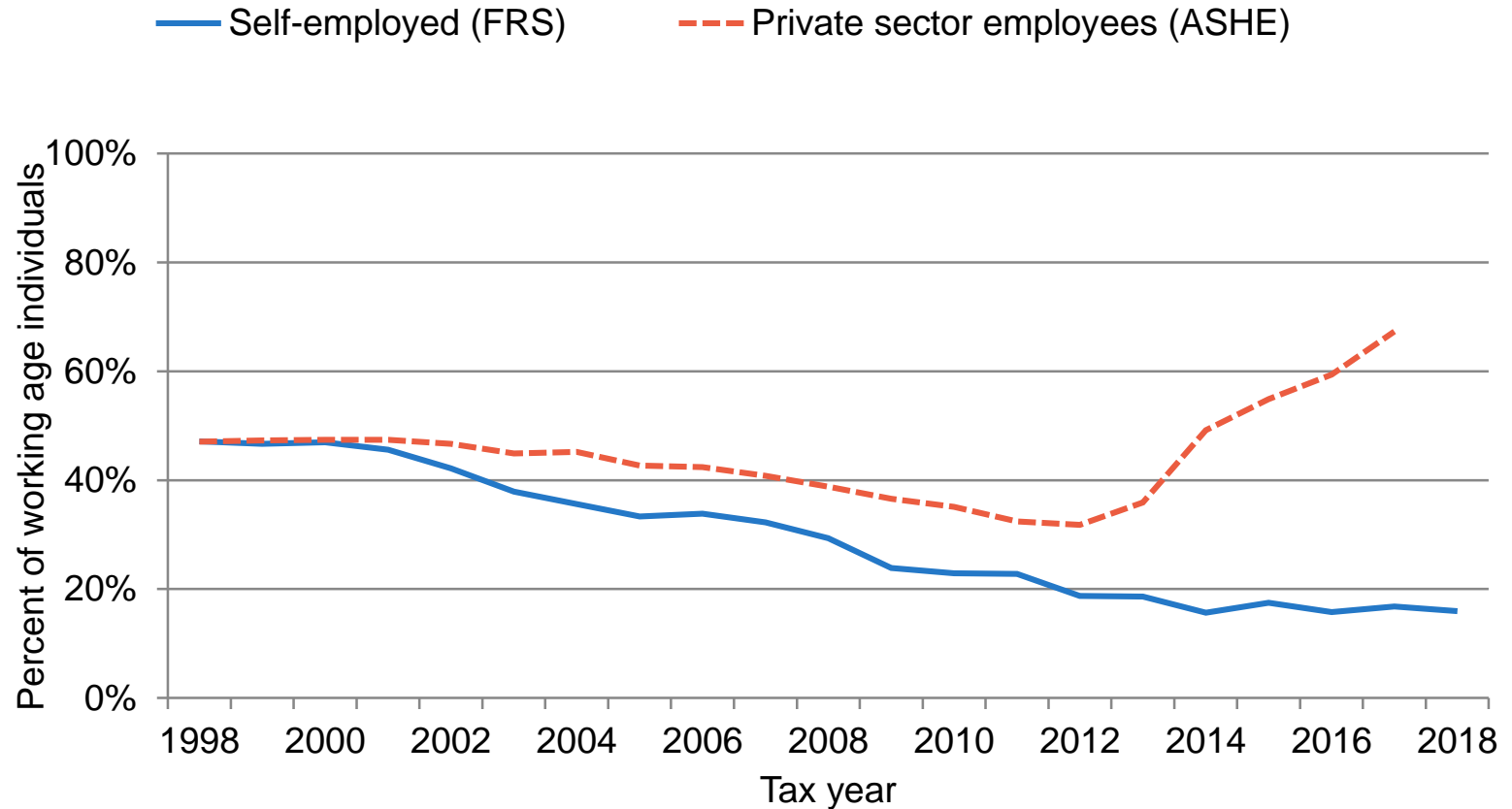
UK pension system



Policy responses

- Automatic enrolment (introduced in 2012)
 - People aged 22 to 64 have to be automatically enrolled to a pension scheme
 - Hugely successful in encouraging people to save into a pension

Impact of automatic enrolment



Source: Crawford and Karjalainen (2020)

UK pension system



Policy responses

- Push private pension saving has been combined with more choice in how to access the pension savings at older ages
- Pension freedoms (introduced in 2015)
 - Flexible drawdowns
 - Lump sum withdrawals

UK pension system

Changes in recent times – policy responses

- Ensuring sufficient income in retirement is increasingly the responsibility of individuals rather than the state or the employers
 - People are nudged into saving (accumulation)
 - People are given more freedom to choose how to draw down their pension wealth (decumulation)



Conclusion

Conclusion



- Pension systems around the world are affected by changing demographics
- UK pension system response means risk transfer to individuals
 - Nudging to accumulate wealth but with flexibility
 - Freedom in terms of decumulation
- The pandemic will be the first big test for a pension system that puts most of the decision making in the hands of individuals

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