Institute for Fiscal Studies

The ageing population and pensions: will we cope?

Public Economics Lectures

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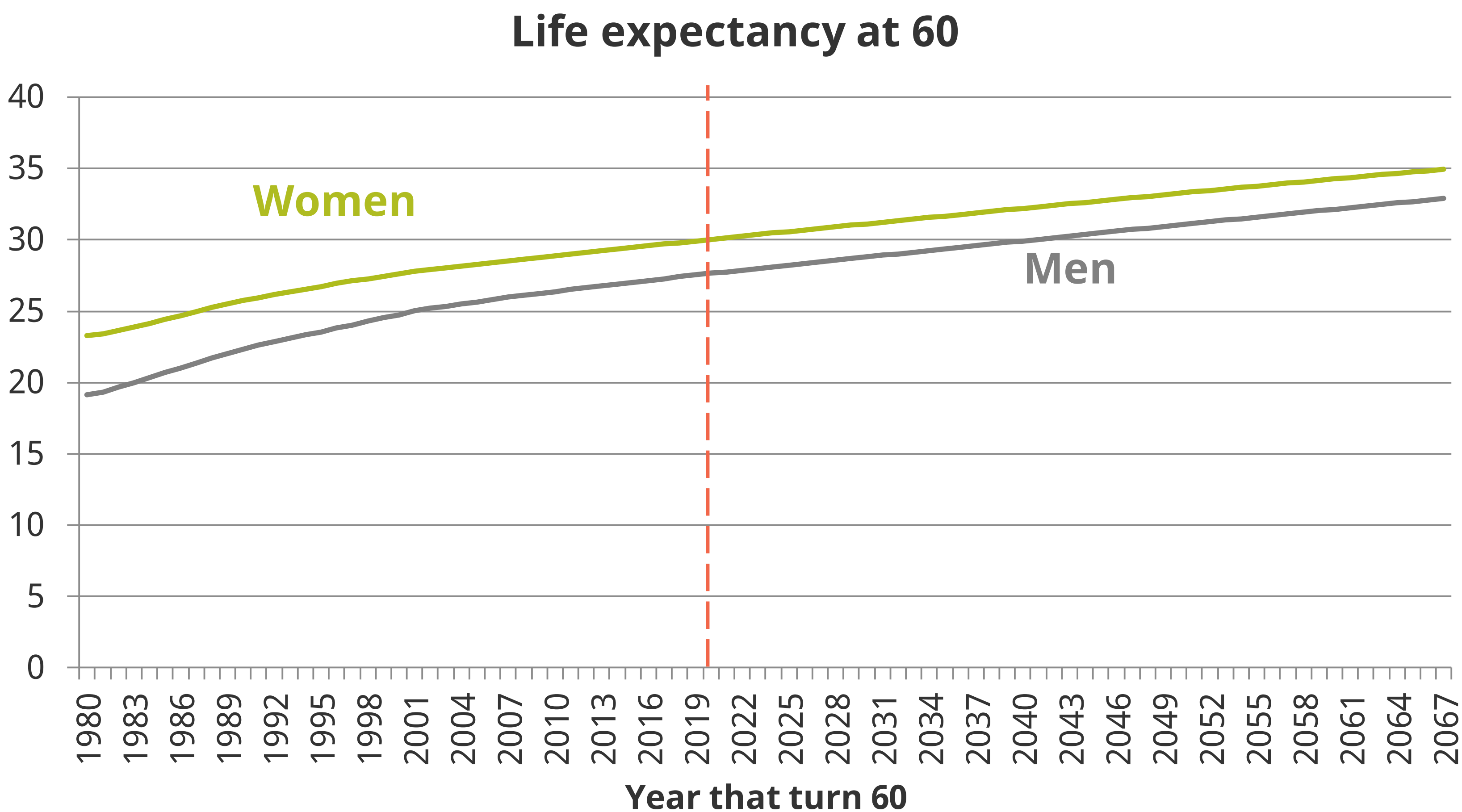
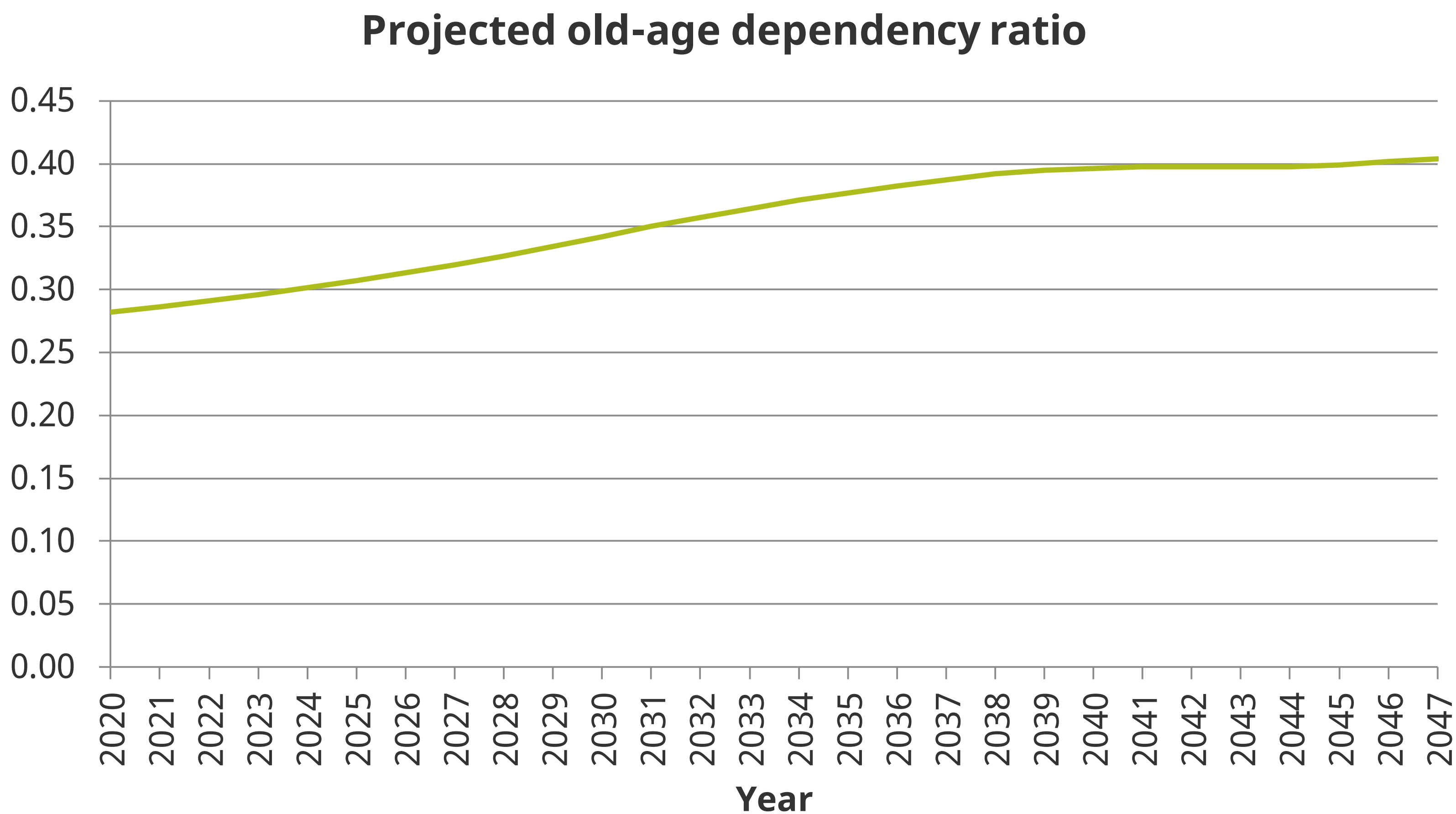
The UK's ageing population



Source: ONS

The UK's ageing population



Note: Old age dependency ratio is calculated as the total projected population aged 65 and above divided by the total projected population aged 16-64.

Source: ONS


FINANCIAL TIMES
World government?
For the first time in my life, I think the formation of such a thing is plausible Gideon Rachman
Pensions lifeboat risks being swamped
Ross inquiry launched as ex rocks Carphon
Pension deficit of UK's leading companies equivalent to 70% of their profits
UK's leading plcs have combined deficit of £62bn, with the percentage of their profits higher than in 2009 after financial crisis
Daily Mirror
Elton: Why my boys won't inherit my £200m fortune
PENSIONS BOMBSHELL
NOW IT'S WORK TO 75
Osborne poised to raise age again
Experts warn of long wait for payout
DAILY EXPRESS
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WOULD YOUR HEART PASS AN MOT?
PENSION CRISIS FOR MILLIONS
Fears of poverty in old age mean many will NEVER retire
Now for the big clean-up... Storm Katie's trail of destruction
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The £1 trillion pension crisis facing 11m (and they're the lucky ones)
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PENSIONS CRISIS TO LAST FOR 20 YEARS
Dapper Duke: Why Prince Philip is our most stylish Royal
UK should axe state pension for rich people, says OECD
News › Business › Business News
UK retirement age could hit 80 as pensions deficit sets off time bomb
World Economic Forum points to shortfall of trillions in what people are saving against the cost of funding their retirement

How will we cope? Is it really all that bad?

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Big changes are taking place. These raise questions:

1. What does ageing mean for the sustainability of pensions systems?

2. How should the government respond?

3. Are people able to going to be able to provide for their retirement?

➢ Using UK data, but lessons apply in many advanced economies

Pensions and the challenge of demographics

Pensions in the UK: a primer

1. **State pension**

- Paid at a **fixed rate** to everyone with sufficient years of eligible activities (currently £160/week)
- Paid out of **current** taxation (“Pay as you go”)

2. **Employer provided pension**

- Defined benefit - pays an amount that depends on earnings in working life according to some rule
- Defined contribution: employee decides how much to contribute into a pension ‘pot’. In retirement, choose how to spend this pot.

3. **Other forms of saving**

- House, holdings of stocks and shares, personal pensions etc.

Population ageing and the state pension

Increasing longevity makes "pay-as-you-go" systems less affordable

- Same number working, supporting more pensioners for longer

For the state pension system, this requires one or more of:

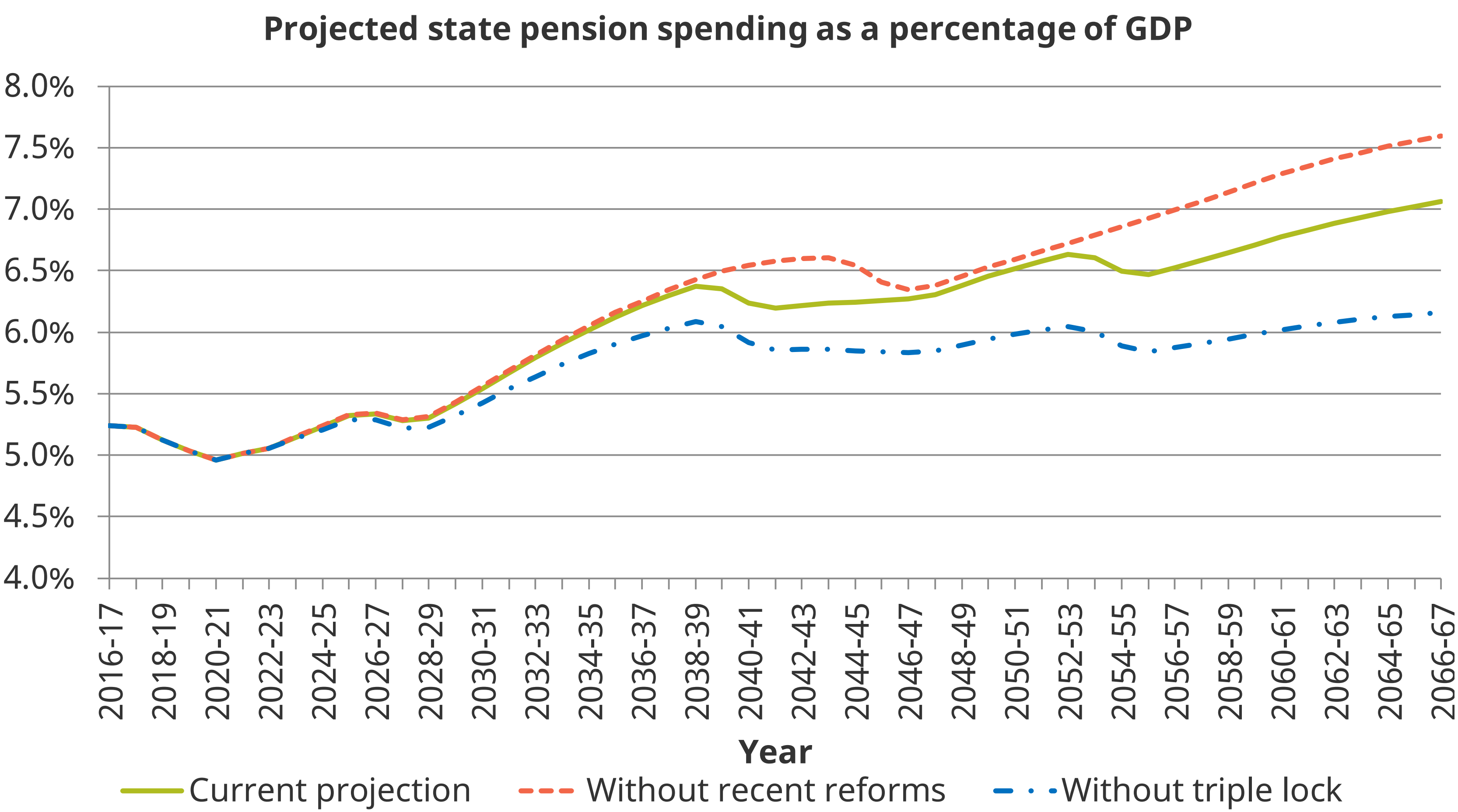
1. Increase in taxation for those working
2. Reduction in generosity of state pensions:
   - Pension paid at a lower rate
   - Increase in the state pension age
3. Government borrowing (i.e. higher taxes or lower spending later)

Population ageing and the state pension

Government has responded by reducing generosity of pensions:

- Elimination of earnings-related components of the state pension
- State pension age (SPA) increasing:
  - Was 65, now rising
  - Will reach 68 by 2039
  - Next review considering further rises will report by 2023

Population ageing and the state pension



Source: OBR Fiscal Sustainability Report

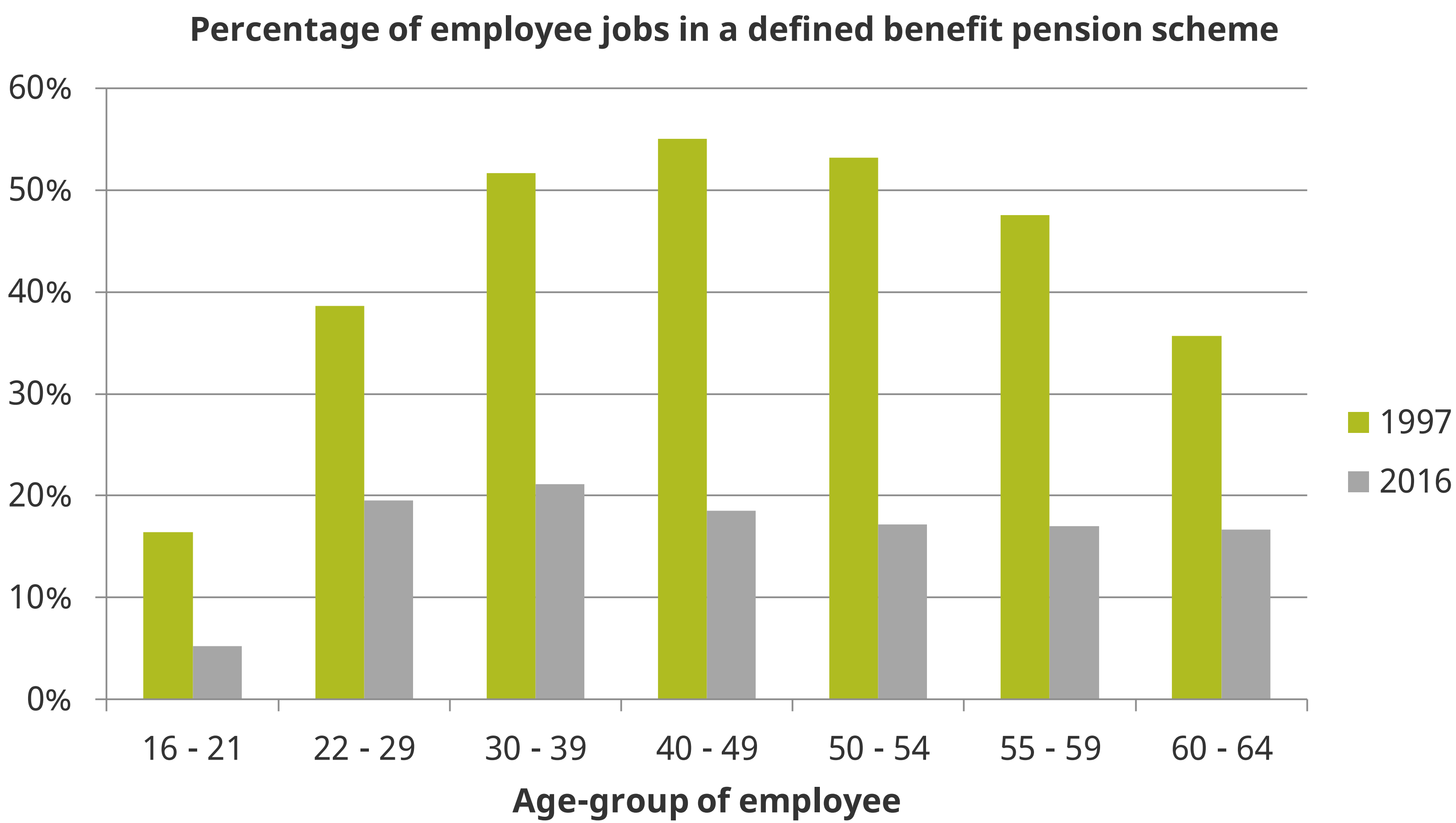
Population ageing and employer pensions

Increased longevity and low interest rates have also put pressure on defined benefit pension schemes

- Many have struggled financially

Employers withdrawing from offering DB pensions

Population ageing and employer pensions



Source: ONS

How do individuals provide for their retirement?

Are we ready?

Providing for retirement is increasingly an individual responsibility

- State pension worth around a third of full-time earnings
- Defined contribution pensions now the norm

If people were completely rational, all-knowing, all-calculating, we might see few problems

- Individuals choose what is best for them: trade-off spending vs saving

But economics tells us the world is not like that – in important ways!

1. ‘Irrationality’: impatience and procrastination about saving
2. Imperfect information: underestimating survival chances

Impatience and procrastination

Individuals tend to give extra "weight" to today when making decisions – **"present bias"**

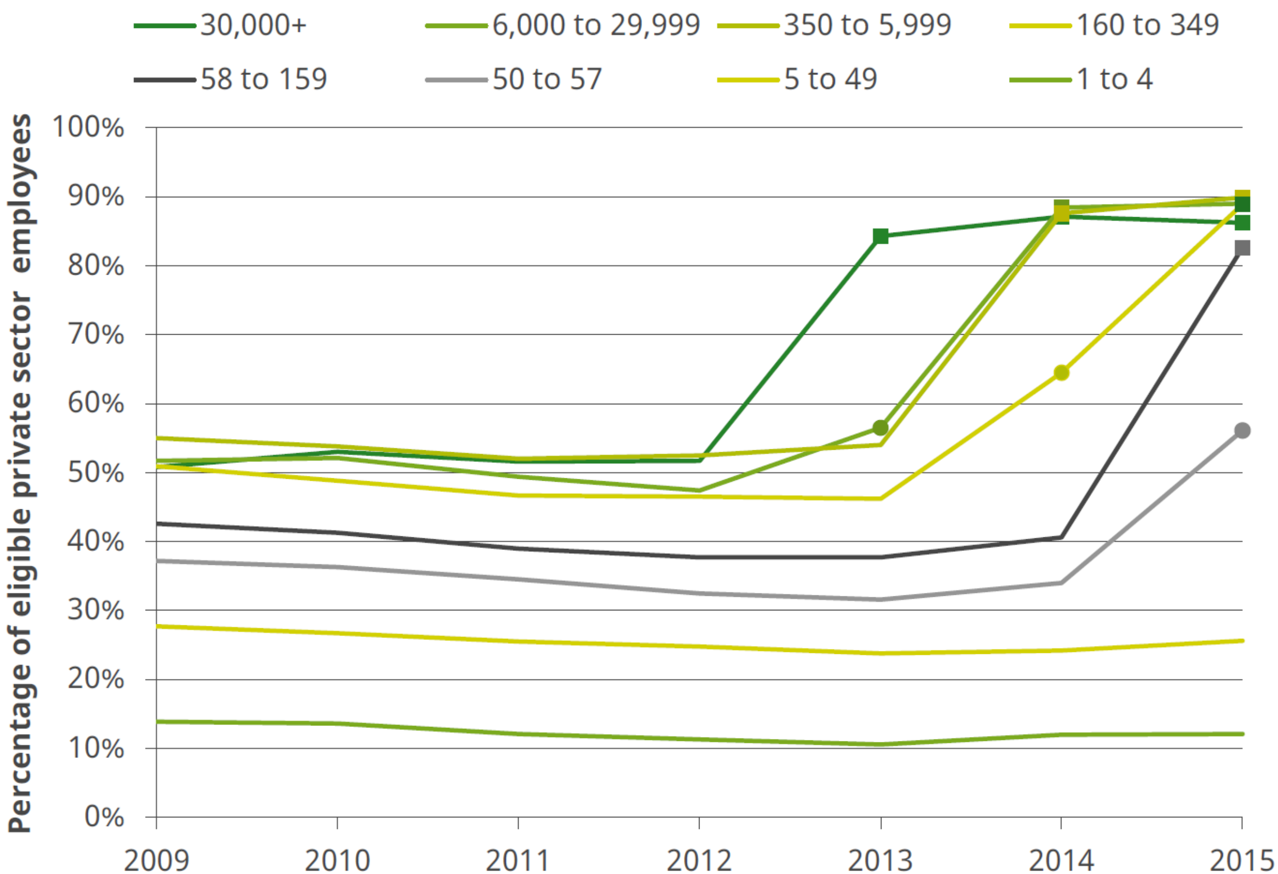
- People also often tend to stick with the default option: **"inertia"**
- This can lead people to put off savings decisions

Policy response has been to **automatically enrol** workers into workplace pension scheme

- US "Save for Tomorrow" schemes (Thaler and Benartzi, 2004)
- In UK, Pensions Act (2005):
  - Default contribution rate of 8% (at least for 3% from employer)
  - Individuals can still choose to leave scheme if they wish

Impatience and procrastination: policy

Workplace pension membership rates amongst private sector employees eligible for automatic enrolment by firm size in 2012



Impatience and procrastination

Individuals tend to give extra “weight” to today when making decisions – **“present bias”**

Policy response has been to **automatically enrol** workers into workplace pension scheme

Workplace pension **participation rates have risen dramatically**

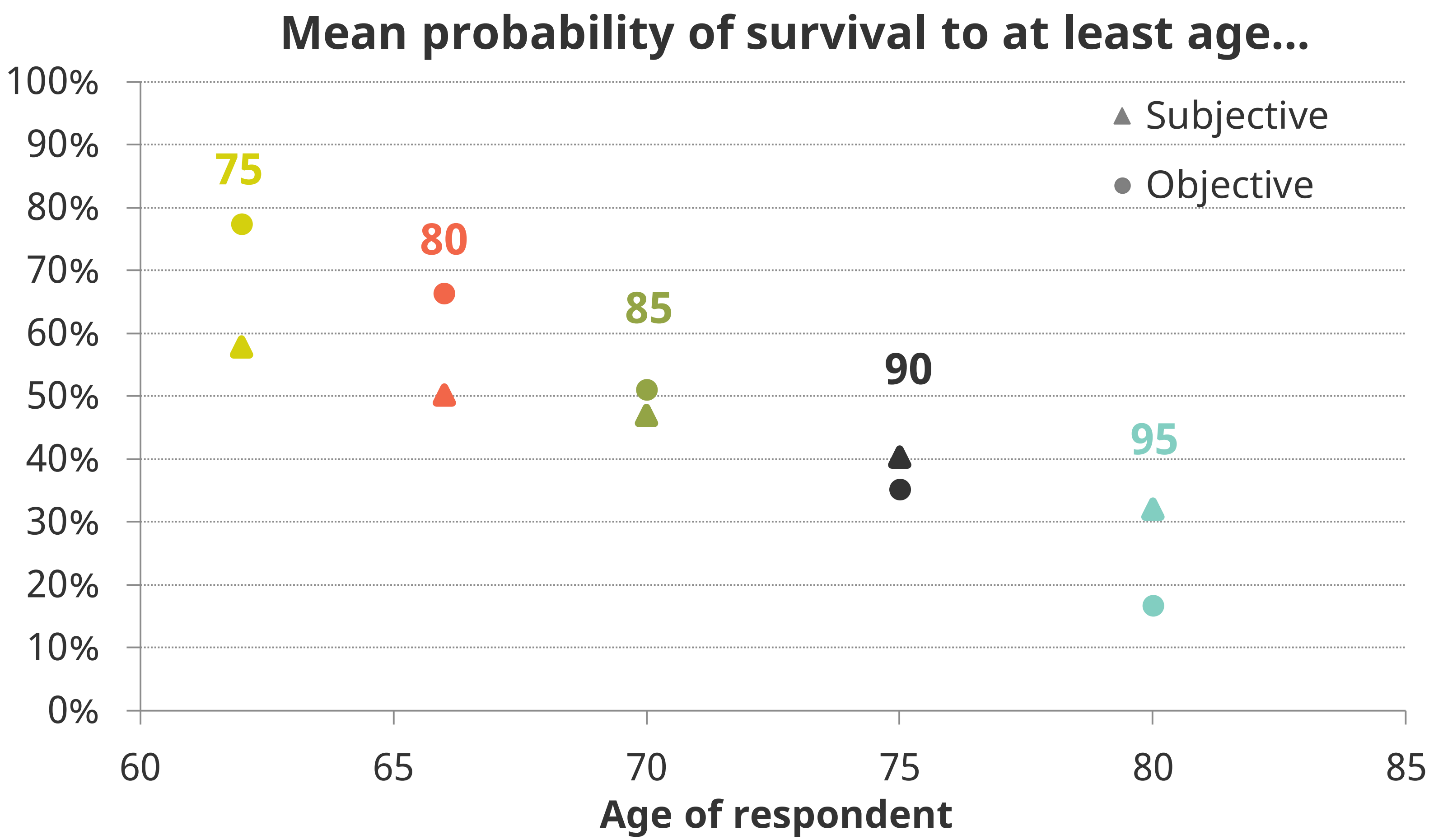
- Are the right people opting out?
- Should contribution rates rise further?

Uncertainty about mortality: survival pessimism

Do people have a good idea of how long they are going to live?

- How can we test this?

Uncertainty about mortality: survival pessimism



Uncertainty about mortality: survival pessimism

Do people have a good idea of how long they are going to live?

- How can we test this?

Pessimism about survival up to 85/90 and optimism for oldest ages

- Might people spend down their wealth too fast? (slow at oldest ages!)

What does this all mean for policy?

- Until 2015, essentially compulsory to use DC pension wealth to buy a guaranteed income, or “annuity”.
- 2015 “Pensions freedoms” gave consumers much more choice about use of wealth at retirement.
- Demand for annuities has fallen sharply (Cannon et al., 2016).

Should we be worried?

Should we be worried?

Most individuals currently reaching retirement can maintain income (Crawford and O’Dea, 2012)

- Only a minority saw significant falls in income at retirement

But what about younger people who are still saving?

Should we be worried?

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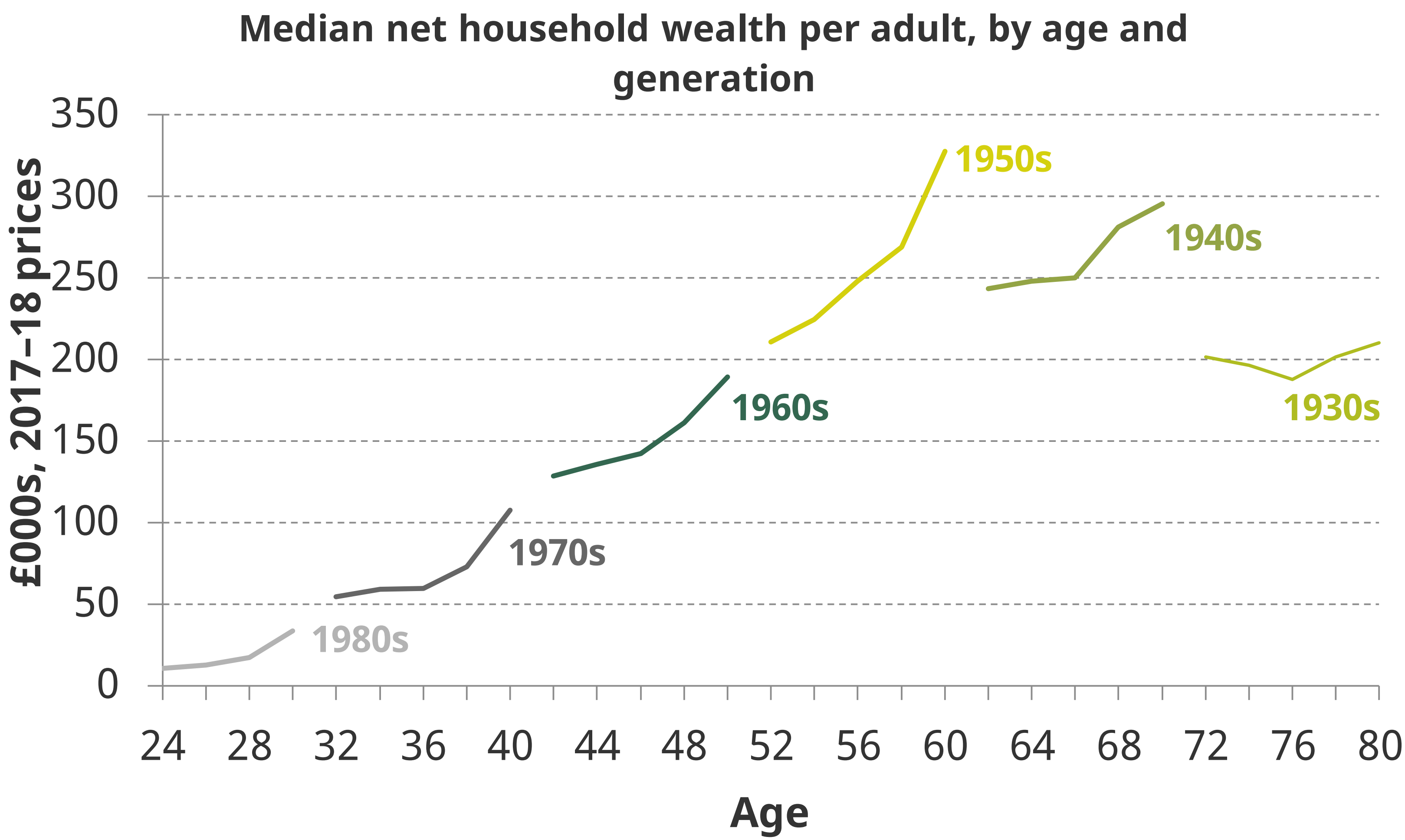

Should we be worried?

Most individuals currently reaching retirement can maintain income (Crawford and O'Dea, 2012)

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Wealth accumulation has stalled for younger generations

- Are young people 'under saving'? Too much avocado toast?

But these generations saved in very different circumstances

- Reasons to save less: lower returns on savings, lower earnings growth
- Reasons to save more: live longer, less generous state pensions

It's not all about savings: people might choose to work longer too

Summary

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Demographic change presents challenges

- Rising dependency ratio poses problems for sustainability of state pensions and defined benefit schemes
- The government is reacting by increasing the state pension age and firms increasingly offer defined contribution pension schemes
- Providing for retirement is increasingly the responsibility of individuals

Greater reliance on individual provision has its own challenges

- Accumulation: procrastination tackled with automatic enrolment?
- Decumulation: survival pessimism raises questions

Important to monitor how younger generations are saving

- Must be considered alongside wider economic circumstances

Further links

The adequacy of wealth amongst those approaching retirement (IFS)

https://www.ifs.org.uk/comms/r72.pdf

Economic circumstances of different generations (IFS):

https://www.ifs.org.uk/uploads/publications/bns/bn187.pdf

TED talk on "Save more tomorrow" (Shlomo Benartzi)

https://www.ted.com/talks/shlomo_benartzi_saving_more_tomorrow

Finkelstein, A. and Poterba, J., Adverse Selection in Insurance Markets: Policyholder Evidence from the U.K. Annuity Market. Journal of Political Economy

Benartzi, S. and Thaler, R., 2007. Heuristics and biases in retirement savings behavior. Journal of Economic perspectives

Thaler, R.H. and Benartzi, S., 2004. Save more tomorrow™: Using behavioral economics to increase employee saving. Journal of political Economy

Cribb, J. and Emmerson, C., 2016. What happens when employers are obliged to nudge? Automatic enrolment and pension saving in the UK. IFS Working Paper

O'Dea, C. and Sturrock, D., 2017. Subjective expectations of survival and economic behaviour. IFS Working Paper

Crawford, R. and Sturrock, D., 2019. How and why might the wealth of different generations be expected to differ? IFS Briefing Note BN257