Why are pensions important?

Monday 1st November
16:00 - 17:00

IFS

UKRI Economic and Social Research Council

ESRC FESTIVAL OF SOCIAL SCIENCE

Introduction

- Why do people save for retirement?
- Why does government intervene in pension saving?
- How does the UK government intervene, and how and why has that changed over time?

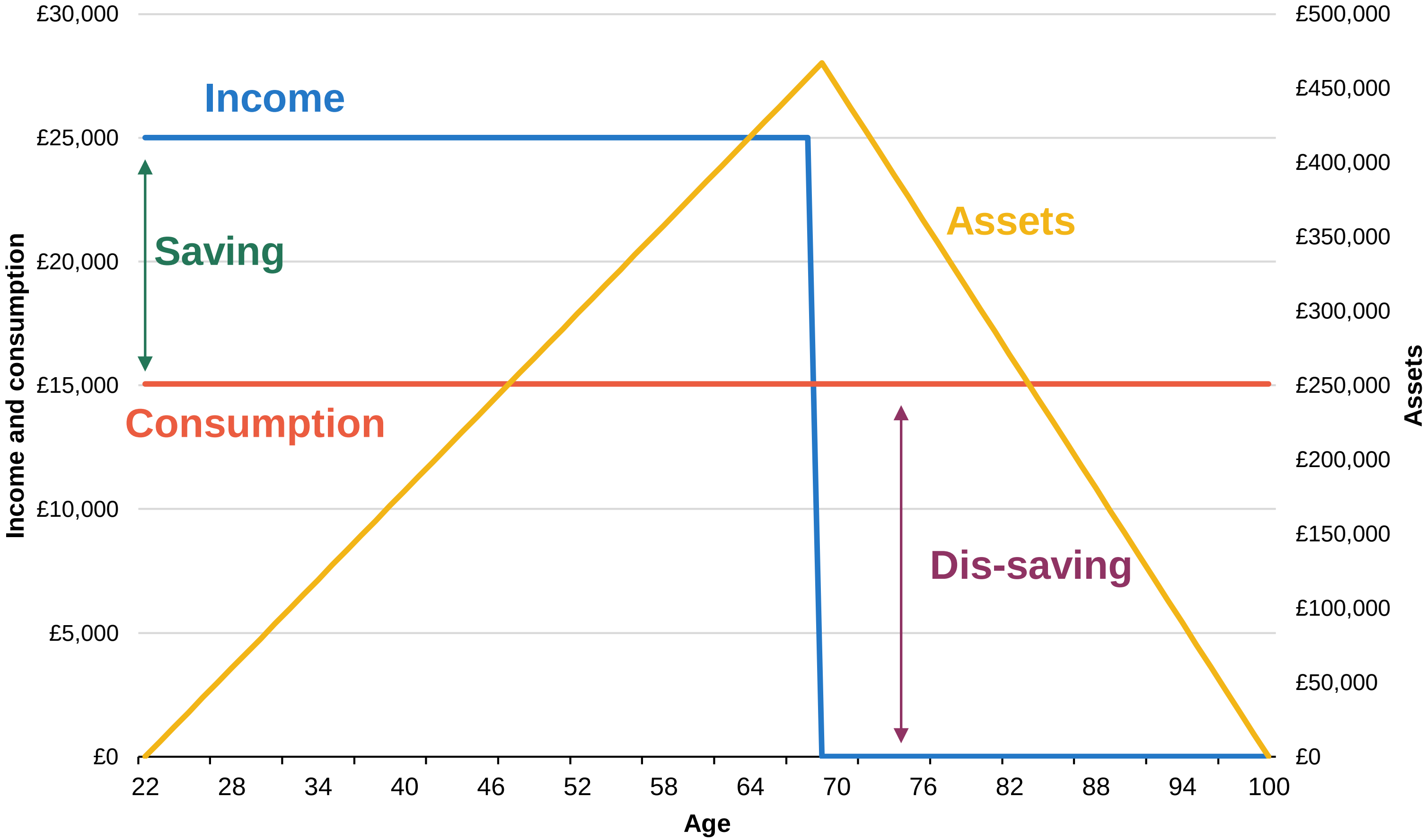
Pension saving

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

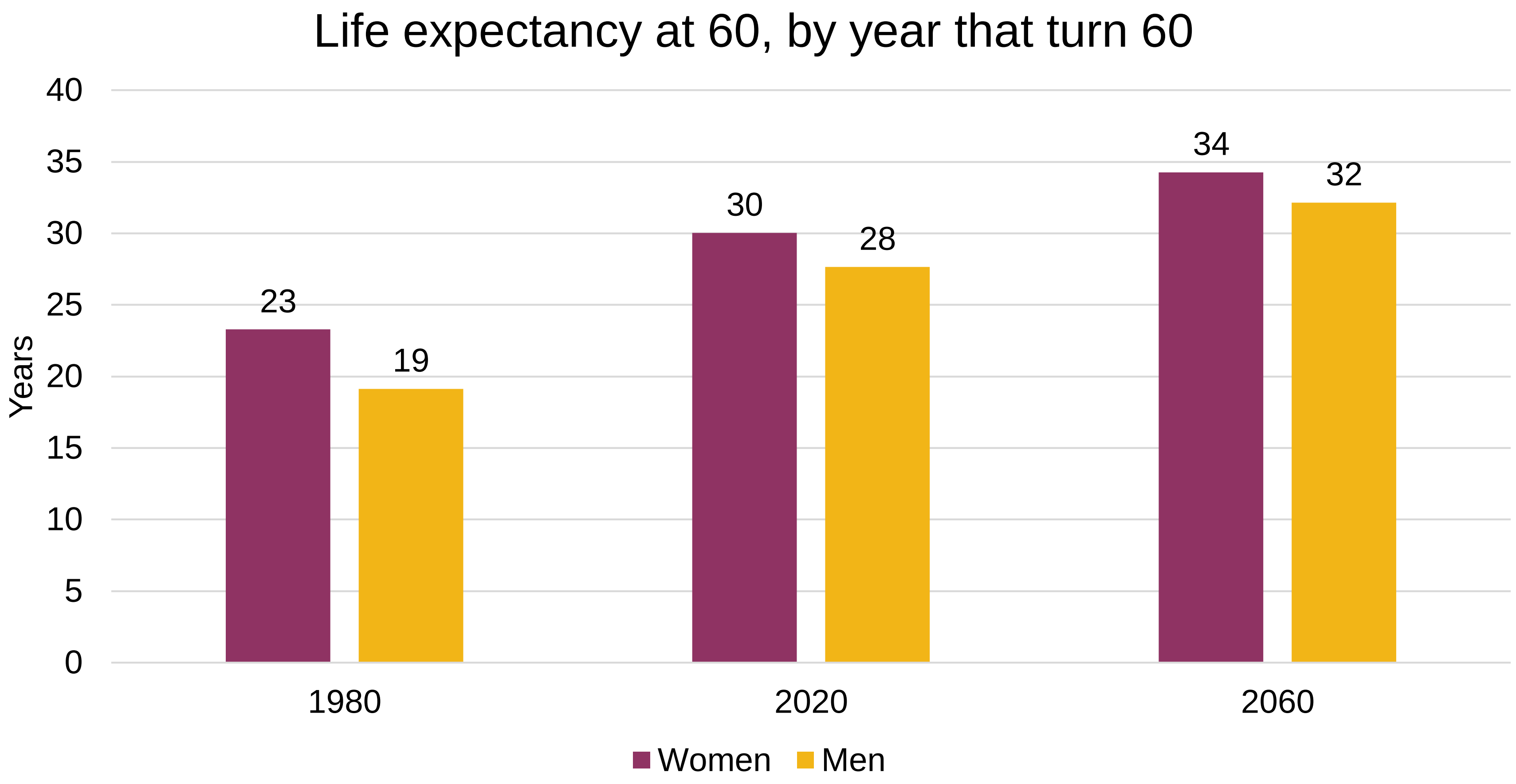
Why does the government intervene?

- 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 redistributional purposes

Public pension systems

Demographic change

Ageing population



Source: ONS

Public pension system sustainability

PAYG public pension system

Demographic trend	People live longer	People spend more time in retirement	People enter the labour force later	Fertility rates falling
Impact on taxes and benefits	Higher total pension payments	People spend a smaller proportion of life paying taxes		Less tax payers
Impact on public pension system	*More money going out*	*Less money going in*		

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 and recent changes

UK pension system

State provision complemented with private saving

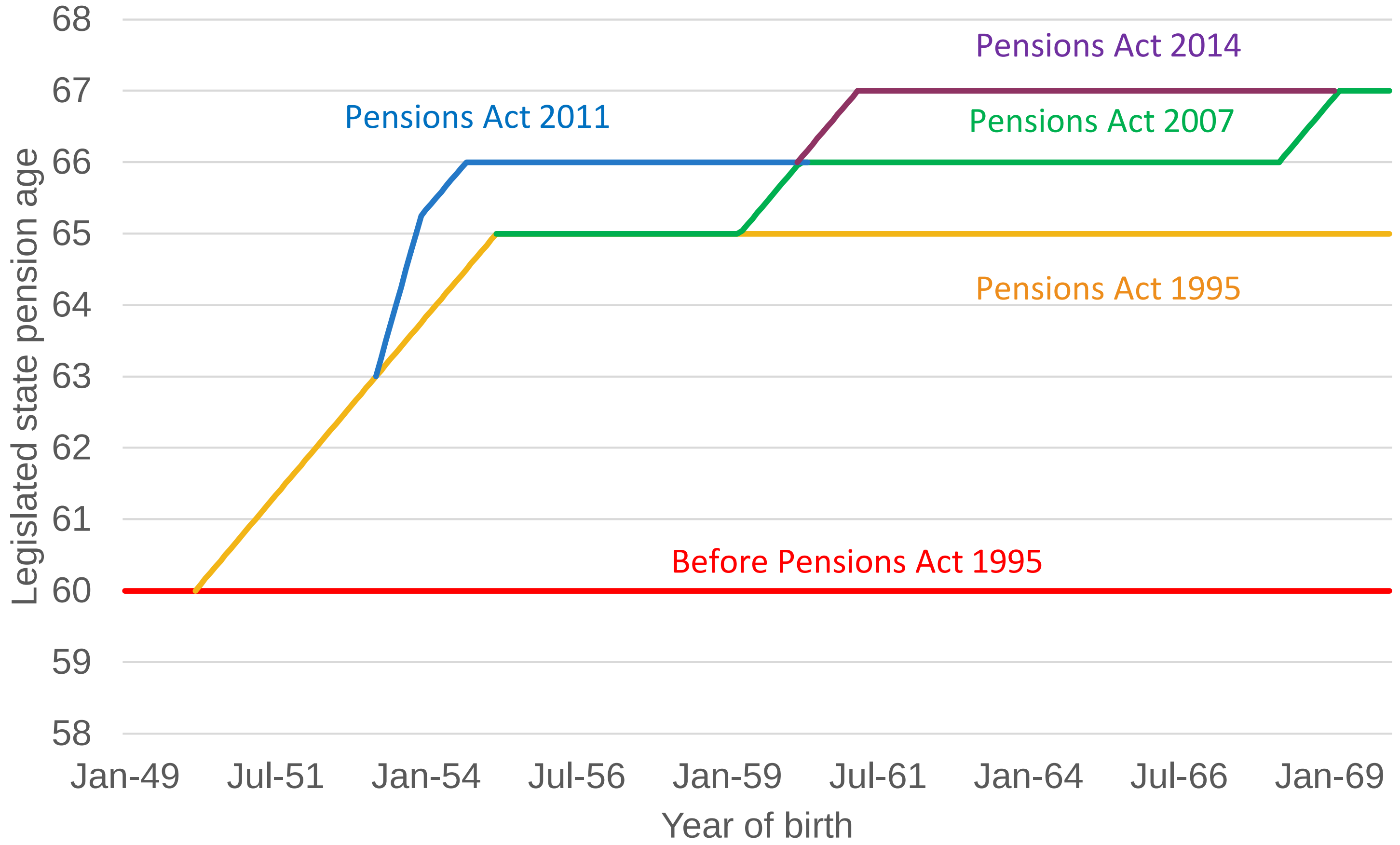
- State pension
  - Flat rate (£179.6 / week in 2021/22)
  - Pay as you go
- Employer pension
  - Defined benefit
    - A set income in retirement, usually defined by earnings and time spent in scheme – risk sits with employer
  - Defined contribution
    - Employee and employer contribute into a pension fund, value evolves according to the investments – risk sits with employee
- Other saving

UK pension system

Changes in recent times – state pension

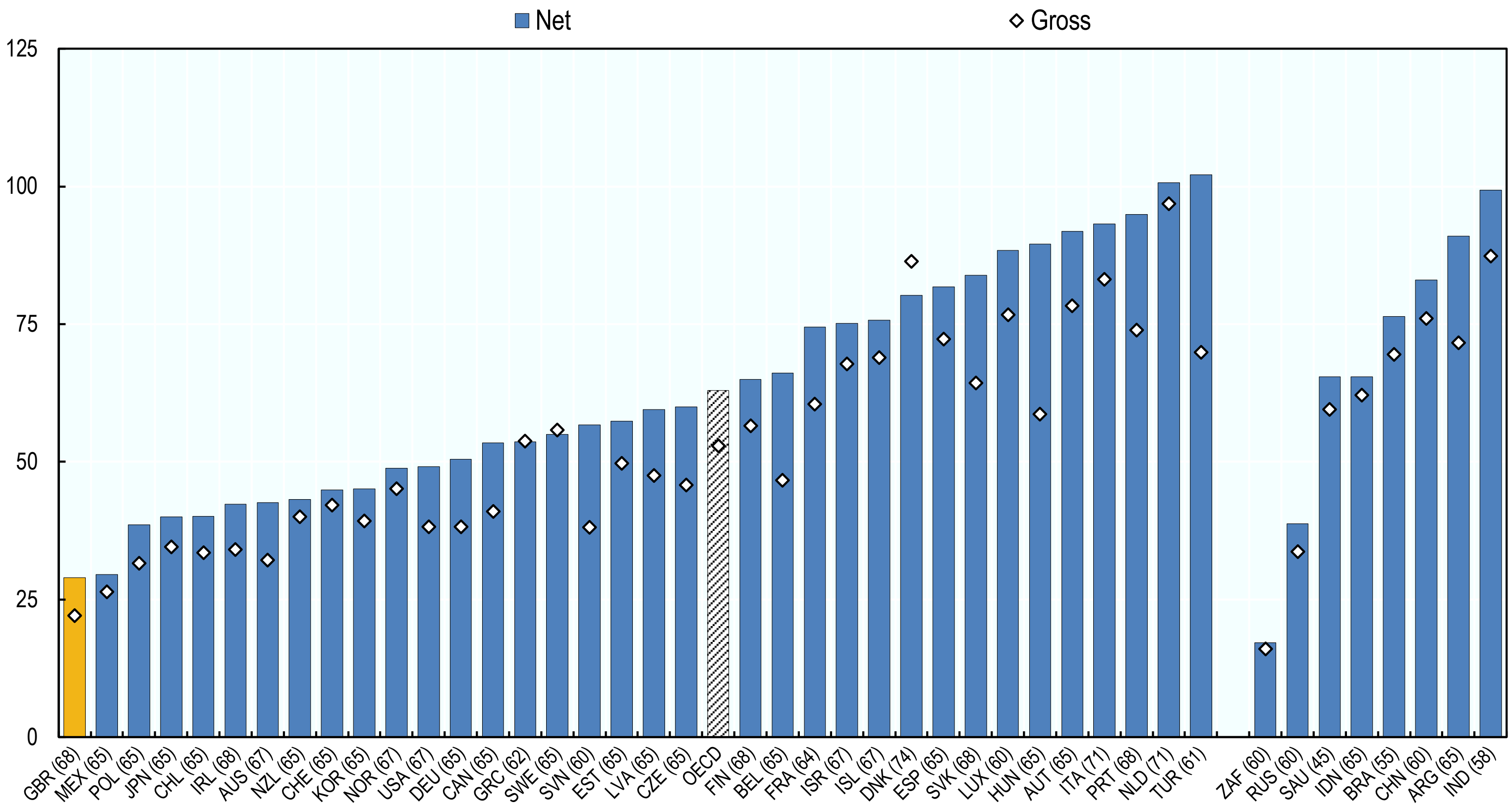
- State pension less generous
  - New (flat rate) state pension
  - Increases in state pension age (age at which people can start receiving state pension)

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

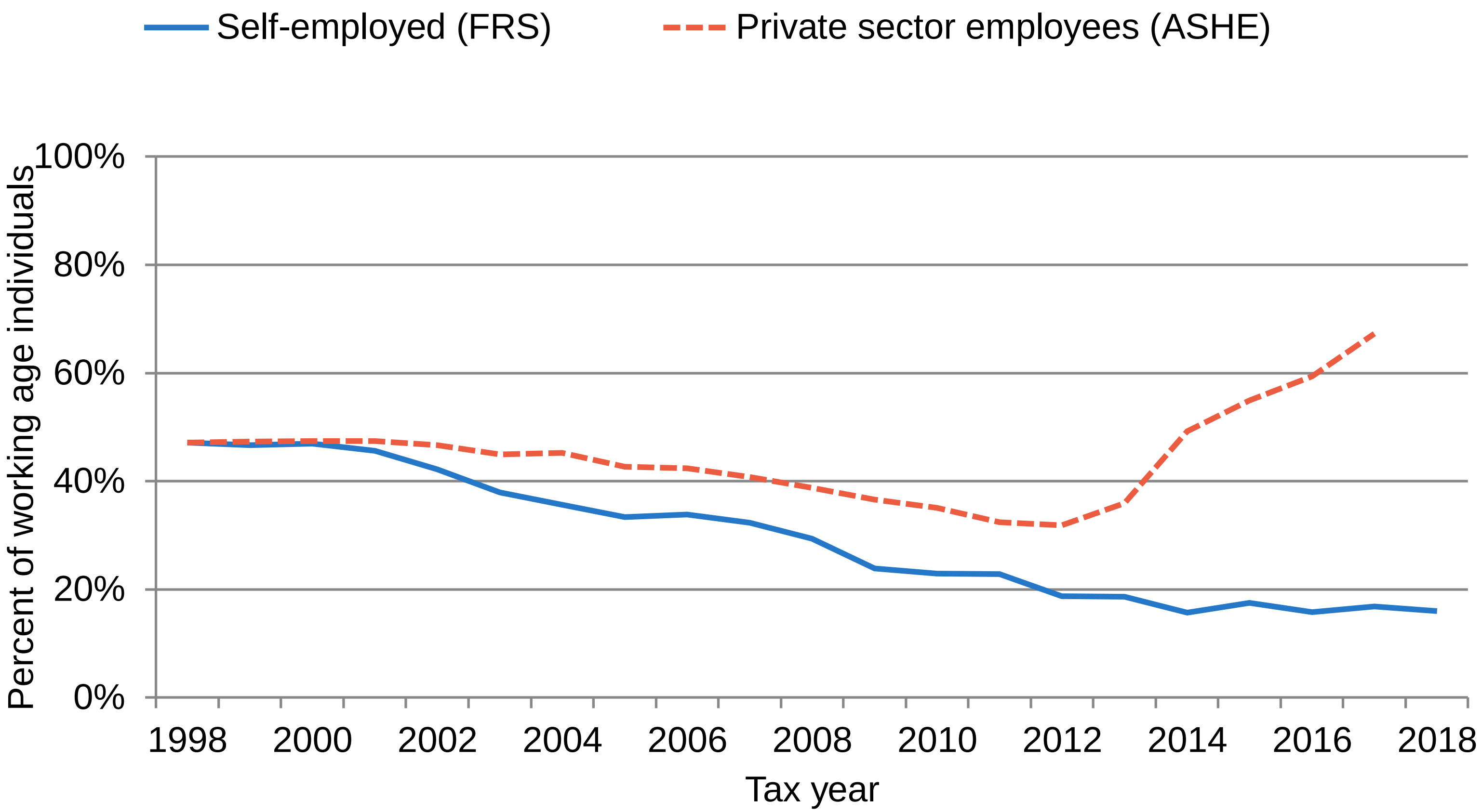
Policy responses to transfer of risk

Policy responses

Accumulation

- 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)

Policy responses

Decumulation

- 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

Policy responses

Summary

- 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 saving helps smooth consumption through the life-cycle
- As with most saving, people may not behave optimally because of behavioural biases and other distortions
- Thus governments often decide to intervene
- Changes to UK pension system means risk transfer to individuals
  - Nudging to accumulate wealth but with flexibility
  - Freedom in terms of decumulation
- Increasingly important for individuals to have an understanding of the pensions and the pension system

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