PENSIONS POLICY INSTITUTE

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Shaping a stable pensions solution: Why are incentives to work and save important?

On Tuesday 24 May 2005 the PPI and the Nuffield Foundation held the second seminar in the *Shaping a stable pensions solution* series at the Nuffield Foundation.

Around 40 people attended the seminar, which was chaired by Mervyn Kohler (Head of Public Affairs, Help the Aged).

Alison O'Connell (Director, PPI) presented key findings from the background paper *Why are incentives to work and save so important?* This showed that the extent to which working longer and savings are important depends on the level and design of state pensions.

Carl Emmerson (Deputy Director, Institute for Fiscal Studies) discussed incentives to save and the effects of recent changes to tax, tax credits and benefits, on the timing of pension contributions and the age of retirement.

Four discussants gave contributions to the debate before questions and contributions were taken from the floor.

Please note that the PPI has not checked any facts referred to in the following, and may not agree with the opinions expressed.

Deborah Cooper (Senior Research Actuary, Mercer Human Research Consulting) highlighted a number of anomalies in the tax treatment of pensions that confuse the system. Although the treatment of pensions is more favourable then other forms of savings, it was not necessarily a subsidy. Further tax incentives for pension savings could be argued for if pensions saving was thought to have greater worth than other forms of saving, for example, in reducing future Government spending.

Stephen McKay (Deputy Director, Personal Finance Research Centre, Bristol University) said that property is still a popular alternative to pensions, but we should not confuse property with inheritance. If a property is used to fund retirement, it cannot be inherited. People are more willing to trust the property market. It is possible to incentivise low income families to save, for example, by the generous matching process of the Government's saving gateway initiative. Those who work longer tend to remain in the same job rather than change employers, work in small, private sector organisations and sometimes have younger partners.

Professor Stephen McNair (Director, Centre for Research into the Older Workforce, University of Surrey) explained that the key issue is understanding what motivates people to stay in work, and the corresponding employer behaviour. Most people make retirement decisions without properly assessing their financial situation, as retirement systems are so complex. This complexity limits the impact of financial incentives. In general, people want to work longer and this is demonstrated by the current drift upwards of retirement ages. The labour market needs to be reorganised to reflect this. More flexible working arrangements need to be made available for people who want a different work-life balance as they get older. Increasing public understanding and trust through long-term consistency is essential for effective reform.

Alan Pickering (Partner, Watson Wyatt) asserted that 'consensus' has to be a political one. Although politicians are currently involved in the pension reform debate at a micro level, focusing on wealth redistribution, they must also highlight the macro level issue of wealth creation. More people need (and want) to work longer, but this requires a change in the mindset of employees and employers. A more generous and simpler state pension is needed to incentivise people to work longer. An over-regulated pension market adds to the complexity. Regulation can be reduced with general incentives that encourage people to engage with the savings industry but do not incentivise particular savings vehicles.

The following points of consensus could be drawn from the discussion:

- In general, people want to work longer. This is a good thing and should be encouraged.
- The state has a role in eradicating the disincentives that exist in the current system.
- The decision whether to save in a pension scheme or some form of non-pension is one for the individual to make. Therefore, compulsion into one form of pension would be inappropriate.
- With an increased state pension, the state would have to spend less effort encouraging people to save.
- A simpler state system that people trusted would encourage people to engage in making their own decisions about their future retirement income.

Further points raised in the discussion included;

1. The psychology of saving needs to be understood. If saving is good for people, it is a rational thing to do. The state, therefore, should not need to provide additional incentives which merely reward rational people for doing what they would do anyway. Instead, the state should focus on reducing the two main disincentives that exist: means-testing and complexity.
2. However, it is difficult to make rational decisions about pensions and saving. If at the point of saving an individual is made less well off, saving is not always good for an individual. For example, the rising debt facing young people needs to be considered.
3. A simpler and more rational system would allow people to make more rational decisions. Incentives can suffer from design flaws; they may not be generous enough, added on to the wrong level of the state pension system, and/or are insufficient to counter the effects of the savings disincentives that exist. Tax credits are generally very poorly understood, therefore, many do not consider them to be an incentive. Opportunity exists for the creation of simple products to allow contributions to build up with increased flexibility and enable Government to more effectively target savers.
4. New Zealand provides a good example of how financial education can be an effective method of increasing saving. However, this is based on a very simple and well understood pension system.
5. Incentives must not just be targeted at individuals, but also be at employers, Finance Directors and the providers of saving products.

6. Incentives only make sense when the rules of the game are understood and acceptable. A consensus on the fairness of the pensions system is required.
7. We need to be cautious of a consensus based on today's labour market, as employment levels are subject to change.
8. There are different issues for working longer for different parts of the labour market, for example, those in highly stressful work environments may need to change their jobs earlier. Reasons why people do not make a second shift in their work life involve many varied irrational and rational factors.
9. Age discrimination in the work place is a real problem; forthcoming legislation will not tackle its structural causes.

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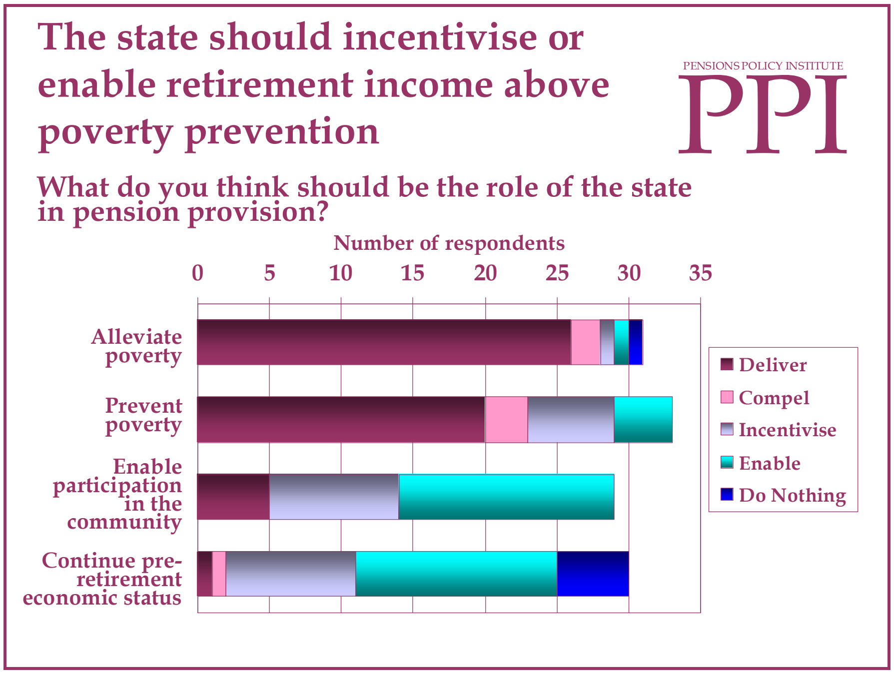
Results of expert opinion survey PPI/Nuffield Seminar 23 May 2005

The views of 29 pension experts were surveyed at the seminar for their opinion on the role of the state in pension provision. Respondents were asked to indicate whether, for each of the four objectives shown (from poverty alleviation to an earnings-related pension), the state should **deliver** a pension, **compel** it to be provided some other way, give **financial incentives** or **enable** it to be provided as an individual chooses, or the state should **do nothing**.



- There is strong agreement that the state pension system should alleviate poverty in retirement.
- A majority of experts would go further, saying that the state pension should prevent poverty in later life.
- Most believe the state should not deliver a pension higher than that needed for poverty prevention.
- Instead, most believe that the state should give financial incentives or enable people to provide a pension as each individual chooses to increase retirement income beyond poverty prevention.
- The idea of people being compelled to provide a pension outside of the state system was rejected by almost all of the experts.