Can work close the ‘savings gap’?

Introduction

Attention is often focused on the so-called ‘savings gap’: the extra that people need to ‘save’ so that future average retirement incomes are not relatively lower than the average today.

However, future retirement income could also be increased by spending more on state pensions and/or working longer. This Briefing Note investigates the potential for working longer to help close the ‘gap’.

Working longer can increase retirement income

Working longer can increase retirement income in three ways: Allowing people to save for a longer time; increasing the length of time that existing saving accrues interest[1]; and reducing the length of retirement (which means that savings need last for a shorter period of time).

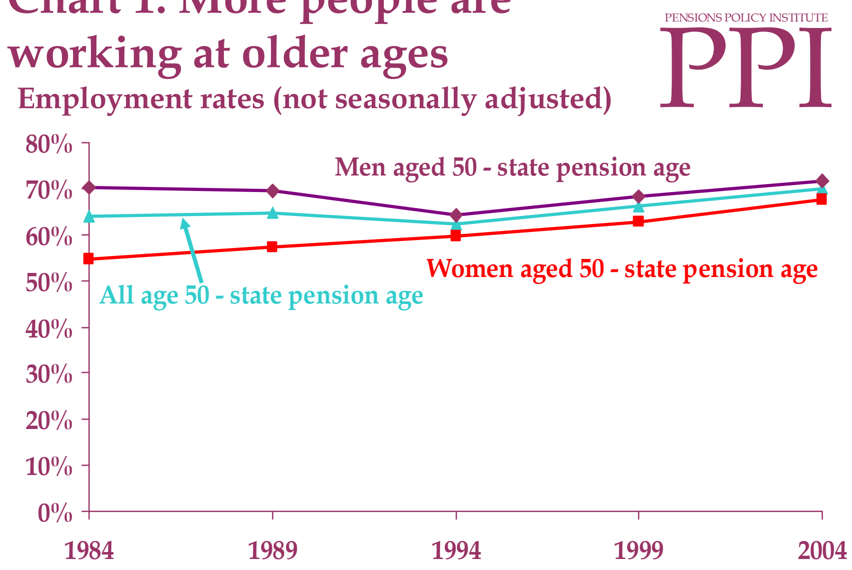
Working longer does not necessarily mean that pension income is increased. Some people may prefer to start taking a pension while still working, and can do so. Earnings will then contribute to a higher income.

More people are working later

There has been an increase in the proportion of people working aged between 50 and state pension age (SPA), from less than 63% in 1994 to almost 70% by 2004 (Chart 1), including a continuous increase in employment rates for women. There has also been an increase in the proportion of people older than SPA in employment, from 7.6% in 1996 to 9.3% in 2004[2].

Chart 1: More people are working at older ages

Employment rates (not seasonally adjusted)



Barriers exist

Even if people wish to work at older ages, it may not be in their existing job, particularly if that job is physically demanding or stressful. More re-training, part-time and flexible working patterns are needed, which some employers may not wish to provide.

But trends seem positive

Evidence as to whether people want to work at older ages is mixed[3]. But recent large surveys indicate that people are willing to accept more working at older ages in future than is in evidence today[4]. For example, 41% of people under 30 reported being willing to work beyond age 65[5].

Changes in private pension provision are likely to increase the number of people working later. From April 2006, employees will be able to take an occupational pension from their current employer[6]. Increasing Defined Contribution pension provision encourages later working, as the value of the pension should continue to rise as work continues. Occupational pension scheme pension ages appear to be increasing[7], as is the minimum age for taking a personal pension[8].

Other welfare policies also encourage later working. The age at which people become entitled to the Guarantee Credit is scheduled to rise from age 60 to age 65 between 2010 and 2020.

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Active labour market policies such as the reform of Incapacity Benefit and the New Deal 50+ help people back into work.

Age discrimination legislation to be introduced in 2006 will prevent employers setting mandatory retirement ages below age 65, and will allow people to ask to remain in their job past age 65.

Healthy life expectancy is increasing. Men can expect at least 11 years of good health after age 65 on average, and women 13 years[9]. The shift from manual to non-manual work is also likely to reduce the proportion of jobs that are physically demanding.

There is likely to be more demand for older workers in future. As the baby boom generation reaches retirement, the number of younger workers will decline. Employers will need to retain or recruit older workers.

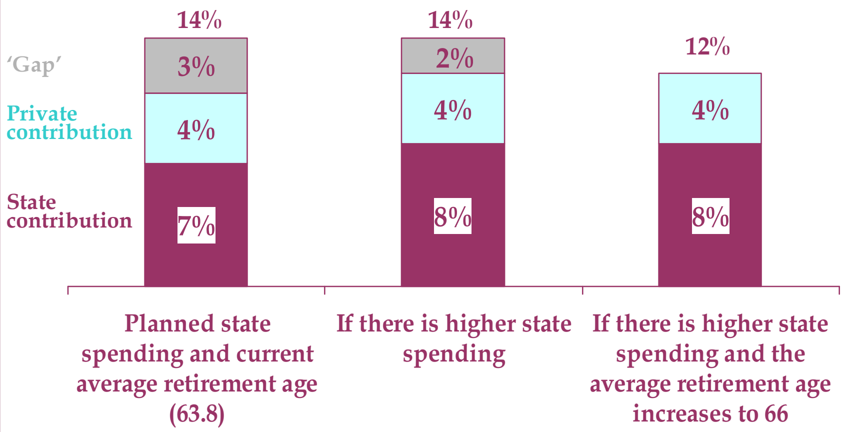
For all these reasons, more working at later ages appears to be a very likely trend. The Government is aiming for 1 million more workers aged over 50 as part of its target of an 80% ratio of workers to people of working age[10].

Working longer has potential

Better state pensions, higher private saving or working longer will not in isolation boost retirement income enough to maintain average retirement income standards. The state would need to double projected expenditure on pensions. The pension savings rate would need to double[11], but even radical policy proposals to increase saving may have only a relatively small impact[12].

Chart 2: Higher state spending and working longer can close the 'gap'

Projected proportion of GDP to be transferred to pensioners to maintain average pensioner living standards, 2050



But combinations of different approaches would have a significant impact on pensioners' incomes. If state spending could be increased by around 1% of GDP by 2050 (roughly a 1.5 percentage point increase in employer and employee NICs[13]), the gap left to be filled by longer working and increased saving is reduced by one-third. If in addition average retirement ages increased in proportion with life expectancy to reach age 66 by 2050, then even with falling contributions to private pensions, enough resource would be transferred to avoid a fall in average retirement income standards (Chart 2)[14].

So, even if working longer does not increase by this much, later retirement has the potential to reduce significantly the gap in retirement income. Enabling work at older ages for all those who can, and supporting those who cannot, are crucial planks of pensions reform.

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[1] Although this also increases the risk that the value of investments in a Defined Contribution plan goes down in the intervening period

[2] PPI analysis of the Labour Force Survey. Spring quarters, not seasonally adjusted

[3] For example, ippr (2005) *Working later: Raising the effective age of retirement*

[4] HSBC (2005) *The future of retirement in a world of rising life expectancies,* AARP (2005) *International Retirement Security Survey*

[5] Scottish Widows (2005) *UK Pension Report*

[6] Until then it is not possible to be employed and paid an occupational pension by the same employer

[7] O'Connell (2003) *Raising State Pension Age: An update* PPI

[8] From age 50 today to age 55 by 2010

[9] O'Connell (2003); ONS

[10] Grattan (2005) *Employment and age CESI Working Brief 164*

[12] Based on the Pensions Commission central estimates, Pension Commission (2005) *Pensions: Challenges and Choices*

[12] PwC for ABI (2005) *Bridging the savings gap: An evaluation of voluntary and compulsory approaches to pension reform*

[13] PPI estimates

[14] PPI estimates based on Pensions Commission (2005) central assumption that current pension saving trends continue (i.e. a 20% fall in private pension contributions over the next 15 years)