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Why is it so difficult to save for retirement?

PPI Briefing Note Number 9

Introduction
This Briefing Note gives an insight into some of the alternative decisions that an individual can make to obtain an adequate pension income.

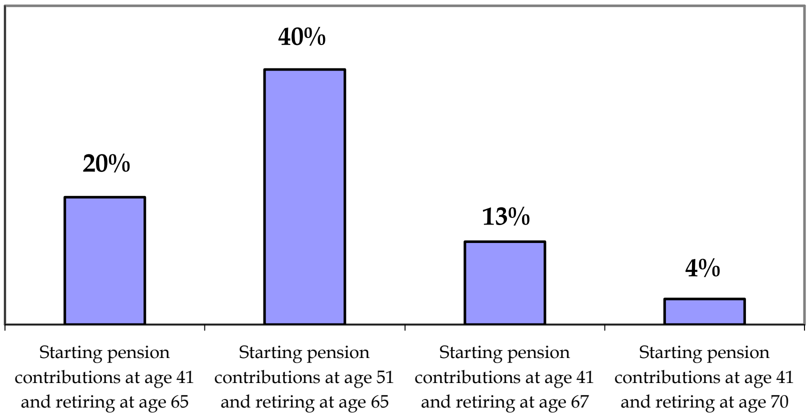
How much retirement income do people need?
Individuals can afford to have a lower income in retirement and still maintain their living standards[1] because their living costs tend to be lower. They usually have paid off the mortgage and their children have left home.

One measure used to compare income after retirement relative to that enjoyed during working life is the replacement rate (RR). The RR is the ratio of initial pension income to final salary income. Acceptable RRs vary from one individual to another.

Low earners may need a higher RR to obtain a minimum standard of living. Means-tested benefits may provide this. Higher earners may find that a lower RR still provides a comfortable living standard.

Even though there is no RR that is right for everyone, new pensioners have, on average, an income that is equal to two-thirds of earned income before retirement[2]. This benchmark is often used as a measure of adequate pension income.

Chart 1: Proportion of earnings needed to save (on top of all state provision) to obtain a gross replacement rate of two-thirds, individual on median earnings reaching 65 in 2028



How much do people need to save?
The PPI has developed a model[3] that calculates entitlements to state and private pension income. Using this model can help to understand the different alternatives that a hypothetical individual has during his or her working life to obtain an adequate measure of pension income.

The individual illustrated is a man on median (middle) earnings throughout his working life. He starts work at 21 and retires in 2028 at the age of 65. He is mainly a full-time worker. However, he is unemployed from 23 to 24 and works part-time from 55 to 59. He is not untypical, although many people will have less state pension than he is entitled to.

Relying entirely on state pension provision — Basic State Pension (BSP), State Second Pension/State Earnings Related Pension Scheme (S2P/SERPS) or contracted-out equivalent and Pension Credit (PC) - results in a replacement rate of around half. This could be increased by private pension saving on top of the compulsory state provision.

The 'illustrative man' would have to save 20% of his salary, starting from age 41, to reach a RR of two-thirds (Chart 1).

If saving is delayed until 50, then a contribution rate of 40% of his salary would be needed.

Currently workers contribute, on average, only around 8%[4] of their salary[5] to a private pension.

Why don't people save 'enough'?
Many individuals will simply not be able to save at these lev-

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els. There are also other factors influencing savings behaviour.

Individuals cannot be sure about their future entitlements to state pension provision. The state pension system is complex. Even when some information is provided, such as in a state pension forecast, other information, such as future means-tested benefit, is not available.

Even if individuals have all the information to act 'rationally', many people are not interested in long-term planning[6].

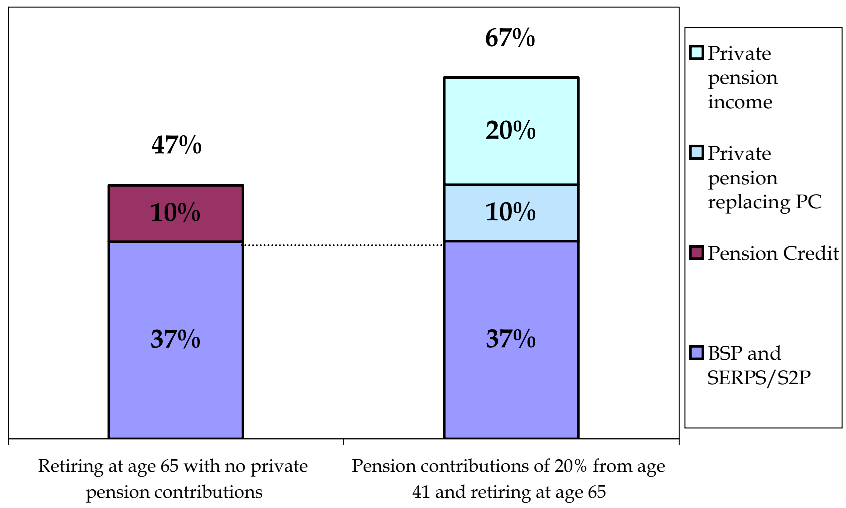
What other options are there?
Accepting a lower RR may seem reasonable for some individuals.

Non-pension forms of savings, such as housing and stock market investments, are also available. However, these options still face the problems of affordability, risk and planning.

If individuals do not want to, or are unable to, save enough to finance their retirement, they could opt to work for longer to offset the reduction in income after retirement. Even working a couple of years longer makes a significant reduction in the amount of savings needed.

Our 'illustrative man' could achieve a two-thirds replacement rate by working until 70. Then he would only need to

Chart 2: Gross replacement rate for an individual on median earnings retiring in 2028 with different private pension savings on top of state provision[7]



save 4% of his earnings from age 41. Alternatively, he could work until 67, saving 13% of his salary (Chart 1).

The impact of the Pension Credit on savings
The introduction of the Pension Credit (PC)[8] and, in particular, the Savings Credit (SC) in October 2003 changed the value of savings.

In 2028 our illustrative man with no private pension provision will be entitled to PC at age 65 and his state pension income will replace half of this final salary (Chart 2).

If he had saved 20% of his salary from age 41, then he would not receive any PC. Overall he would be better off and have an RR of two-thirds. However, the first third of his saving is caught in the means-testing trap, replacing what PC would have given him.

Given the low level of average pension saving, many people will find themselves caught in the means-testing trap in the future, and claiming PC[9].

The PC has therefore extended the savings barrier for many of today's workers. A large proportion of pension saving will simply replace state benefits that would otherwise be payable.

1 Individuals do not like jumps in their consumption patterns and they prefer to adjust their savings to obtain a smoothed consumption path. See Romer, D., *Advanced Macroeconomics*, (2002) for further discussion of this topic.
2 See *Simplicity, Security and Choice: Working and saving for retirement*, DWP (2002), p.27.
3 The Individual Model (IM) is part of a broader project funded by the Nuffield Foundation. For further details, go to www.pensionspolicyinstitute.org.uk/news.asp?p=54&s=4&a=0
4 This estimate also includes private pension contributions by the employer on behalf of the employee.
5 See *The Pension Landscape*, PPI (2003), p.37 .
6 See *The Pension Landscape*, PPI (2003), pp 54-56.
7 BSP includes BSP and other state benefits such as Winter Fuel Payment, Age Addition, Age Addition Winter Fuel Payments and Christmas Bonus.
8 For a discussion on the Pension Credit, see *The Pension Primer*, PPI (2003).
9 By 2025, between 60% and 75% of pensioners may be eligible for PC. See *The Pension Landscape*, PPI (2003), p. 30.

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