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PENSIONS WATCH – ISSUE 3: WHAT'S BEEN HAPPENING AND WHAT'S ON THE HORIZON IN THE WORLD OF PENSIONS

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In this edition we focus on the sustainability of the state pension in securing a basic standard of living for many people in retirement and its role in reducing the gender pensions gap...

Earlier this month I was prompted by former Pensions Minister (and the UK's longest serving), Sir Steve Webb, to sign a petition for the Department for Work and Pensions to review the state pension entitlements of those women – principally widows, older married women and the over-80s -who may have been underpaid. Based on a system long since past, when married women's state pensions were mostly based on their husband's working life national insurance contributions (NICs) records, these underpayments might now collectively amount to north of £100m. That had me thinking about the potentially crucial role the state pension plays in many peoples' retirements, especially in that of many women.

A short history lesson

The state pension originated in Germany in 1889. However, a means tested *Old Age Pension*, payable at age 70, didn't surface in the UK until 1909. Eventually becoming a universal non-means tested *state pension* in 1948, payable to women at age 60 and 65 for men, the state pension has, since its inception, been financed by the taxes of the working population, on a so-called Pay As You Go (PAYG) basis. It has also largely been based on working life NICs records, more latterly individuals own NICs records, with women typically receiving much less than men, given women's generally shorter working lives. This is reflected in the gender pensions gap which, in the UK, stands at 35% against an OECD average of 25%.[1]

However, given women's ever greater participation in the labour force, this should narrow with the recent equalisation of State Pension age (SPa) initially to 65 in 2018, then to 66 this year, with further planned increases to 67 and 68 over the next couple of decades. The new single-tier state pension[2] should do similarly. Introduced in 2016 for those reaching SPa on or after 6 April 2016, the "new" state pension is paid in full (at £8,767 per annum for 2020/21) for those accruing a 35 year NICs record and pro-rated for those with at least a 10-year NICs record. This has seen the gender pension gap relating specifically to the state pension reduce from 17.2% to 4.8%.[3]

Crucially, since 2010, the state pension has been generously uplifted each year in line with the "triple lock" – the *highest* of Consumer Price Inflation, average earnings growth or 2.5%. With the state pension now paid to almost 13m people,[4] this policy has led to a dramatic increase in its cost from £66.9bn in 2009-10 to a projected £96.7bn in 2018-19. In fact, the triple lock has single-handedly made spending on state pensions the biggest item in the social security budget.[5]

[1] OECD (2019), *Pensions at a Glance 2019: OECD and G20 Indicators*, OECD Publishing, Paris. p.22. The gender pensions gap is the difference between the pensions of men and women at age 65 as a percentage of men's pensions.
[2] This replaced a complex two-tier system, which comprised a basic state pension and second state pension (S2P).
[3] Benefits statistical summary. DWP. February 2020.
[4] 12.6m people in the UK were receiving the state pension at August 2019. DWP (February 2020). op.cit.
[5] Guidance: Benefit expenditure and caseload tables. DWP. November 2018.

So is the state pension now a retirement panacea?

However, despite the rapid escalation in the cost of its provision, the UK state pension after-tax is only equivalent to 28.4% of pre-retirement income for the average UK earner, as compared to an OECD average of more than twice that.[6] Only South Africa has a lower, so-called, net replacement ratio.[7] That said, once all sources of pension income for the median UK earner are accounted for, the net replacement ratio rises to 61%, which isn't that far off a fairly respectable OECD average of 65.4%. However, for someone with a pre-retirement earned income 50% higher than the national average, the net replacement ratio falls back to 47.4% against 61.6% for the OECD.[8]

Of course, as defined benefit pensions increasingly give way to less generous defined contribution, these numbers will simply deteriorate in the absence of greater levels of long-term saving. Indeed, this year's Mercer CFA Institute Global Pensions Index once again recognised the importance of weaning people off their dependency on the state pension by encouraging higher levels of saving into occupational and private pensions.[9] Indeed, the Pensions Policy Institute suggest that, "a median earner might need to contribute between 11% and 14% of band earnings to have a two-thirds chance of replicating working life living standards if contributing between age 22 and SPa." Currently, the median employee and employer contribution to an occupational DC trust-based scheme is 4% and 3% respectively.[10]

Why does all of this matter?

As the first pillar of most developed pension systems, the state pension serves to fulfil peoples' basic living needs in retirement. For many, notably older married women, it is the principal source of retirement income.

With pensioners having largely been insulated from government post-financial crisis austerity measures and benefitting from the retention of the triple lock underpin to the state pension, the UK has moved from a position where, 30 years ago, pensioners were at least three times as likely to be poor as non-pensioners, to one since 2011 where median pensioner incomes now exceed median non-pensioner incomes. However, a 15.3% old age poverty rate for the UK's over-65s (against a poverty rate of 11.9% for the UK as a whole) is telling. Moreover, a gender pensions gap also exists in this metric with 17.7% of women aged over 65 (versus 12.5% for men) caught in the old age poverty trap.[11]

Despite this, it is clear from the above numbers that the state pension with the triple lock has become an unsustainable burden on the public purse. Indeed, given that well over 5m second wave baby boomers, born in the early to mid-1960s, will attain SPa between 2026 and 2032, thereby further shrinking the UK workforce and the tax base from which the state pension is paid, politicians may well be forced to review their position on the triple lock far sooner than they think.

Moreover, moving from a universal to a means tested state pension has even been suggested by the OECD and prominent commentators, not least because the more affluent tend to live longer than the less affluent and so benefit more from a welfare benefit that is principally targeted at the less well off. In so doing, this may halt any further increases to the SPa and refocus the purpose of the state pension to that of its 1909 origins. Whatever the eventual outcome, for those who can afford to save more, relying on the state pension to meet basic living needs may well prove to be foolhardy and result in a retirement that is endured rather than enjoyed.

[6] The OECD average of 58.6% represents the income paid from all mandatory pension sources which, in some OECD countries, extends to mandatory private provision. See: OECD (2019), op.cit.p.155.
[7] The net replacement ratio measures how effectively a pension system provides a retirement income to replace earnings.
[8] OECD (2019). op.cit.p.157.
[9] Mercer (2020), Mercer CFA Institute Global Pension Index, Mercer, Melbourne.
[10] The DC Future Book 2020. The PPI in association with Columbia Threadneedle Investments. September 2020. pp.20-23.
[11] OECD (2019). op.cit.p.187. The old age poverty rate defines the percentage of those over- 65 who live on below of national median. income. The OECD average of 13.5% is split 15.7% for women and 10.3% for men.

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