Living longer, but poorer

***Les Mayhew** discusses whether the UK's pension system can support the ageing population and why it makes sense to save as much as possible into a pension*

Following the completion of the latest pension review, the government had been looking at increasing the UK state pension age to 68. As things stand, there will be a staggered rise from the current pension age of 66 to 67 for those born on or after April 1960; and then a staggered rise to 68 between 2044 and 2046 for those born on or after April 1977.

The government had been considering bringing forward the rise to 68 to 2037-2039 but a slowdown in the rate of increase in life expectancy is said to have given ministers some breathing space and a decision is now expected after the next election in 2024.That does not mean action will not be needed. However, when the pension age should increase is open to debate and is ultimately a political decision.

Like many other countries, the UK state pension system follows a pay-as-you-go model in which today's pensions are paid by today's taxpayers. That makes the fiscal cost important. Pension age is not the only lever for controlling cost, but increasing taxes or reducing the value of the state pension would be deeply unpopular and could mean losing votes at an election.

The problem, though, is that people are living longer and resources are finite, even if the UK were to see a sudden leap in its relatively poor rate of productivity. By 2040, there will be 17m people of pension age in the UK – 4m more than today. There will be only two and half people of working age per state pensioner compared with three and a half today – underlining the need to consider intergenerational fairness.

This is referred to as the dependency ratio. To ensure it is in constant balance, pension age needs to rise to keep costs (currently £110bn a year) under control. Each extra million pensioners costs the exchequer about £10bn a year, to which must be added the triple lock (ie the promise to increase the state pension in line with the highest of average wage growth, inflation or 2.5%), which is revisited each year. But you also need to give people a lot of notice for changes in pension rights. Ten years is normal.

Ministers would like some sort of automated process linked to factors such as changes in life expectancy or its value as a proportion of government expenditure. Work by the International Longevity Centre UK and Bayes Business School compared three other metrics using demographic as opposed to fiscal criteria. All seem reasonable and logically based – but they all give different results.

For example, a policy that allows for one third of adult life (20 and above) in retirement, which is reflected in current policy, would be the most expensive. Pension age would remain at 67 until the late 2040s.

A policy based on maintaining a constant average life expectancy on reaching state pension age (currently 22.5 for a 66-year-old) would see the pension age rising to 68 in 2041, which is sooner than the one third rule.

One based on keeping the proportion of the population reaching state pension age the same (currently 85.5%) would be similar to the fiscal rule, with the state pension age increasing to 68 in the early 2030s.

> *"Public-sector workers with generous inflation-linked occupational pensions should not have to worry*

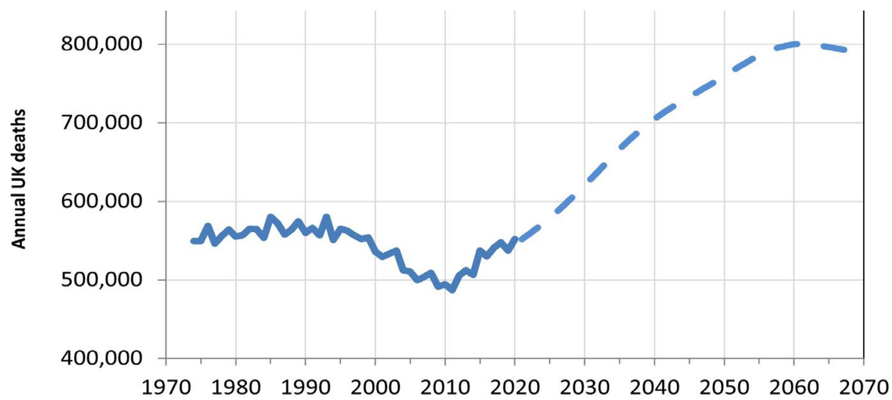
For financial reasons, therefore, we expect the state pension age will rise to 68 somewhere in the mid-2030s, but not earlier to allow sufficient time for the public to adjust. What will be the reaction? It is important to remember that while the state pension is not very generous, the UK has a multi-pillar pension system that includes occupational and private pensions, which can be taken from age 55 (soon to be increased to 57).

Despite this, and the introduction of automatic enrolment, there are concerns that many people are not saving enough for retirement. Pension pots need to be larger – and both planned and expected increases to state pension age reinforce that view. It is also the case that many people will not be fit enough to work until 68, however generous the state pension is.

What can be done? The situation will vary between different groups in society. These are, broadly, those with a private or occupational pension, those with housing wealth, those with both housing wealth and a pension, and the rest. It will also greatly depend on your current age and personal circumstances including, for example, whether you live with a partner, which is cheaper, or own or expect to own your home.

Those with generous inflation-linked occupational pensions as they exist in the public sector should not have to worry. Equally, home-owners should be able to benefit from high property

Forecast annual deaths in the UK



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prices by monetising their asset through downsizing or equity release, or other mechanisms. Those with both will be best off. For the rest saving more is important.

The people facing the most difficulty are mainly those who are already struggling but who will now find it even harder to cope – those in poor health, for example, or looking after someone else. The latter are often women. Their needs must be addressed by broadening the rules on private pensions or making creative use of the benefits system.

Then there is another group that we haven't considered, which is those with independent means or inherited wealth. The annual number of deaths in the UK has been running at about 500,000 to 600,000 for many years, as shown in the chart. The sharp upturn in the pattern after 2020 is due to the dying of the baby boomer generation who will start to turn 80 from 2025.

As the chart shows, the annual number of deaths will rise to an estimated 700,000 by 2040 and to 800,000 by 2060 according to the Office for National Statistics. The age composition of deaths is also changing. In 1980, 16% of deaths were among those aged under 60, but this is changing as people are living longer. That will delay inheritance and any financial windfalls and may even consume them – for example, with care costs.

That said, it is clear that huge amounts of inherited wealth will be coming down the line in the next 20 years. What will be the age of inheritance? If your mother was young, say age 20, when she had you and you were born in 1960 your expected age of inheritance would be roughly 67, based on life tables in that year. But that is not fixed in stone.

Assuming your mother outlives your father, it ultimately depends on your mother's life expectancy. That has been improving over time. There is a kind of competition between her year of birth and yours, the net effect of which suggests the age of inheritance is creeping up.

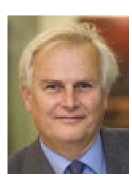
Where you end up in terms of pension provision is, therefore, partly a lottery that depends on many factors. That's why it's best to be cautious and save as much into your pension as possible. A rough recommended rule of thumb is that your minimum income in retirement should be the average wage at the time – assuming you have paid off your mortgage but higher if not – as well as inflation-proofed. A second implication

> *Staying healthy and working for longer will be important not just for individuals but for the economy as a whole*

is that you should aim to retire gradually because of the differences in age at which you can access different pensions, while also working less than previously.

Our analysis depends crucially on continued economic prosperity, which cannot be guaranteed. In an ageing population, staying healthy and working for longer will be important for every individual but also for the economy as a whole.

A more powerful warning sign than the shrinking dependency ratio is a different ratio – that between the number of active and inactive workers. There are now only 1.7 economically active workers for each inactive adult aged 16+, ie nearly two in five are not earning. Despite pensions and other reforms and the removal of the default retirement age of 65, this level is at its highest in 30 years. Of the inactive, nearly 2.5m aged 16 to 64 are unavailable for work because of long-term sickness. This is the ball government policy should be keeping an eye on. ■



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