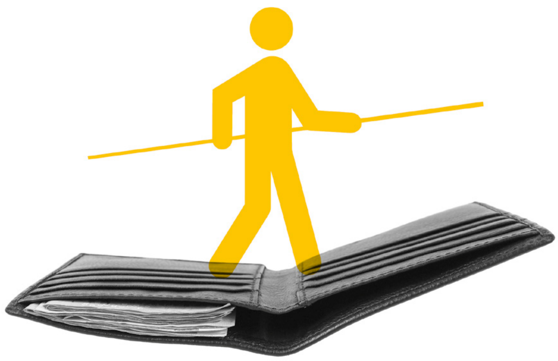
EVERSHEDS SUTHERLAND

Striving for balance
What's next for pensions and intergenerational fairness?



For various reasons – from housing costs, to wage stagnation, to climate change – in recent years there's been a growing concern that younger generations may face more challenges than their parents did, at least in financial terms.

The pandemic gives this issue new salience. Young people disproportionately work in hard-hit sectors, such as retail and hospitality. What's more, government borrowing will take years to repay, so younger generations may bear most of the cost.

In this article, we take a whistle-stop tour of what this might mean for pensions policy.

What has this got to do with pensions?

Pensions are most people's first or second-largest asset – so they have to be taken into account in any analysis of how wealth is split between generations.

What's more, the median income of pensioners is now more than that of working age people (after accounting for housing costs), giving further impetus to this debate.

A key aspect of this issue is the different types of pensions that have been available to different generations.

Older workers generally had the option to save into defined benefit (DB) pension schemes, which promised them a given level of income in retirement.

In contrast, most younger workers (at least in the private sector) can only join a defined contribution (DC) scheme – effectively a retirement savings account with tax advantages – with no promise they'll have enough to see them through retirement.

What might we see?

This blog looks at three areas where pensions policy might promote intergenerational fairness: tax reform, state pension reform and auto-enrolment.

Tax reform

Pension savers benefit from tax relief at their marginal tax rate (subject to limits). The result, some argue, is that higher earners, who tend to be older, get more of a government subsidy to their pensions than lower earners, who tend to be younger.

A flat rate of pensions tax relief might address this. Some commentators go even further and propose an age-differentiated system of pensions tax relief – to give younger people more support and incentive to save into their pensions.

Another tax change that could promote intergenerational fairness would be to change how DB pensions are valued.

Currently, DB pensions are calculated for certain tax purposes by applying arguably arbitrary multiples to the annual pension they provide. These multiples often understate the true value of DB pensions and result in members of DB pension schemes – generally older generations – paying less tax than they would with a DC pension of an equal value.

State pension reform

The state pension is protected by a 'triple lock', meaning it increases annually by the highest of earnings inflation, price inflation, or 2.5%.

So, no matter how the economy is doing, or what's happening with the incomes or working-age people, the triple lock means the state pension will always rise. This widens the generational income divide.

The furlough scheme might exacerbate this. It may

artificially inflate the extent to which average earnings appear to rise next year – as earnings may appear to rise significantly as employees return from their 80% furlough pay to full pay. Because of the triple lock, This means the state pension may be set for a significant rise just as many young people may be struggling.

Given these issues, and the expense of the triple lock, there have been calls to rethink how the state pension is protected - e.g. by protecting it instead through a double lock, or through a link to long-term average earnings growth.

Expanding auto-enrolment

Pensions auto-enrolment has increased the number of young people saving into a pension – but it doesn't cover very low earners or workers in the gig economy, who tend to be young. Expanding auto-enrolment to these workers could help.

Other proposals have included raising the minimum level of pension contribution employers have to provide, or using approaches from behavioural economics to 'nudge' employees into making higher pension contributions in other ways. These proposals, along with more education about pensions, might help younger workers to save enough money for the retirement they want.

What's next?

Pensions are inextricably linked with intergenerational fairness. Given the disproportionate economic impacts of COVID-19 on younger workers, the issue may well rise up the political agenda. This article has only touched the surface on what we might see, so watch this space.

Micah Smith
Associate

T: +44 20 7919 0644
micahsmith@eversheds-sutherland.com