

**tomorrow's  
company**

a future for business  
which makes equal sense  
to staff, shareholders  
and society

## **The Ageing Population, Pensions and Wealth Creation**



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*Tomorrow's Company*

235-241 Blackfriars Road  
London SE1 8NW

t +44 (0)20 7021 0550

e [info@tomorrowscompany.com](mailto:info@tomorrowscompany.com)

[www.tomorrowscompany.com](http://www.tomorrowscompany.com)

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# Foreword

On average, we are living longer. Never has such a good news story got such a bad press. Demographic time bombs and Doomsday scenarios permeate media coverage. Increased longevity provides us with a splendid opportunity to enrich society.

Traditional responses to increased life expectancy have been both static and one-dimensional. Dependency ratios have been discussed as if the only watershed that matters is that which delineates work and retirement. Retirement ages can be changed and the whole process modernised. State pension age and individual retirement age should be disentangled. Individuals should be encouraged to mix and match work and retirement, pay and pension. What an older worker needs is not a pension but a training opportunity. Others in society are wastefully excluded from the labour market too.

While it is good to encourage our citizens to forego some immediate consumption in favour of saving, they must not be led to believe that increased saving alone will finance unrealistic retirement aspirations. It is ludicrous to define a pension savings gap based on the aggregation of perceived individual needs. Who knows what we will need in 30 or 40 years? Who knows what the economy will bear at that time?

Not for the first time, Tomorrow's Company has challenged conventional wisdom by making a thoughtful contribution to contemporary debate which is both timely and timeless. It does not duck difficult challenges. While economic growth and increased productivity are essential, how do we create a politically acceptable mechanism which will transfer wealth from producer to consumer? However, unlike many other participants in the debate, Tomorrow's Company is asking the right questions and coming up with many right answers. Hopefully, Tomorrow's Company and its ideas will benefit from longevity. Few books are more deserving of a long shelf life than this one.

Alan Pickering CBE  
Watson Wyatt Limited

# Acknowledgements

Tomorrow's Company engages business leaders in asking the difficult questions that everybody knows to be important, but no-one else has time to tackle. This project is a good example. In following up some of the agenda-setting work of the Restoring Trust inquiry, Philip Sadler has brought together a group of experienced professionals who are well placed from both their experience and their intellectual firepower to offer a distinctive voice in the debate.

I would like to thank all the members of the group for their contribution:

- \* Patricia Cleverly - Head of Research, Tomorrow's Company
- \* Jason Coates - Partner, Wragge & Co LLP
- \* Polly Dryden - Trustee of Tomorrow's Company
- \* Jeremy Goford - Former Principal with Tillinghast-Towers Perrin and President of the Institute of Actuaries from July 2002 until July 2004
- \* Chris Hirst - Former Executive Director Investment Management, CIS
- \* Phil Mullan - an economist and business adviser, and non-executive director of Easynet Group.

Special thanks are also due to the Tomorrow's Company staff team Dermot Egan, Judith Pearson, Stacy Peters, Dennis Wilson Cole and Keshav Zarakar; to Dawson Holdings, who kindly hosted a consultative dinner at a key point in the development of our thinking, and to Wragge & Co LLP who kindly hosted the launch event.

Mark Goyder  
Director

# Executive Summary

## Background

Tomorrow's Company published a report in June 2004 - 'Restoring Trust - an inquiry into the effectiveness of the UK investment system' - which was authored by an Inquiry Team made up of representatives from across the financial services industry.

Following on from this, Tomorrow's Company has undertaken this short study which examines some of the issues raised in the First Report of the Independent Pensions Commission, but placed within a wider social and economic context.

The Pensions Commission Report drew public attention to just one aspect of the future age structure of the UK population - the affordability of pensions and how they are to be funded.

The affordability of pensions and how they are to be funded must be looked at in the light of the nation's long-term economic and social objectives and should take account of the other claims on public spending and how these, too, are likely to be affected by demographic factors.

## Challenging the assumptions

In this report, we challenge the assumptions that have created a sense of crisis. We encourage others to widen the horizon of the debate and also to challenge those assumptions.

In particular we challenge both the way in which the terms 'support' and 'dependence' are used and the way in which they are measured. We also challenge the notion that there is a quantifiable savings gap and the idea that it can be closed. The UK already has more wealth in the form of pensions savings than the rest of Europe put together. The problem is that it is unevenly distributed. Over half the population have no significant pensions savings and cannot afford to save the significant sums that are needed. This situation will not be helped by the decline in defined benefit pension schemes.

*We challenge the assumptions that have created a sense of crisis...*

Much store is also placed on people retiring later. However, it is almost certainly the case that as longevity and health improve, or for social reasons, many people will both wish and be able to work longer. What is uncertain is what the level of demand for older workers will be.

It is impossible to forecast accurately what society will look like in 30 to 40 years when ageing might peak in Britain. This is because we are bound to experience much change in many factors over this time - technological, economic, social, political, as well as demographic. It is therefore dangerous to draw up a pensions regime now that supposedly anticipates how society might look like around 2045.

## Assumptions about support and dependence and the measures used

### Defining support and dependence

The terms support and dependence assume a one way relationship. Yet they are rarely all or nothing things. The elderly are depicted as dependent 'takers' but they also give support. Many are financially independent. Even if they do not feature in the employment statistics they pay taxes such as VAT and excise duty and they provide support for the younger generations in myriad ways from more formal voluntary work to childcare.

*The terms support and dependence assume a one way relationship. Yet they are rarely all or nothing things...*

Support can be provided in two distinct ways:

- \* **In terms of real wealth** (i.e. non-workers consume goods and services produced by workers). The question to be answered here is, given future demographic trends, can the UK produce enough goods and services to meet peoples' expectations in terms of living standards? The answer is that provided productivity continues to rise this should not be a problem.
- \* **In financial terms** (via transfer payments). The question here is how can purchasing power be transferred to an increasing number of retired persons in ways that are both politically acceptable and economically efficient? The answer will depend on how 'retired' they are, the level of their financial needs and the courage and vision of politicians and their advisers.

## The measures used

The extent to which the need for support might grow is measured by various 'support ratios'.

The one most commonly used is the 'old age support ratio' which is the ratio of persons aged 65 and over to the numbers of people of working age. This is neither the most useful nor the most relevant measure for the present debate. It ignores the fact that some nine million people of working age do not work.

*A more relevant ratio is the 'economic support ratio...'*

A more relevant ratio is the 'economic support ratio' which relates the numbers of people who are working to the numbers not working i.e. children below the age of 16, adults of working age who for various reasons are not working and non-working people over State Pension Age (SPA).

Using this ratio the change between 2003 and 2041 reduces from a fall of 42 per cent, under the old age support ratio, to a fall of only 13 per cent.

Taking into account that those working have to produce goods and services for their own consumption it is also possible to arrive at a 'total economic support ratio'. This was 0.48, in 2003, and is projected to decline to 0.45 by 2041, at which point it will be almost the same as it was in 1961.

*...the economic support ratios in 2041 will be almost the same as in 1961...*

An important reason for focusing on the economic support ratio is that it shifts attention to employment rates. On the one hand, these are easier to influence than demographic trends. On the other hand, higher employment rates influence the economic support ratio to a greater degree than the crude old age support ratio.

## Assumptions about the role of savings

The second assumption to be challenged is that there is a quantifiable savings gap and that the solution to the ageing of the population is more saving.

The Oliver Wyman report for the ABI estimated the UK's annual savings gap as £27 billion. Of the £27 billion, £11 billion related to households where the annual income is less than £17,500. A further £2 billion related to under 25s on higher incomes, leaving a gap of £14 billion that related to what is usually seen by financial advisers as the target population.

Goldman Sachs made a more recent attempt to quantify the gap. Their report estimated the savings gap at approximately £50 billion.

The failure to distinguish between national savings, including government and corporate savings on the one hand, and household savings on the other, is a weakness of many of the studies of the so-called savings gap. From the viewpoint of the economy and the flow of funds for investment, it is the overall level of national savings, as well as cross-border capital flows, that are relevant.

Savings can help individuals but are not necessarily a good thing for the economy. There is no automatic link between savings, investment in productive resources and economic growth. Indeed, in some circumstances savings can slow economic growth. The only savings that will contribute to the creation of future wealth are those which are directed into productive investment. Retained corporate profits provide the main source of investment in the future growth of the economy.

There is also a failure to distinguish between pensions savings and other savings. The UK already has more wealth in the form of pensions savings than the rest of the European Union put together. The problem is that it is unevenly distributed. Over half the population have no significant savings and cannot afford to save the significant sums that would be needed to support themselves in retirement.

There are strong barriers to overcome if those who can afford to save are to be persuaded to save more:

- \* loss of trust in the financial services industry
- \* the scale of initial charges and management fees
- \* the existence of means testing.

What if savings had stayed at the 1992 level throughout the last 11 to 12 years? According to Geoffrey Dicks, Chief Economist, Royal Bank of Scotland, consumer spending would have been 6 per cent lower by the end of the period, lowering employment by one per cent and pushing the unemployed claimant count above the 1 million mark.

*A weakness of many of the studies of the so-called 'savings gap' is the lack of clear definitions...*

*Over half the population have no significant savings and cannot afford to save and for those who can, there are strong barriers to overcome...*

## Are houses as pension funds a viable alternative?

Funded pension schemes operate through the purchase of financial assets, mainly equities and bonds. In principle, however, there is no reason why the purchasing of housing assets by individuals should not serve the same purpose.

The size of the asset class, £2,250 billion net at the end of 2003, suggests that this is feasible. From April 2006 people will also be able to put residential property into a self-invested personal pension (SIPP), thus enjoying a very substantial tax advantage.

However, if houses are to provide a solution to the problem of retirement income for the majority of homeowners, it will have to be through releasing the equity in their homes to fund retirement.

In any case most houses are worth less than £130,000, while only 10 per cent of homes are worth more than £330,000. It is this latter value which would be needed to secure, via equity release, an income of £100 a week.

The fact also remains that more than a quarter of the adult population do not own a house.

*Ownership of houses can provide retirement income... but many people do not own a house...*

## Assumptions about a later retiring age

Can people working to a later age solve the pensions problem?

When a person stops working is and should remain a matter for individual choice. However, it is almost certainly the case that as longevity and health improve, or for social reasons, many people will both wish and be able to work longer. What is uncertain is what the level of demand for older workers will be.

The priorities should be to increase the proportion of men and women between the ages of 50 and 65 who are working and continue to create greater scope for flexibility in the approach to retirement and to get away from the traditional all or nothing assumption.

*Many people will both wish and be able to work longer but what will be the level of demand for older workers?...*

# Wealth creation and distribution

There are two big questions:

1. How can a working population that is expected to remain around 27 to 28 million create sufficient wealth over the next 35 years to support an additional five million pensioners?
2. How can wealth be transferred from the wealth creators to the dependent population by means that are politically and socially acceptable?

Whatever the funding arrangements, pensions are provided out of the current wealth creation of people at work. Different arrangements, whether pay-as-you-go or funded schemes, are just different ways of accumulating or exercising claims on this wealth. Without funding it is taxation that makes the transfer from wealth creation to pensions.

The main factor affecting our ability to afford an ageing population without the erosion of living standards is the impact of rising productivity. More than anything else, rising productivity explains the paradox that ageing societies have simultaneously become wealthier.

At a mere 1.75 per cent productivity growth per year, by 2045, an average British worker will be about twice as productive as today. In other words, a doubling of new value and resources being produced while the number and share of over 64s grows by less than 50 per cent. Our ability to manage the implications of an ageing population based on a change in the total economic support ratio of 7 per cent should not be an issue as long as our future ability to create wealth provides the flexibility to adapt should this ratio change dramatically. This will depend on a number of factors that promote innovation and productivity growth, among which the following are the most important:

- \* to have a strong corporate sector of companies of all sizes that are globally competitive
- \* to continue to be an attractive choice for foreign direct investment for world-class companies with world-class research facilities in such fields as bio-technology, nanotechnology, new sources of energy and other 'horizon' industries
- \* a quality of education at every level from pre-school to the universities which matches the highest international standards
- \* greater emphasis on skills training
- \* hi-tech business start-ups and more of these developing into major companies
- \* a much-improved national transport infrastructure and the adoption of modern telecommunications technologies
- \* more long-term investment projects.

*Whatever the funding arrangements, pensions are provided out of the current wealth creation of people at work...*

*More than anything else, rising productivity explains the paradox that ageing societies have simultaneously become wealthier...*

# An agenda for change

There is no ageing crisis. As a society we can afford to grow old. Rising productivity can outweigh any negative impact on living standards arising from an ageing population.

## An agenda for government

### Changes to the basic state pension

There is a growing consensus, among expert groups, favouring a universal taxation-funded state pension. This would remove the deterrent to saving created by means testing, would greatly improve the position of women and give the poorest people in our society a firm promise of a degree of security in old age.

*There is a growing consensus favouring a universal taxation-funded state pension...*

It would have the important virtue of simplicity, both in administration leading to lower costs, and in terms of being understood by the public. Calculations carried out by the Pensions Policy Institute have demonstrated its affordability.

The need is to establish this as the objective of government policy and set a timescale for its achievement over the next five years. To achieve this would call for the ending of means testing and of contracting out.

### Removing barriers to later retirement

When a person stops working is and should remain a matter for individual choice.

Whilst there are steps being taken in the right direction, there is a need to continue to focus on creating flexibility in the approach to retirement through, for example, greater provision for part-time and temporary employment and changes in employer attitudes.

*...the level of productivity of the future workforce is more important than its size...*

## A quinquennial approach

We can approximately assess the impact of the changing age structure on the demand for such things as healthcare, education and pensions, but we can only guess at the resources that will be available by 2040 with which to meet the demand.

Provided there is no major shock to the economy in the immediate future we can make reasonable estimates for, say, the next five years and begin learning about adapting to the increase in ageing. We can repeat the process each quinquennium thereafter and so on until the baby boomer bubble has worked its way through.

*...make reasonable estimates for, say, the next five years and repeat the process each quinquennium thereafter...*

## An agenda for government and companies

### A focus on wealth creation and employment opportunities

The fundamental reason why ageing populations are affordable in developed countries is that rising productivity will outweigh any potential negative impact on improving living standards arising from an increase in the proportion of elderly non-workers.

Greater prosperity can both allow everyone's living standards to improve and also allow society to adjust to any challenges it may face in the future, including those of funding relatively higher levels of retirement income than those currently prevailing.

A highly competitive economy arising from both public and private investment, and from innovation and enterprise, is the best means of ensuring that the predicted crisis does not materialise. Most of the energy and discussion about the implications of an ageing population would be better spent on helping to ensure a strong economic foundation for wealth creation into the future and continuing to focus on creating flexibility in the approach to retirement.

*Greater prosperity can both allow everyone's living standards to improve and also allow society to adjust to any challenges it may face...*

## Implications for companies

The shift from defined benefit schemes, together with the generally lower rates of employer contribution to defined contribution schemes has rapidly shifted the risk of pension provision from companies to individuals. As time unfolds, the role of companies in pension provision will decline substantially. However, companies will continue to be the underlying source of pensioners' incomes in real terms. This is because the prosperity of the country in future years, and hence its ability to afford pensions that provide a reasonable standard of living, will be a function of the wealth creating capability of industry.

*...companies will continue to be the underlying source of pensioners' incomes in real terms...*

## Implications for the financial services industry

### Restoring the 'loss of trust'

In 2004, Tomorrow's Company published 'Restoring Trust - an inquiry into the effectiveness of the UK investment system'. This report made a number of recommendations, the principal ones being the creation of a forum for self-regulation supported by an overarching 'statement of principles'. The recent decision to set up a 'Financial Services Forum' is a move in the right direction and it is hoped that the structure will include:

- \* the development of a set of principles and standards against which the industry commits to be judged
- \* the setting of targets for progress and continuous improvement, including regular indicators of the financial awareness of consumers; whether treated fairly, and trend indicators of the proportion of people's savings swallowed up by commission, charges and other costs.

*...the establishment of a 'Financial Services Forum' is a move in the right direction... but needs further development...*



**The Ageing Population, Pensions and Wealth Creation** is the result of a study by a Tomorrow's Company Research Group, led by Philip Sadler. The report argues that there is no 'pensions crisis' and that as a society we can afford to grow old. It challenges a number of the common assumptions often used in the 'crisis scenario' and highlights the link between wealth creation and rising productivity and the ability to pay future pensions.

**Tomorrow's Company** is a not for profit research and agenda-setting organisation committed to creating a future for business which makes equal sense to staff, shareholders and society. Its business-led programme of publications, events and activities focuses on three issues fundamental to the future of business:

- \* an improved investment system
- \* an inclusive approach to leadership and governance
- \* closing the gap between business and society.

Having had a strong influence on business leadership and governance in the UK, Tomorrow's Company is now approaching these issues on an international basis under the theme of Tomorrow's Global Company.