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# 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

**www.tomorrowscompany.com**

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Contents

# 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
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* Polly Dryden – Trustee of Tomorrow's Company
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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.

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

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.

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'.

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

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' 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.

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

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.

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.

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

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.

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

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.

## 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.

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

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.

## 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.

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

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.

# 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...*

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:

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

- 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.

# 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 favouring a universal taxation-funded 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.

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

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

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.

However, the most important issue to bear in mind is that 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.

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

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.

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

## 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.

## Implications for the financial services industry

### Restoring the 'loss of trust'

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

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 Study - The Ageing Population, Pensions and Wealth Creation

# Part 1 - Introduction

*"We have reached a point where it is essential to move the debate beyond the narrow view on the technical parameters of pension schemes. A wider consideration of the social and economic factors influencing whether we will be able to build financially sustainable and adequate pension schemes for the future is needed"*. Dalmer Hoskins.[1]

In June 2004, Tomorrow's Company published 'Restoring Trust - an inquiry into the effectiveness of the UK investment system' - which reported the findings of a research programme led by an Inquiry Team made up of representatives from across the financial services industry.

Following on from this, Tomorrow's Company has carried out the study reported here which examines some of the issues raised in the 2004 Report of the Commission on Pensions, but placed in a wider social and economic context.

The pensions issue is only one of a number of implications of an ageing population and it is important to consider it in context. 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.

This study:

* examines and questions some of the assumptions on which much of the pensions debate has been based
* considers the viability of some of the solutions being proposed
* suggests some alternative ways of looking at the key issues
* sets out an 'Agenda for Change' for government and companies and the implications for companies and the financial services industry.

# Part 2 – Questioning the assumptions

## Introduction

The most common argument presented in the pensions debate, including in the First Report of the Independent Pensions Commission, is that the ageing population is 'unaffordable' and pensioners will become poorer relative to the rest of society unless one or a mix of three things occur:

1. taxes/National Insurance contributions devoted to pensions must rise
2. savings must rise
3. average retirement ages must rise.

Whatever arguments may be made about pension reforms or about the impact of changes to falling birth rates and longevity, the core argument often presented is that nothing can alter the negative economic impact resulting from an ageing population.

*The old age support ratio is used to substantiate the unaffordability of an ageing population... but the reality is that society can afford to grow old...*

Pessimism about the unaffordability of an ageing population invariably relies for substantiation on the old age 'support ratio' or its inverse, the 'dependency ratio'. We will summarise several ways in which this assumption breaks down and leads to false conclusions. The reality is that society can afford to grow old.

Furthermore, there is a need for clarification of the meaning of 'support'. Does it mean support from taxation or in the sense of consuming goods and services produced by the working population?

## What is support? What is dependence?

'Dependence' and 'support' are complex and multi-faceted concepts. They cannot be meaningfully represented by a single number, fraction or percentage.

*Society comprises people who are interdependent in all sorts of ways – non-financial as well as financial...*

For a start, the terms 'support' and 'dependence' presume a one-way relationship that is misleading. Society comprises people who are interdependent in all sorts of ways – non-financial as well as financial. For example, there's a tendency to view the elderly as dependent 'takers', but they also give 'support' too. Even if they do not work, they are sources of demand in the economy through their spending, they pay taxes and they support younger generations in myriad ways such as childcare, formal and informal mentoring and voluntary work.

Interdependence is also not something confined to a particular point in time. Most elderly people who are not working or are otherwise 'inactive' today were in the past the workers who created the foundations of today's prosperity, and today's wealth creators will be tomorrow's 'dependants'.

*...support and dependence are rarely all or nothing things...*

Also support and dependence are rarely all or nothing things. For example, very few young people have independent means for living: most are to a very large degree financially dependent on others. However many people, such as some unemployed people and many retired people, are likely to have built up a stock of resources, savings, property and other assets, which they are able to turn to when not working as a source of income, either temporarily or permanently.

Focusing for a moment on the elderly without any independent means, their support requirements also vary considerably:

* everybody above the State Pension Age (SPA) is entitled to draw a state pension, but only some need healthcare and even fewer, about one in five today, will need long-term care at some point
* support needs tend to change over time and fluctuate up and down. Healthcare, for example, is a sporadic requirement. Someone may have a costly operation in their late 60s but be fully fit and healthy and able to work again during their 70s and 80s.

# Assumption 1 - The support ratio

## Introduction

The old age support ratio is the statistic most often used in debates about the future of pensions. This ratio measures the relationship between two age sections of the population: the 'working age' group, usually measured as the 16 to 64 year olds and the group of 65 year olds and over, who are designated as 'dependent'.

In most developed countries this support ratio is projected to fall from about 3 or 4:1 today, to about 2:1 half way through this century.[2]

Take those life expectancy increases plus forecasts of fertility and immigration, and the ratio of people above 65 to people of working age, or at least what we used to define as 'working age' is going to go from about four today to about two in 2050.[3]

The shorthand conclusion of this ratio is that each person of working age will have to support about double the number of elderly dependants compared with today. Superficially, the pure numbers would suggest that in financial terms we face a substantially more challenging future.

However, despite the fact that it is so often quoted, this ratio tells us nothing about the economics of an ageing population. It is misleading to the point of being meaningless. The composition of the population is very different to the crude two-sector model implied, with working age people (who are assumed to work) supporting the elderly (who are presumed to be totally financially dependent).

## What is wrong with the assumption?

### Not all old people need support

Not all old people are financially dependent and in need of support.

Some have substantial assets built up earlier in their lives that they could live off, not least homes with significant positive equity.

*More elderly people will remain employed even as they simultaneously become state pensioners...*

Some elderly pensioners work and as healthy life expectancy grows more will be able, and want to do so. In almost every industrialised country the trend towards later working is strengthening.[4] Although in 2004 only about 4 per cent of people aged 65 and over in the EU were in work, this compared to a rising UK rate of about 6 per cent and a rising US rate of about 14 per cent.[5]

Anticipated rises in healthy life expectancy, as well as the relative decline in 'heavy' industrial employment, make working in one's 60s and 70s even more feasible in the future, assuming that the jobs are available. So, more elderly people will remain employed even as they simultaneously become state pensioners.

## Support is capable of more than one interpretation

*...those who are not working are supported in their consumption by the production of those who are...*

**Support by producing goods and services**
One way in which support and dependence can be viewed is with regard to the production and consumption of goods and services. In the end, all consumption is out of the current production of goods and services. Therefore, as a general rule, those who are not working are supported in their consumption by the production of those who are.

It can be argued that international trade modifies this in practice. Goods can be imported, as can some services but this does not really change the basic relationship of support /dependence. Ultimately, in any economy, imports will have to be paid for by the export of other goods and services or by the sale of assets.

**Support from taxation**
From a tax funding perspective it is harder to distinguish dependant from supporter.

*From a tax funding perspective it is harder to distinguish dependant from supporter...*

The terms 'worker' and 'taxpayer' are not synonymous. Although most workers pay income tax, those who do not work also pay taxes of one kind or another, such as VAT, excise duty or property tax.

Even though the average total tax contribution from pensioners will be well below that for many younger people, most commentators ignore the pensioners' contribution completely. Some 1.3 million retired people pay more in taxes than they receive in benefits. This moves them from the 'supported' to the 'supporter' category.

The latest figures, for 2002/2003 show that the top 20 per cent of retired households in terms of disposable income paid £8,392 in taxes and received £7,557 in pension and benefits from the taxpayer (some of which, such as the disability living allowance were not age related).[6]

At the same time, many workers owe their employment to tax spending:

* in Britain at least a quarter of everyone in jobs works for the public sector. Taxation pays these wages directly
* many others working in the private sector are dependent on government expenditure and contracts that are also tax-financed.

*Many workers owe their employment to tax spending...*

Government in Britain spends about £125 billion a year on goods and services from the private sector.[7]

There has been steady growth in public sector employment since 1998 and in the first quarter of 2004 it is up 583,000 in total. In the year to March 2004 public sector employment increased by 146,000.[8]

Highlighting one element of tax dependence, public old age pension payments, tells us little about what is happening to most of the other tax dependencies, and therefore the impact on the total level of society's dependency on tax and on the corresponding overall required tax take.

There is also the matter of priorities. More spending on pensions might be offset by less spending on education, defence or health.

## Misleading distortions of the old age support ratios

### Not all working age people are in employment

The old age support ratio ignores the fact that a large number of people of working age do not work. These comprise the unemployed, full-time carers, those over 16 remaining in education, those unable to work and those who are in early retirement.

*The use of age support and age dependency ratios ignore the fact that a large number of people do not work...*

In most developed countries about a third, or more, of the working age population are not in jobs.

In the UK, the total economically inactive working age people rose to nearly 8 million by October 2004 (21.5% of the working-age population), but has since shown a very slight reduction.

Young dependants are usually those aged 0-15, and old dependants are those of state pension age (65) or over. Those in between are the potential workforce. These definitions are controversial in themselves, since in the UK 43% of young people go into higher education and can therefore be dependants until about the age of 21. In 2004 more than a million people entered higher education. A study by Professor Gill Jones of Keele University found that the age of independence is now "effectively 24" [The parenting of youth: social protection and economic dependence, 11 August 2004]. The trend is attributed to more young people continuing in education, particularly those from middle-class families. The survey concluded that "government policies affecting young people tend to assume that basic maintenance will be subsidised by parents into the mid-twenties", with 61% of people interviewed (aged 16-25) saying that their families had "helped a lot", 16% that they received "little or no assistance", and only 39% that their parents "could have afforded to help more". Another survey, by the online bank Egg, revealed that more than 500,000 parents are still giving money to children over the age of 30, with financial support for nearly 150,000 children extending beyond the age of 44. [Egg, 11 November 2004] It is possible that young dependants are a higher economic burden than old dependants, to both parents and the public sector.

Dependency ratios in 1976 were: 42.1 children (under 16) and 29.5 older people (males 65 and over and females 60 and over) per 100 people in the potential workforce - a total of 71.6 young and old dependants per 100 of working age. [Table 2.2 Key Demographic and health indicators, Population Trends 113, Autumn 2003]. In 2003 the dependency ratios were 31.8 children and 29.9 of pension age (total 61.7) per 100 people in the potential workforce - a marked improvement since 1976. Paradoxically, there has recently been a high level of concern about dependency ratios, while there was little concern about the much higher dependency ratios in 1976.[9]

The use of the old age support ratio is misleading; and just as misleading as assuming that all people aged 16 to 64 are employed.

## Falling birth rates

It is also misleading to focus on the old age support ratio because it does not take into account the offsetting effect of a fall in the number of young people.

It is well recognised that historically the ageing population is more a result of falling fertility than of rising longevity. Although the latter has become a more significant influence in developed countries since the 1970s, falling and now persistently low fertility remains important in understanding demographic trends over the next 40 years, as the large baby boom generation is succeeded by much smaller cohorts.

*Falling birth rates tend to be overlooked in the old age support ratio discussion...*

Falling birth rates are usually factored in to the demographic projections as a driver both of ageing and in reducing the size of the working age population, but tend to be overlooked in the old age support ratio discussion. Low fertility produces a fall in the number and proportion of the age group that more than any other can be legitimately labelled as 'dependant' and in need for support from others - children under the age of 16. Child 'support' ranges from material and financial dependence, usually on their parents, to relying on educational facilities and health care.

At the end of the next 35 years, by 2041, the official British projections are for 600,000 fewer children representing a fall in their ratio of the working age population from 29 per cent to 26 per cent.[10] It is therefore more reasonable and accurate to include this additional demographic change to provide the total picture.

While Britain's old age support ratio falls from 4.1 in 2003 to 2.36 in 2041, a decline of 42 per cent, the fall in the total age support ratio (of young and old) is much less, by 23 per cent from 1.92 to 1.47.

Great Britain (GAD figures, 23 December 2004):[11]

| | 2003 | 2041 | Change |
|---|---|---|---|
| Old age SR | 4.1 | 2.36 | -42 % |
| Total age SR | 1.92 | 1.47 | -23 % |

## The alternative – the economic support ratios

*The economic support ratio is a much better measure of real 'support' relationships than the old age support ratio...*

The economic support ratio is arrived at by relating the numbers of people who are working (including those over SPA) to the numbers of people not working e.g. children below the age of 16, the unemployed, and those not able to work.

The economic support ratio is a much better measure of real 'support' relationships than the old age support ratio. As we can see in the table below, the economic support ratio gives a much less dramatic picture of the future than the old age support ratios used by the Pensions Commission and others. For completeness, the pensioner support ratio is included, which in effect adjusts the old age support ratio for the equalisation of the female SPA from 60 to 65 between 2010 and 2020. This includes women between age 60 and 64 within the working group prior to the increase in their SPA.

Great Britain (GAD figures, 23 December 2004):[12]

| | 2003 | 2041 | Change |
|---|---|---|---|
| Old age SR | 4.1 | 2.36 | -42 % |
| Pensioner SR | 3.4 | 2.36 | -31 % |
| Economic SR | 0.92 | 0.80 | -13 % |

*The importance of economic support ratios, rather than the old age support ratio, is recognised but then ignored...*

Some other parties discussing the economic impact of demographic ageing have, themselves, noted the more modest shift in the economic support ratio. Unfortunately, it is often relegated to a brief aside or a footnote. For example, the Economic Policy Committee of the European Commission recognised this essential point back in 2001:

> *'the key variable is not so much the old-age dependency ratio, but rather the balance between economically active and inactive persons…. Whereas the old age dependency ratio for the EU is projected to double in coming decades, the economic dependency ratio will only increase by one-fifth'.*[13]

Although recognised, this point does not appear as the 'key variable' in their conclusions nor, as far as we are aware, in any other official EU paper that has since been written.

Bearing in mind that those who are working have to produce the goods and services for their own consumption, as well as for the rest of the population, it is also possible to arrive at a total economic support ratio relating workers to the entire population, as follows:

| | 2003 | 2041 | Change [14] |
|---|---|---|---|
| Total Economic SR | 0.48 | 0.45 | -7% |

On average, each worker already supports themselves and one-and-a-bit more other people.

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

Whether the economic support ratio or total economic support ratio is used, it is difficult to make the level of change over the next 40 years appear particularly menacing.

The fact that these ratios will fall to 0.80 and 0.45 by 2041 is even less a cause for concern given that the ratios in 1961 were almost the same at 0.81 and 0.45 respectively.[15]

| | | | | Change [16] |
|---|---|---|---|---|
| | 1961 | 2003 | 2041 | 2041/1961 |
| Economic SR | 0.81 | 0.92 | 0.80 | -1 % |
| Total Economic SR | 0.45 | 0.48 | 0.45 | 0 % |

# Conclusion

*Employment rates are much more subject to our control and active intervention than the age structure...*

The benefit of focussing on the economic support ratios is that they shift the focus to the work situation rather than age. This has two consequences:

1. First, employment rates tend to be much more influential on movements in the economic support ratio than the pace of ageing. This has certainly been the case in the past. Chris Shaw, from the UK's Government Actuary's Department, reported:

   *"Research shows that changes in workforce participation rates have in the past been a more important factor than demographic trends in influencing real (economic) dependency."* [17]

   This is an easy point to demonstrate historically, though it is rarely done. For example, one analysis of the period from 1979 to 1994 showed that labour market changes affecting the size of the employed population, including making an adjustment for the shift that occurred from full to part time employment, were three times as large as the change over the same time in the population over SPA.[18]

2. Employment rates are potentially much more subject to our control and active intervention than the age structure.

*...the improved well-being of future generations would be better served by focusing on economic growth, employment availability and employment opportunities...*

The improved well-being of future generations would be better served by focusing on economic growth, employment availability and employment opportunities.

# Assumption 2 - The solution is more saving

## Definitions of saving

The failure to make clear what the different roles of government, corporate and household savings are and to distinguish between pensions savings and other savings at the level of the household are weaknesses 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.

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

"In judging whether the British people save enough the right procedure is to look at the rate at which they build-up savings in general and the rate of return on their investments. Further, analysts must not confuse 'the savings of the personal sector' with the entirety of the savings that people make. The key point here is that companies, financial institutions and even the government itself have no economic purpose other than to serve 'we the people'. If a company retains profits and invests on behalf of its shareholders, those investments belong to the shareholders (i.e. people); if a life insurance company makes successful investments and massively increases the value of its life fund, the fund belongs to its policyholders. Companies, financial institutions and the government are legal fictions, and ultimately the economy consists only of people and things. The correct concept of saving is therefore not the personal savings ratio, but the savings ratio of the nation as a whole."
Tim Congdon.[19]

"…the relevant measure is not "household savings" but the UK national savings ratio. And this – at around 17 per cent — has been reasonably consistent over a 55-year period." Tim Congdon.[20]

Household gross saving in the first quarter of 2005 amounted to 4.8 per cent of GDP, corporate saving making up the balance.[21]

In 2003 the household sector had £3,076bn in financial assets of which some £1620bn took the form of pension or life insurance funds. Households also held some £3,424bn gross in housing equity.[22]

In everyday speech, investment can mean the same as savings. The purchaser sees the buying of shares or bonds as an investment. In a more precise sense, the term 'investment' describes the process of allocating current wealth for the purpose of creating wealth in the future. This may involve fixed capital formation such as buying plant and machinery or buildings (treated as capital expenditure in accountancy practice) or take less tangible forms such as the allocation of funds to research and development, education or training (normally treated as current expenditure).

*The only savings which will contribute to the future growth of the economy are those directed to investment in productive resources...*

The relationship between savings and investment thus defined is extremely complex, but it should not be assumed that a given level of savings leads to a related level of investment of the kind likely to stimulate growth in the economy. Indeed, in some contexts, savings and investment are opposites, for example companies retaining earnings but not investing in new projects.

The only savings which will contribute to the future growth of the economy are those directed to investment in productive resources. Most of the money invested in productive assets derives from retained company profits, i.e. corporate savings, rather than from household savings.

## The 'savings gap'

The Oliver Wyman report for the Association of British Insurers, defined the savings gap as the difference between the amount currently being saved and the amount that needs to be saved in order to secure an acceptable retirement income for all UK citizens.[23] Three of the key modeling assumptions used in arriving at these conclusions were:

* a retirement age of 65
* an average annual investment return of 7 per cent gross
* an acceptable post retirement income level of 68 per cent of income at retirement.

The report concluded that the UK's annual savings gap amounted to £27 billion. To close this gap would require a 54 per cent increase in the amount currently being saved. Of the £27 billion, £10.7 billion related to households where the annual income is less than £17,500. A further £2.5 billion related to under 25s on more than £17,500, leaving a gap of £14 billion that related to people more able to afford to save.

Goldman Sachs has made a more recent attempt to quantify the gap:

> UK saving is too low. Even without the ageing problem, official data indicate that national saving is around 1.5% of GDP below the level necessary to sustain the domestic capital stock and keep the current account in balance. But a bigger problem is the prospective decline in the working-age share of the population. In proportionate terms this will drop by close to 10% over the next 30-40 years. Without higher employment, output per head will fall by the same margin, relative to base; without higher saving, so will average consumption. Factoring in these demographic prospects and assuming current age-specific employment rates, the UK's current "savings gap" rises to 4.5% of GDP, over £50bn.[24] (2005)

The paper then looked at what the country needed to save to offset the effects of an ageing population. Allowing for the possibility that this can be partially offset by longer working, the conclusion was that it would require more saving, perhaps £30 billion a year on top of the £17 billion. Rounded, the savings gap was estimated at £50 billion.

*The additional level of saving required would send the economy into recession and place a considerable burden on the state...*

Does this mean that households in the UK should be saving an extra £50 billion a year towards pensions? Leaving aside the sheer feasibility of this, not only is the loss of demand of approaching 5 per cent of GDP likely to send the economy into recession, but such an amount of money would severely test the capacity of the savings industry and probably result in lower returns, as well as placing a very considerable burden on the state in terms of tax relief and lower tax receipts. Additionally, much of what is being saved today by individual households will be liquidated long before the savers in question reach retirement age and will not help to provide a pension.

*...much of what is being saved today by individual households will not help to provide a pension...*

# Can the savings gap be closed?

## Why people save

People save for a number of different reasons other than for a retirement income.

Some savings are for a specific purpose, such as saving for a deposit on a house, car purchase, children's education or a family wedding. Other saving is much less purposeful and may be prompted by the urge to put something aside for a 'rainy day' or by having been taught the value of thrift. There is, however, an important residual element that reflects people simply not spending all that they earn.

## What are the barriers to increased household pensions savings?

**Those on low incomes cannot afford to save**

The most important barrier is that very many people cannot afford to save significantly for retirement other than through an occupational scheme in which their contributions are supplemented by a significant employer contribution.

The decline in the numbers of defined benefit (DB) schemes means that membership will decline over the next thirty or so years. The replacement of DB schemes by Defined Contribution (DC) schemes is resulting in much lower levels of take-up and much lower levels of employer contribution.

72% of employees earning between £25,000 and £39,999 were in an employer sponsored scheme in 2003 but only 43% were in the £9,500 - £17,499 earnings band.[25]

In 2003, 80 per cent of stakeholder schemes had no members and only 13 per cent of employers were contributing to such schemes. The participation of employers is crucial in that where they do contribute average scheme membership is in the region of 69 per cent.[26]

In addition, the rising level of personal debt not only impacts on people's disposable income which could be put towards saving, but for many people repaying their debts is a financially more beneficial use of spare funds than saving.

*One third of households have no savings...*

Total pensions contributions were £69bn in 2004 of which £15bn were to personal schemes and £37bn to funded and £18bn to unfunded occupational schemes.[27]

In the financial year 2003-2004 some two thirds of both men and women in full time employment in Great Britain were members of a pension scheme, 55 per cent of men and 56 per cent of women belonging to an occupational scheme.[28]

The figures above tie in with the family resource survey, 2002/3, which showed that one third of households had no savings and a further 20% had less than £1500. Only 13% had non-pension savings of £20,000 or more.[29]

As at August 2005, total net lending to individuals has reached £1122.3bn of which £190.5bn was consumer credit.[30]

Those who can afford to save also face several barriers, amongst which the following are probably the most important:

### Loss of trust

*"The trust gap is real – among young and old alike. And that gap extends to government and employers, not just the pensions and investment industry. Putting the needs of ordinary people at the heart of pensions reform – with fairer savings incentives, affordable access to basic financial advice and low cost, safe savings products – is vital to closing that gap."* Ed Mayo.[31]

Trust in the integrity of the financial services industry has been eroding. A series of mis-selling scandals and the collapse of Equitable Life are amongst the things that have served to undermine the level of trust in the integrity of the financial services industry. These problems reflect lack of transparency, lack of alignment between the interests of investors and those of intermediaries and the failure to manage endemic conflicts of interest. The benefit of active fund management has also been questioned given that justification for the higher fees charged is not always evident in terms of out performance compared with passive funds.

*Trust in the integrity of the financial services industry has been eroding...*

**Means-testing of benefits**

Means-testing can penalise savers to such a degree that they might as well not have bothered to save at all - they will effectively be taxed on their savings at the higher rate.

According to Tim Keogh, of the actuaries Mercer, a single man now needs to save £95,000 before retirement just to match his entitlement to state benefits. Because women tend to live longer, a single woman would need to save £107,000 to buy the same income from an annuity that the state will provide. Couples need to save £144,000. Anyone saving less has wasted their time and could have spent the lot and received the same income in benefits.[32]

Around 70% of all pensioners are likely to be eligible for the means-tested pension credit by 2050. In total, the number eligible could double from around 5.5 million in 2004 to around 11 million pensioners by 2040, taking into account the ageing of the population.[33]

As Jeremy Warner stated in an article in The Independent:

> *"It makes no sense for the low paid or even some middle income earners to save for retirement, as it only deprives them of spending power while the amounts involved are likely to be too small to provide any more than a pittance in retirement."*[34]

Also, as the Guarantee Credit is expected to be linked to earnings while the basic state pension is linked to price inflation, more and more people will be drawn into claiming means-tested benefits.

*The impact of means-testing means that it makes no sense for the low paid or even some middle income earners to save for retirement...*

As things stand, so many of the population will qualify for income support in retirement that whether the money is paid as a means-tested minimum income guarantee or on some other basis may be relatively unimportant from the point of view of the cost to the state. One way or another, the state will have to find the funding, and the cost of administering whatever process is adopted should be an important consideration.

## The cost of advice and management of funds

*The total cost base of the life assurance industry last year was about £12 billion. That is commission, administration and so forth. That is around about £570 per household in the UK.* Ned Cazalet.[35]

*The level of charges and the cost of annual management charges reduce the benefits far more than customers appreciate and make savings particularly unattractive when inflation is low and returns are falling below 7 per cent a year...*

Saving is not a natural choice for most individuals. It usually takes the intervention of an employer, an adviser or a salesman to prompt the process of deferring consumption to a later date. The level of charges and the cost of annual management charges reduce the benefits far more than customers appreciate and make savings particularly unattractive when inflation is low and returns are falling below 7 per cent a year. The financial service industry's business model relies on distributing products through financial advisers paid by commission from the providers.

*"the objections (to commission control) on anti-competitive grounds seems … misconceived … it can never be to the advantage of the public to permit insurance companies to compete with one another … by escalating their commission rates"* Mike Kipling quoting Professor Gower.

*"Shortly after the FSA was implemented, some of Gower's worst dreams rapidly came true. Sir Gordon Borrie's OFT objected to the Maximum Commission Agreement on anti-competitive grounds. It was removed … The result was that commission rates to IFAs rose, on average by perhaps 30% but with instances of much higher rates."* Mike Kipling.[36]

The view of the Office of Fair Trading (OFT) that a maximum commission agreement would be anti-competitive is unchanged to this day and commission rates have continued to rise on products unfettered by statutory limits on their charges. It would be helpful to savers if the OFT would revisit this logic.

Commission also diverts advice towards products that pay commission. For example, advice on repaying debt does not attract commission in the same way as selling an investment bond.

The current structure of remunerating Independent Financial Advisers (IFAs) is by commission on products sold (with the option of a fixed fee), not on the advice or on the quality of that advice. The logical behaviour of a saver to such a structure would be to take the (free) advice and buy a commission free product directly from the provider. The fact that that doesn't happen is further evidence of a far from perfect market in unregulated commission.

Disclosure is not working either. Even Gower's expectations of disclosure were not realised.

*" disclosure [of commission in cash terms] would "probably lead to far fewer sales of life insurance since a client would often be shocked to find how much the salesman would earn on the one sale to him – not realising that that may have followed many abortive and unrewarded attempts to sell to others."* Mike Kipling quoting Professor Gower.[37]

**Incentives to save**

According to a recent study by the Pensions Policy Institute the effectiveness of tax incentives to save is unproven.[38]

There is no evidence that tax incentives increase the overall level of saving. They are complex, and do not solve the basic problem for most low income people - that they do not have the money to save. All taxpayers pay for the tax incentive system, but it benefits higher earners most.

*There is no evidence that tax incentives increase the overall level of saving...*

**No-one wants to take the risk of pension provision**

There are three major sources of financial provision in old age; the state, employer pension schemes and other personal savings. For the retired population as a whole, the relative amount of provision from each source is difficult to determine because of the difficulty in ascertaining provision through the realisation of personal assets such as property. However, state provision as a proportion of the total has undoubtedly been declining over the past twenty years because state pensions have been linked to increases in the Retail Prices Index rather than average earnings.

*State provision of pensions has been declining... and DC pension schemes and personal savings provision put the investment risk with the individual which may discourage voluntary saving...*

A further more recent change is the rapid move away from DB pensions provision by private employers, usually to DC provision which is almost invariably accompanied by a reduction in the funding rate by the employer. DC pension schemes and personal savings provision for old age put the investment risk fairly and squarely with the individual.

This risk may discourage people from making voluntary savings for retirement so increasing the proportion of the retired population claiming means tested benefits.

## 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.

*...more than a quarter of the adult population do not own a house...*

The size of the asset class, £2,250 billion net at the end of 2003, suggests that this is feasible.[39] From April 2006 people will be also be able to put 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.

The fact also remains that more than a quarter of the adult population do not own a house.[40]

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.[41]

It may be that inheritance will play a part in enabling housing wealth to be used to provide pensions. Now that owner-occupation has become so common, more and more people may inherit their parents' property in addition to owning their own. Any inherited property can then be sold to provide a capital sum that will buy a pension in just the same way that a maturing pension policy does. However, in many cases in England and Wales, property values will be absorbed by the need to provide care.

## Should the Government be encouraging, let alone compelling people to save more?

There are a number of problems with compulsion whether at the employer or individual level:

* relying on employers for compulsory contributions, as in Australia, would increase the burden of employing people with a possible knock on effect on the level of employment
* compulsory contributions from individuals are just a disguised form of tax
* compulsion undermines the principle of savings being a matter of individual choice
* as already discussed, compulsion does not solve the problem of those who cannot afford to save
* compulsory saving would lead to a huge increase in the cost to the taxpayer in extra tax relief
* saving through compulsion may simply substitute for voluntary saving and therefore have no net impact on the overall level of savings
* any resultant fall in consumer spending could damage the economy.

*There are a number of problems with compulsion whether at the employer or individual level...*

The Independent quoted research by Geoffrey Dicks, the Chief Economist at Royal Bank of Scotland, who posed the question:

> *"What if savings had stayed at the 1992 level throughout the last 11 to 12 years?"*

The answer is not an economically, or politically attractive one. According to Mr Dicks:

> *"consumer spending would have been 6 per cent lower by the end of the period, lowering employment by 1 per cent and pushing the unemployed claimant count above the 1 million mark."* [42]

*"If people with occupational and personal pensions doubled their contributions that would cut consumer spending by £38bn or 3.8 per cent of GDP. The Treasury would also have to pay out an extra £4.6bn in tax relief - equivalent to 1.5p on the basic rate of income tax. Another way of looking at the same problem is to assume that the savings ratio is doubled from its current exceptionally low level of 5.5 per cent of household income to its 1992 peak of 11.5 per cent. This would mean savings £46bn higher and consumer spending £46bn lower."*
Geoffrey Dicks.[43]

*"Some people and institutions, faced with those barriers, urge the Pensions Commission to recommend compulsion. And we know that many individuals say that they would like to be compelled to save: but we also know that many say very clearly that they do not want to be compelled. And we know that resolving that conflict by saying " well let's just compel employers not employees" – is not an answer since there is a wealth of economic theory to suggest that in the long-term compulsory employer contributions will be at the expense of cash wages. Indeed in the major developed country which has introduced compulsory pension savings in the last two decades – Australia – that trade off – pension contributions instead of cash wage increases was a deliberate aim of the policy, recognized by government, employers and unions alike. Finally, we know that simply compelling people to save doesn't necessarily fix the cost efficiency problem – Australia again is a case in point. They have compulsory savings, but high annual management charges."* Adair Turner.[44]

There is, however, considerable support for 'auto-enrolment', the process whereby new employees are automatically presumed to be members of their employers' pension schemes unless they decide to opt out. This would, at least, ensure that where employers do provide occupational pension schemes their employees would be more likely to join them than not. However, it would do nothing to persuade more employers to start schemes in the first place, and might well have the opposite effect.

# Conclusion

Attempts to estimate the 'savings gap' are missing the point.

There is little possibility of significantly increasing the level of household pensions savings, partly because millions of people simply cannot afford to save, partly because of lack of trust in the system and partly because people are simply not interested in saving for the long term.

The existence of means-testing means that it makes little sense for many of those who can afford it to save for a pension.

The overall level of pensions savings is also likely to decline in the years ahead given the continuing phasing out of defined benefit occupational pension schemes and the move to defined contribution schemes where the risk falls only on the individual.

Although there is potentially a bigger role for housing to fund pension provision, it remains the case that not everyone owns a property.

The case for compulsory saving falls down for a number of reasons and in any case, a substantial increase in pensions savings could be to the detriment of economic growth and would require a very significant increase in tax relief.

# Assumption 3 - A later retiring age?

One of the options being considered by the Pensions Commission is that the average retirement age will need to rise.

*"Forty years ago the male employment rate in Britain was about 95 per cent. Now it has fallen to the high 70s. To reverse that trend by about two thirds, back to a rate in the high 80s over the next 40 years, would be enough on its own to stabilise the economic dependency ratio at the current level. If this happened, the entire 'unaffordability' thesis would disappear. Or, to put it another way, if Britain raised its employment rate to the level currently enjoyed by Sweden or Denmark, that would also do it."* Phil Mullan.[45]

## To what extent do people want to retire later?

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.

*Will there be a desire to work longer?...*

The EFA conducted research to discover people's attitudes to and experience of work within each decade - the teens, 20s, 30s, 40s, 50s and 60s.
Nearly a third of people are happy to work until they're 70.
More sixtysomethings are happy to work until they are 70 than any other group.[46]

However, it is one thing for a senior executive or senior civil servant with a retiring age of 60 to want to carry on working and quite a different matter for a shop floor worker with a retiring age of 65. The former will have started work aged 22, have worked 38 years and will have a life expectancy at 65 of 86, while the latter will have started work at 16, have worked 49 years and have a life expectancy at 65 of 81.[47]

## Will there be significant demand?

Many older workers have skills, experience and attributes which are beneficial to an employer and to the economy as a whole. For example, reliability, flexibility, fewer days off, understanding customer needs and politeness.

FiftyOn recently conducted research through NOP which showed that employing the over-fifties can also enhance the reputation of the company doing so. Key findings of the research were:

- 83% think that employing older people is good for a company's image;
- 75% agree that older people tend to be more honest in the advice they give and aren't so interested in a quick sale;
- 89% agree that retraining is not a problem for older people and that they are able to take on new skills.

This last point was supported by earlier research carried out for FiftyOn, which illustrated the growing propensity for older people to take on new IT skills.[48]

What is uncertain is what the level of demand for older workers will be given continuing growth in productivity.

Given that today there are some 500,000 job vacancies, a level consistent with the normal rate of churn as people change jobs, it is difficult to see where a significant number of jobs for older people would come from unless economic circumstances and job opportunities improve.

One in three people aged 50 to retirement age are not in employment. This is partly an indication of low demand from employers and partly a reflection of the fact that many people have chosen early retirement.[49]

Demand may also be affected by a number of factors including:

* Discriminatory attitudes to older workers.
* Legislation banning age discrimination. By October 2006 employees will have protection against discrimination on the grounds of age.
* The overall demand for labour in the economy, in turn a function of the level of economic activity and the rate of productivity growth.
* The pace of immigration in the future.

***Will there be a demand for older workers?...***

A study by Age Concern found that:

- More people, 29%, reported suffering age discrimination than any other form.
- From age 55 onwards people were nearly twice as likely to have experienced age prejudice than as any other form of discrimination.
- One third of respondents say that the over 70s are viewed as incompetent and incapable.
- 'Being young' on average ends at age 49.[50]

There would be little point in raising SPA to 67 or 70 if most people were unable to find employment up to that age. They would become unemployed and claim benefits that would be more costly to administer than the more straightforward state pension.

Similarly if jobs were to be created in the public sector primarily to provide employment for people aged 65 to 70, the cost to the taxpayer would be considerably greater than the cost of providing the same number of people with a state pension.

# Conclusion

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

The first priority would appear to be to encourage an increase in the proportion of men and women between the ages of 50 and 65 who are working.

The second priority is to create greater scope for flexibility in the approach to retirement and to get way from the traditional all or nothing assumption. Greater provision for part-time and temporary employment is very much needed. There are steps being taken in the right direction such as:

*The most important point is that the level of productivity of the future workforce is more important than its size...*

- changes made to the State Pension deferral scheme
- changes in pensions legislation providing the possibility for people to draw an occupational pension and continue to work for the same employer.[51]

However, as we discuss in the next part of this report, the most important issue to bear in mind in relation to our ability to pay for pensions is that the level of productivity of the future workforce is more important than its size.

# Part 3 - The creation and distribution of wealth

## Introduction

The key issue in the pensions debate has been clearly stated by Alan Pickering:

> *"The pensions debate is all too often focused on wealth distribution and not on wealth creation. If our economy does not create wealth there is not enough to go round for the workers, let alone for pensioners."* [52]

*The pensions debate is all too often focused on wealth distribution and not on wealth creation...*

This raises two big questions:

* How can the working population that is expected to remain around 27 to 28 million create sufficient wealth over the next 35 years to support an additional 5 million pensioners?
* How can wealth be transferred from the wealth creators to the dependent population by means that are politically and socially acceptable?

## Financial assets versus real wealth

Individuals can purchase assets, physical or financial, at any given point in time with a view to resale in the future in order to provide a capital sum or an income stream.

However, this way of providing for the future carries risks. People can have a lot of wealth accumulated in property or in financial assets, but wealth in this form cannot be consumed. These assets need to be sold and exchanged for real goods and services at the time required for consumption. And if there are not enough goods and services being produced at that time, the wealth that has been saved will not meet expectations. The money value of the assets will have fallen and this will be expressed in higher prices for currently produced goods and services. So ultimately, all consumers depend on the level of production prevailing at the time they need to liquidate their savings.

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

This distinction - between wealth in the form of assets, financial and property, and wealth in the real sense, goods and services - is of fundamental importance. Whatever the funding arrangements, pensions are provided out of the current real wealth creation of people at work. Different arrangements, whether pay-as-you-go (PAYG) or funded schemes, are just different ways of accumulating or exercising claims on this wealth. This is the point that makes differences between PAYG and funded schemes irrelevant in this context.

This transfer of goods and services to pensioners is, of course effected through monetary transfers. In the case of the state pension this involves tax revenues being allocated to paying pensions.

The money transfer involved with funded pensions is different and more complicated than in the case of state pensions. Some of the funds for paying funded pensions will come from the returns on pension fund assets such as dividends and interest payments. Only some of the assets sold by pension funds to provide retirement income will be purchased by concurrent members of the working population. Others will be bought by institutions and overseas investors.

# How can a working population create sufficient wealth over the next 35 years to support an additional five million pensioners?

*The prosperity or standard of living of a society is a function of its ability to create wealth...*

The prosperity or standard of living of a society is a function of its ability to create wealth in both the market and non-market sectors. In each case, the ability to go on creating wealth will be a function of the amount and efficiency of investment in future productive potential either in terms of capacity growth or productivity growth.

The main factor affecting our ability to afford an ageing population without the erosion of living standards will be 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 65s grows by less than 50 per cent.

From the viewpoint of the economy, what matters is the level of savings and capital inflows and the extent to which these savings are used to fund investments in productive resources.

# Productivity and growth

In the past decade or so the UK has achieved a remarkable success in halting the economy's relative decline. On many indicators of economic performance the UK has kept pace with, if not outpaced, many other major economies in the developed world, especially in Europe.

The World Economic Forum Global Competitiveness 2004-05 Report ranks the UK eleventh in the world in terms of competitiveness in 2003, up from 13th the previous year. In terms of large economies, however, it ranks third behind the USA and Japan, but above Germany, (13th), France, (27th) and Italy (47th).

*The UK currently faces a transition to a new phase of economic development...*

However, as Professors Porter and Ketels pointed out in their 2003 study, the UK is facing a transition to a new phase of economic development which presents the challenges of moving from competing on a low cost basis to one based on innovation and unique value.[53]

During this phase the UK will face growing competition from countries such as China and India, not just in the traditional area of low cost manufacturing, but increasingly in more knowledge-intensive industries such as software. To respond to this challenge will call for further restructuring of the economy, considerable investment in research and development and in training and education and a faster rate of innovation.

The possibility of an 'investment gap' could pose a greater threat to the UK economy than a 'savings gap' and there is a concern about the level of investment by UK companies. The CBI have highlighted that there is anecdotal evidence to suggest that companies are in a cautious mood with regard to investment and there is a focus on improving efficiency rather than increasing capacity.[54]

*The possibility of an 'investment gap' could pose a greater threat to the UK economy than a 'savings gap'...*

Expected business expansion for the year ahead sank to its lowest level for 21 months, and this in turn is affecting investment plans. Companies plan to cut spending on land & buildings and on vehicles, plant & machinery. Investment in IT is expected to be unchanged. Uncertainty about demand remains the most significant factor constraining investment. CBI.[55]

# Consumption and the 'grey pound'

At any one time in a particular economy the total sum of goods and services being produced will be a function of two things – the productive capacity of the economy and the level of demand. In today's highly productive economies, consumer demand plays a very real role in stimulating economic growth. In the case of Germany and Japan in recent years, economic growth has been sluggish partly as a consequence of relatively low consumer spending.

*In today's highly productive economies consumer demand plays a very real role in stimulating economic growth...*

In the UK, an important factor in sustaining demand in recent years has been the role of the 'grey pound' as more and more people have entered retirement with either a public sector or private defined benefit occupational scheme. Demand could weaken in the future as a greater and greater proportion of the population consists of people over state retiring age with very low levels of discretionary spending power.

The counter argument is that strong consumer demand can stimulate growth in the short term but that this cannot be sustained, particularly when associated with high levels of debt, both at the level of the individual and the economy as a whole. It is an economist's axiom that you cannot lift output above its long term, supply-constrained ceiling – but in the modern economy productivity growth and new technology may be beginning to raise the ceiling and in some cases break through it i.e. web-based information and telecommunications.

# Distribution of wealth

There may not be a potential crisis in creating the wealth that can provide the means for adequate provision for retirement, but there is potentially a crisis in determining how that provision is to be financed. The issue involves economic, social and political considerations; a balance has to be struck between the economically expedient, the socially desirable and the politically acceptable.

However we construct a pension system, there has to be a transfer of resources from future production to future pensioners. In a PAYG system the transfer works through taxes and/or NI contributions so that pensioners obtain the financial means to buy goods and services they require.

*However we construct a pension system, there has to be a transfer of resources from future production to future pensioners...*

UK pension fund assets are in the region of £1.2 trillion which exceeds all the rest of the EU15 combined.[56] However, the problem arises from the fact that this massive pensions wealth is owned on behalf of about half the population. As regards the rest, the Organisation of Economic Co-operation and Development (OECD) has recently said that the UK's state pension system provides just about the lowest pensions in the whole of the Western World. Out of a survey of OECD countries the UK came out at 27th out of 30 when comparing the percentage of average post-tax salary that can be expected as a pension from the state.[57]

Given that half of the population has no significant pensions savings, and that they are unlikely to be able to afford to remedy the situation, it follows that providing these people with a basic standard of living of living can only be achieved through adjustments to the taxation system both in terms of tax collected and relief given.

*"Over recent decades, living standards have risen sharply, including, on average, those of pensioners. Moreover, assuming that the economy continues to grow at 2.5 per cent to 3 per cent a year, there will be a massive increase in incomes in the decades to come. Accordingly, the idea that a larger proportion of our income may need to be devoted to pensions provision should not fill us with dread. We should be able to do this while still enjoying increases in the standard of living."*
Roger Bootle.[58]

# Conclusion

From the viewpoint of the economy what matters is the overall savings rate, including household non-pensions savings as well as corporate and government savings and flows from overseas, and the extent to which these savings are used to fund investments in productive resources.

*Our future ability to create wealth provides the flexibility to adapt should the total economic support ratio change dramatically...*

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.

Our future wealth creating capability cannot, however, be taken for granted. It will involve improving our ability to adjust to a changing world economic environment and to promote innovation and enterprise. This will depend on a number of factors that promote innovation and productivity growth.

Peter Drucker (1969) in The Age of Discontinuity pointed out that in an information-based economy the schools are as much primary producers as the farmer, and their productivity perhaps more crucial.[59]

*"The supply of people able and qualified to carry out the myriad specialist tasks that an advanced economy will require in the future is not simply the responsibility of national educational provision in schools and universities. Indeed, given the speed of change it is only by life-long learning that these skills can be adapted to emerging technologies. In tomorrow's world, successful companies will be those that take up this challenge and see their organizations as institutions of learning as well as production."* Philip Sadler.[60]

The economy in the future will be more a function of the quality of the workforce than its quantity.

# Part 4 - An agenda for change

*"There is no demographic timebomb. Do not be frightened by falling ratios between working and retired people. The number of people over 65 is projected to rise at about 1.5 per cent a year between now and 2021. So long as the economy grows faster than this, we can cope. The higher the rate of growth, the less the fiscal problem. If output grows at 2 per cent a year, we can manage. If trend growth is above 2.5 per cent, it should be comfortable."* Graham Searjeant.[61]

Attitudes will change over a period of years and what may be in favour today, may not be tomorrow. For example, equity and general risk investment is out of favour with people of low to quite high incomes but a period of good performance by risk markets could change this attitude.

On the other hand, investment in houses is currently in favour but may not be so if there is a decline in house prices as a considerable number of forecasters are predicting. Therefore, what is needed is a structure for provision for retirement that is not subject to fluctuating fortunes.

***...what is needed is a structure for provision for retirement that is not subject to fluctuating fortunes...***

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

## An agenda for government

### Changes to the basic state pension

It is desirable in a fair society for the state to provide at least a basic standard of living for retired people. There is a growing consensus favouring a universal taxation-funded state pension.

***In a fair society it is desirable for the state to provide at least a basic standard of living for retired people...***

A state pension, equivalent to the current Guarantee Credit Level, based on citizenship and linked to median average earnings would remove the deterrent to saving created by means testing, would greatly improve the position of women and would give the poorest people in our society a firm promise of a degree of security in old age.

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.[62]

A study by the Pensions Policy Institute (PPI) (concludes that the UK could afford an immediate transition to a Citizen's Pension of £105 a week for each individual.
This conclusion is based on the following analysis:

* The offset of accrued rights against the Citizen's Pension significantly reduces the cost of transition to a Citizen's Pension by around £5bn.
* After allowing for savings from Housing Benefit, Council Tax Benefit and increased income tax receipts, the current best estimate of the net annual cost of introducing a Citizen's Pension at £105 a week in April 2006, allowing for the offset against accrued state pension rights, is calculated to be £7bn.
* In 2006/7 it is projected that £12bn will be spent on contracted-out rebates so that there is £5bn more than enough to pay for year 1 transition to a Citizen's Pension.

The study also argues that a Citizen's Pension would be easier and cheaper to administer than the current system of NI contributions and means-tested benefits.
However, given the paucity of data to quantify the administration cost savings possible with a Citizen's Pension, none have been taken into account in the PPI's cost estimates.

The PPI study concludes that not only is a Citizens' Pension affordable now, the future long-term cost could be within the future cost of the current system. The PPI estimate of the long-term cost of a Citizen's Pension at £105 a week is that at the peak in 2041 the additional spend is up to 2 percentage points of GDP. This could be afforded by one of the following, or a combination of partial implementation of each:

1. Switch some state spending from other areas to pensions
2. Raise taxes (or National Insurance contributions).
3. Raise the state pension age.

Restructure tax relief for private pension saving. (A change to the system of individual tax relief may be desirable to rebalance the current bias towards higher rate tax payers).

*A state pension based on citizenship and linked to median average earnings should be established...*

The need is to establish the above as the objective of government policy and set up 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.

A state pension should be regarded as the minimum provision for a standard of living for retired people and people should be encouraged to make a personal contribution towards the provision for their retirement beyond this level.

A possible approach is exemplified by the KiwiSaver, a scheme recently proposed by the New Zealand government which involves employees being automatically enrolled as they commence employment. However, they can subsequently opt out. Employers then send a percentage of salary (the default amount is 4 per cent) to the Inland Revenue from where it is channelled to the fund manager of the individual saver's choice. The fund managers involved are ones with which the Inland Revenue has negotiated low investment management fees.

This is a very low cost way to save compared with normal retail products. The government provides a one-off incentive from the state of NZ $1,000. In principle, the money is locked away until age 65 but can be accessed if the individual incurs financial hardship, emigrates or wishes to put down a deposit on a first home. At age 65 there is flexibility in the way the accrued sum can be used – it does not have to be used to purchase an annuity. In this scheme there is no requirement for the employer to contribute.[63]

*"It is quite clear that the message has gone out to all too many of our constituents that savings can damage their retirement income. We cannot explain the collapse in savings in this country in any other way than by saying that people are being very rational and that about 40 per cent of working people cannot now save to make themselves a penny better off — let alone substantially better off — through forgoing income now and trying to push it into their retirement."*
Frank Field, MP.[64]

## 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.

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

However, the most important issue to bear in mind is that the level of productivity of the future workforce is more important than its size.

## A quinquennial approach

*...make reasonable estimates for the next five years and begin learning about adapting to the increase in ageing and repeat the process each quinquennium thereafter...*

Provided that 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 how to adapt to the increase in ageing based on the right assumptions and ratios. The process can then be repeated each quinquennium thereafter and so on until the baby boomer bubble has worked its way through.

# An agenda for government and companies

## A focus on wealth creation and employment opportunities

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:

*Our future ability to create wealth provides the flexibility to adapt...*

- 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.

# Implications for companies

The closing of the majority of defined benefit schemes, together with the generally lower rates of employer contribution to defined contribution schemes mean that the risk-carrying aspect of pensions is being rapidly shifted from companies to individuals. It is clear that as time unfolds the role of companies in pension provision will decline substantially.

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

It remains the case, however, that 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.

# 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. The 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' to cover all aspects of the industry and to which all parties can commit.

The recent decision to set up a financial services forum is most welcome and it is hoped that the more detailed structure, proposed by the Inquiry Team that produced 'Restoring Trust', will be taken forward. In particular:

* 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; the proportion of customers saying that they believe they have been treated fairly, and trend indicators of the proportion of people's savings swallowed up by commission, charges and other costs.

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**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.