The Pensions Review

Jonathan Cribb
Carl Emmerson
Paul Johnson
Heidi Karjalainen
Laurence O'Brien

Summary

The Pensions Review: final recommendations

IFS Institute for Fiscal Studies

UKRI Economic and Social Research Council

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Jonathan Cribb
Carl Emmerson
Paul Johnson
Heidi Karjalainen
Laurence O'Brien

Drawing on significant contributions from Bee Boileau and David Sturrock

Copy-edited by Judith Payne

Published by **The Institute for Fiscal Studies**

2 Marylebone Road
London NW1 4DF
+44 (0)20 7291 4800
mailbox@ifs.org.uk
http://www.ifs.org.uk/
@TheIFS

ISBN 978-1-80103-226-1

Executive summary

This final report of the Pensions Review, a major project launched in April 2023 by the Institute for Fiscal Studies, in partnership with abrdn Financial Fairness Trust, examines the main risks to today's working-age individuals in the UK pension system and sets out policy proposals primarily focused on improving outcomes for future generations of retirees. This report does further analysis and draws on the large number of reports we have published as part of this review.

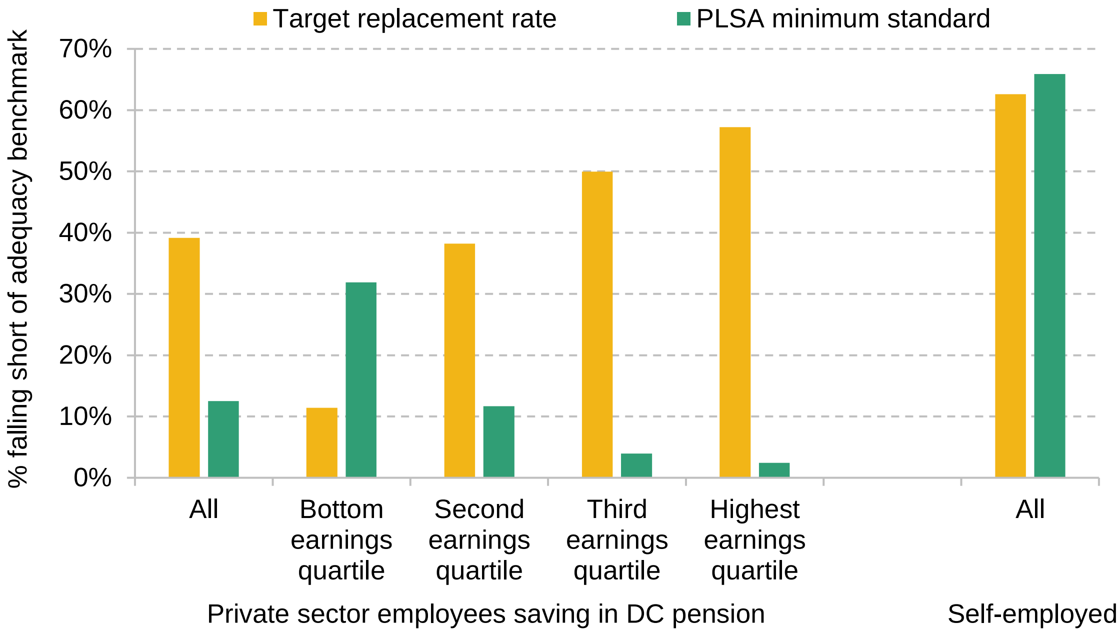
Challenges within the current system

The current UK pension system, with automatic enrolment of most employees into private pensions alongside a flat-rate state pension payable from a single state pension age, offers significant advantages. This simple design encourages private pension saving while also providing flexibility for those who wish to either opt out of saving or alternatively contribute more. It does not need a complete overhaul. But despite its strengths, the system faces significant challenges.

An ageing population places pressures on the public finances through increased spending on state pensions and in particular on health and social care. A generously indexed state pension adds to these growing pressures. The 'triple lock' increases the value of the state pension in an unpredictable way and it could reasonably be expected to push up state pension spending by anywhere between £5 billion and £40 billion a year in 2050 in today's terms. Rising state pension ages have substantially pushed up the risk of income poverty among those in their mid 60s. Those reaching retirement in the private rented sector, increasing in number, are also at a heightened risk of poverty throughout their retirement.

Additionally, many employees – and an even higher fraction of the self-employed – are not saving enough privately for their retirement. As shown in Figure ES.1, 39% of private sector employees are not on track to reach their 'target replacement rate' – a benchmark for avoiding large falls in standards of living at retirement as defined by the 2002–06 Pensions Commission. The graph also shows that 13% are not on track for the Pensions and Lifetime Savings Association (PLSA) minimum standard (a post-tax income of £13,400 per year for a single pensioner or £21,600 for a pensioner couple, after housing costs and living outside London). Low earners are considerably more likely not to meet the PLSA minimum standards (32% are projected not to meet this level on the basis of their individual incomes). Middle and higher earners are particularly likely to face a significant drop in living standards at retirement (e.g. 50% of those in the third quartile of the earnings distribution would miss their target replacement rate). With low rates of pension participation among the self-employed, 63% of self-employed workers are projected to fall short of their target replacement rate and 66% are projected to miss the PLSA minimum standard. More saving is needed.

Figure ES.1. Retirement income adequacy: percentage of private sector employees saving into a defined contribution pension, and self-employed, projected to fall short of selected benchmarks



Source: The sample contains 25- to 59-year-olds in Round 7 of the Wealth and Assets Survey. We simulate their projected future retirement income under their current saving rate, modelling everyone at the individual level and without accounting for future housing costs or receipt of inheritances.

At the same time, while there is a clear case for many working-age people to save more for retirement, it is important to recognise that increasing saving – and therefore reducing spending – of working-age households who are currently on a low income and struggling would create greater hardship today. Evidence suggests that this trade-off remains the case if the saving is undertaken by employers on behalf of their employees, as wages would likely fall (or grow less quickly) – at least somewhat – in response to higher mandated employer contributions.

There are also clear challenges in the current pension system for when and how pension wealth is accessed. The introduction of ‘pension freedoms’, which means that since 2015 no one is obliged to purchase an annuity with their pension pots, has had advantages for many. But it also exposes some people to risks they would not have faced had they either had a defined benefit pension or purchased an annuity, and then spent their income each year. Many are insufficiently supported on how best to manage longevity, investment and inflation risk when drawing down on their pension wealth through retirement, especially at older ages. This is an even bigger challenge when each change of employer creates a new pension pot for employees, which fragments retirement savings, making them easier to lose track of and unduly hard to manage well.

Combined, these factors are a recipe for too many to have poor financial security through retirement. In this report, we therefore make a set of proposals designed to address these key issues facing the pension system.

Reforms for an improved pension policy framework

Our proposals aim to ensure that the state pension system provides a reliable foundation for private saving. We focus on reforms to improve outcomes for those most at risk of poor retirement outcomes under the current system. We recognise that not everyone can afford to save more every year, so our recommendations help protect take-home pay for lower-income groups. More needs to be done to simplify decision-making for individuals, to help strike a fairer balance of responsibility among the state, individuals and employers when it comes to pension saving.

To achieve these outcomes, we propose a series of reforms, set out in more detail in Chapter 2. The key themes of these reforms are:

- **State pension.** We propose a ‘four-point guarantee’ for the state pension to increase confidence in the state pension as a stable and secure basis of the pension system. This guarantee means that: (1) a clear earnings-linked target for the new state pension should be set to improve predictability and to make sure that pensioner incomes keep up with increases in living standards; (2) the state pension will always increase in line with at least inflation; (3) the state pension will never be means-tested; and (4) the state pension age should continue to increase as longevity at older ages rises, but not by as much as that increase in longevity.
- **Private pension saving.** Many need more income in retirement. Too many employees miss out on employer pension contributions, so minimum employer contributions should be extended to almost all employees and apply from the first pound of their earnings. The automatic enrolment system should help people save at points of life when it is easier for them to do so. By increasing defaults for total pension contributions when individuals are on (and above) average earnings, the government can protect take-home pay when individuals are on low earnings, but still deliver a boost to many people’s retirement incomes. The government should make it easier for self-employed people to participate in a private pension, utilising HMRC’s Self Assessment system and drawing on the lessons of what has made automatic enrolment such a success in boosting workplace pension participation among private sector employees.
- **Means-tested support.** As the state pension age continues to rise, universal credit should be enhanced for those in the run-up to that age. This can be done for a small fraction of the

fiscal savings from increasing the state pension age, and would help to alleviate the increase in poverty that would otherwise occur. Means-tested support for pensioners should be streamlined to boost take-up, and housing benefit should be made more generous for the growing number of pensioners residing in the private rental sector.

- **Managing retirement incomes.** Pensions need to be easier to manage, particularly through retirement. Fragmentation across many small pots needs to be reduced dramatically, with the level for automatic consolidation of pensions rising once it has been successfully implemented for the very smallest pots. People should be guided towards sensible ways of drawing on their pensions that reduce the risk of them running out of private resources, such as hybrid ‘flex then fix’ solutions (combining the flexibility of drawdown earlier in retirement and the purchase of an annuity later in retirement). However, even very well-designed default solutions will not be right for all, and people should be able to get high-quality information to make sensible decisions without having to take expensive financial advice.

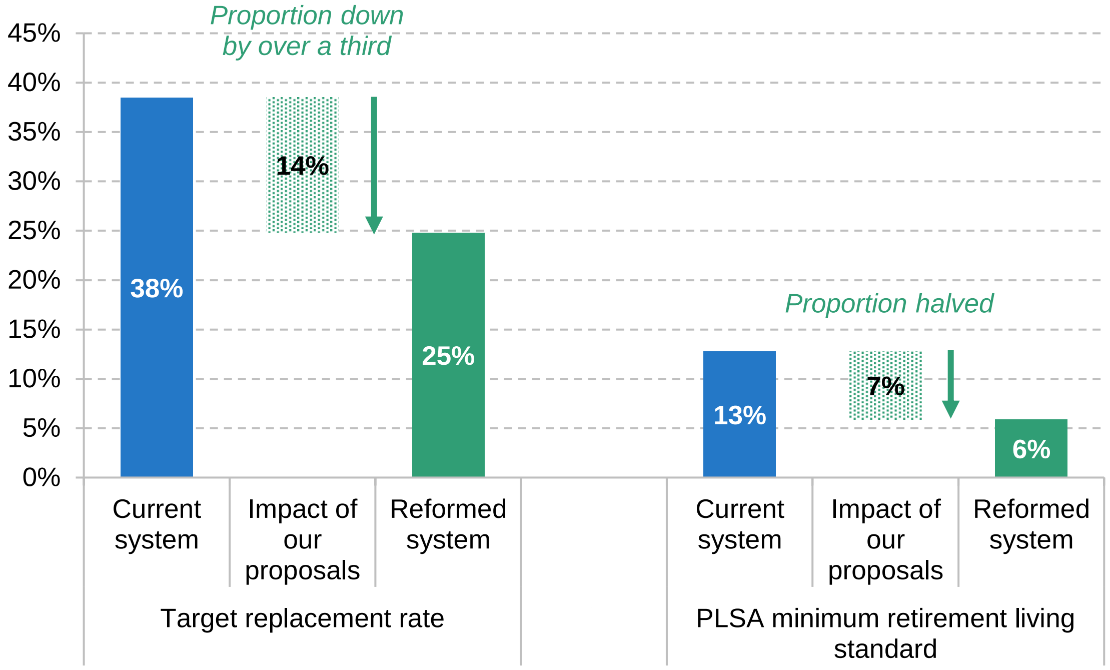
Benefits of our policy reforms

Our proposals for the state pension would improve the predictability of the future level of the state pension and guarantee that state pension income is never means-tested, building confidence in the state pension system and allowing it to provide a stable foundation upon which to build private retirement savings.

Our proposed reforms to private pensions would result in more private saving – our modelling suggests around £11 billion a year – on top of the foundation provided by the state pension. Our suggested enhancements to automatic enrolment would reduce the share of people with an ‘inadequate’ income in retirement, and the largest percentage increase in retirement incomes would come for those currently most at risk of low retirement incomes. Importantly, the effects would be substantial for younger adults, who would see the benefits of our proposals over the whole course of their working lives (see Figure ES.2). The share of 25- to 34-year-old employees saving in defined contribution pensions who are projected to miss their target replacement rates would fall by 14 percentage points, from 38% to 25%, while the share predicted to fall short of the PLSA minimum retirement living standard would more than halve under our proposals, from 13% to 6%.

The effects on pension adequacy for older working-age adults are smaller, as they have fewer years before retirement to save more. This highlights the cost of delay. Acting swiftly ensures more generations have time to benefit for longer from increases in private pension saving. By implementing these policies sooner rather than later, the pension system can better help more of today’s working-age population build a more financially resilient retirement.

Figure ES.2. Share of 25- to 34-year-old employees saving in defined contribution pensions projected to be on course for an inadequate retirement income, under current system and under our proposed reforms to automatic enrolment



Note: The sample contains 25- to 34-year-old private sector employees saving into a defined contribution pension in Round 7 of the Wealth and Assets Survey. We simulate their projected future retirement income under their current saving rate, and under our automatic enrolment proposals, modelling everyone at the individual level and without accounting for future housing costs or receipt of inheritances.

In addition to reducing the fraction of workers facing inadequate retirement incomes, what really sets our proposals apart is that, by carefully targeting increased saving, we would achieve this while mitigating falls in working-life take-home pay for those struggling on lower earnings. And, by both increasing the level and extending the reach of minimum employer contributions, we would ensure this extra saving is the shared responsibility of both employees and their employers. Our automatic enrolment proposals would boost private pension saving by around £11 billion a year, with roughly half of this coming from increased employer contributions and half from increased employee contributions. This increase in contributions would attract around £3 billion a year of additional up-front tax relief. Our proposals to facilitate pension saving for the self-employed would also benefit this group which has particularly – and worryingly – low pension participation.

However, just helping people to accumulate more savings is not enough. Currently, people are reaching retirement with too little assistance in how to put the savings they have built up to good use. Our proposals would reduce the risk of people making poor financial decisions with their retirement savings by helping them consolidate their pension pots, thereby simplifying the problem, and guiding them towards good decisions – for example, through default product offers – without necessarily having to access expensive ongoing financial advice.

Finally, there will always be some who need extra financial support from the state in old age. Our proposed reforms would help these people in a well-targeted way by boosting means-tested support for some of those hardest hit by increases in the state pension age and the growing numbers living in the private rented sector in retirement.

Detailed summary of proposals

1. Our proposed reforms can help move towards a pension system that will: (1) provide a secure and stable state pension; (2) provide increased support to many hit hardest by state pension age rises and others particularly at risk of poverty in retirement; (3) increase the number of people saving into a private pension and help many others save more; and (4) offer solutions to help people manage their pension wealth through retirement.

The state pension

2. The current flat-rate state pension, first claimable from a single age and with a simple structure, has many benefits. However, the state pension system faces significant challenges. The ageing population will add considerable additional pressure on the public finances in coming decades, and 'triple lock' indexation ratchets up the value of the state pension over time, increasing the cost of the system in a way that creates additional uncertainty compared with increasing the state pension in line with earnings growth. Relying only on raising the state pension age to rein in spending would hit those with lower life expectancy – disproportionately including many on lower incomes – harder. And despite its new-found simplicity, there is a mixture of confusion and pessimism about the state pension.

3. To help with these challenges, we propose a 'four-point guarantee' for the state pension. This is designed to give people more confidence and certainty over what they can expect their state pension to provide; help them avoid old-age poverty; and provide a bedrock on top of which private pension saving can be built.

4. The four points are:

4.1 There will be a government target level for the new state pension, expressed as a share of median full-time earnings. Increases in the state pension will in the long run keep pace with growth in economy-wide average earnings, which ensures that pensioners benefit when the incomes of working-age households rise.

4.2 Both before and after the target level is reached, the state pension will continue to increase at least in line with inflation every year. Together with the first point, this means that the state pension will follow a ‘smoothed earnings link’, as is used in Australia.

4.3 The state pension will not be means-tested.

4.4 The state pension age will only rise as longevity at older ages increases, and not by the full amount of that longevity increase. To increase confidence and understanding, the government will write to people around their 50th birthday stating what their state pension age is expected to be. Their state pension age would then be fully guaranteed 10 years before they reach it.

5. A key feature of this guarantee is for the government to set a target level of the state pension, expressed as a fraction of average (median full-time) earnings. A full new state pension is currently worth 30.2% of average earnings. As an illustration, a 9% boost to its value would mean a full new state pension being worth 33% of average earnings – and on average give a bigger percentage boost to the incomes of lower-income retirees. But it would cost around £15 billion more per year in 2050 than if the target was the current level of 30.2%.

6. The target level will ultimately be based on political priorities, but under our guarantee the government would not have to move away from the triple lock immediately. Rather, it could communicate what level it wants the state pension to reach, and commit to keeping the triple lock in place until then, introducing the Australian-style smoothed earnings link set out above from the point the target is reached.

7. The smoothed earnings link is an important improvement to the system. Retaining the triple lock while raising the state pension age would hit poorer people more because the loss of a year of state pension income is more important for those with lower life expectancy, as they spend fewer years above the state pension age. On the other hand, those with a higher life expectancy benefit relatively more from the triple lock, as they are more likely to be receiving a generously indexed state pension in their 90s and beyond.

Means-tested benefit system

8. We do not think that early access to a state pension at an actuarially reduced rate is desirable, as it would add complexity to the system and increase individuals’ risk of

income poverty at older ages. Instead, there is a case for enhancing the working-age means-tested benefit system, especially as the state pension age continues to rise.

9. We therefore propose additional means-tested support for those within a year of their state pension age, i.e. those aged 66 from 2028 onwards. This support could either be offered to everyone with low incomes and assets (those receiving universal credit) or targeted only to those with low incomes and assets who are also receiving health-related benefits (alongside universal credit). This type of additional support comes at a cost to public finances (costing £600 million or £200 million, respectively). It also reduces work incentives and potentially increases the incentive to apply for health-related benefits if that is the basis of targeting. However, these kind of mitigation measures can play an important role in helping groups that are most harmed by a higher state pension age, as well as in maintaining political and public support for state pension age increases (which significantly increase employment). The public finance costs are a small fraction of the approximately £6 billion annual saving from increasing the state pension age by a year. And to the extent to which such mitigation boosts public support for increases in the state pension age, it might make such increases more likely to be successfully implemented.

10. For pensioners entitled to means-tested benefits, low take-up of pension credit remains an issue. It is essential that the government delivers its plans to integrate pension credit and housing benefit to help with the take-up issues. Private renter pensioners face higher poverty rates and risks due to lower housing security, and the fraction of privately renting retirees is set to grow significantly. We propose that the government increases the maximum housing benefit for private renter pensioners by allowing an extra bedroom in setting the maximum allowance (initially costing around £150 million per year). This would mean that, for example, a pensioner couple would be entitled to housing support that was always based on (at least) the local rents for two-bedroom properties, which would bring the treatment of privately renting pensioners closer to that of social renters. Furthermore, focus groups run alongside this Pensions Review revealed much support for pensioners being entitled to have a ‘spare’ bedroom.

Private pension saving – employees

11. Our modelling shows that many average and higher earners are not on track to reach commonly used benchmark retirement income replacement rates. A significant fraction of lower earners are not saving in a pension. Even if they are saving in a pension, a significant minority of employees are projected to fall short of their ‘target replacement rate’ – a benchmark for avoiding large falls in standards of living at retirement (as defined by the 2002–06 Pensions Commission). A smaller minority are on track for a

retirement income that falls short of the ‘minimum standard’ defined by the Pensions and Lifetime Savings Association (£13,400 per year for a single person and £21,600 for a couple, measured after tax and after housing costs, living outside London). There is a clear challenge with two competing priorities: we need policies to help employees reach adequate levels of retirement income, while also mitigating concerns around lower take-home pay in working life. These concerns exist irrespective of whether increases in private pension saving come from employee or employer contributions, as evidence shows that a large fraction of mandated employer contributions are passed on to employees in the form of lower wage growth.

12. There is a strong case for employees to receive an employer pension contribution of at least 3% of their pay, regardless of the employee’s contribution. This would ensure that (most of) those who currently earn too little to have to be automatically enrolled, and those who opt out from saving for affordability reasons, do not miss out on an employer pension contribution. We think this should apply to anyone earning at least £4,000 per year, and for the contribution to be based on total earnings up to the annual equivalent of £50,270 (the higher-rate income tax threshold).

13. As the new state pension provides the same flat-rate amount to everyone with the full number of qualifying years, it alone takes lower earners much closer to their target replacement rates (though it alone does not ensure single people reach the PLSA ‘minimum standards’). Many middle and higher earners will need more significant private savings to ensure that they do not see a large fall in their material standards of living upon retirement. Thus, increases in minimum default total (i.e. employee plus employer) contributions should be targeted in particular at average – and above-average – earners. Those with low earnings in some years, but higher in others, would also (by default) end up saving more – but importantly targeted towards when they were more able to do so.

14. There are many ways in which this could be achieved, and in this report we propose a new set of rules for minimum default total contributions. For employees earning at least £10,000 per year, the minimum default total contribution would equal 3% of £9,000 (£270), plus 10% of the portion of earnings between £9,000 and £90,000. For a middle-earning employee on £35,000 per year, minimum default total contributions would rise by around £570 per year, from £2,300 to £2,870.

15. People should have the ability to contribute less, as well as more, than these defaults if they wish to. We also think the age range targeted by automatic enrolment (currently 22 to state pension age) should be extended to all who are eligible to make tax-

relieved pension saving (i.e. all aged 16–74). To future-proof the system, thresholds should be uprated over time in line with earnings.

16. Our proposals would reduce the share of current 25- to 34-year-old employees saving in defined contribution pensions who are projected to fall short of their target replacement rates by more than a third (from 38% to 25%). There would also be falls in the share of employees failing to reach that standard for older groups, though they are much smaller (e.g. from 42% to 39% for current 50- to 59-year-olds) as they have less time to benefit from increased saving rates.

17. These proposals would boost private pension saving by around £11 billion per year. Roughly half of this increase would come from higher employee pension contributions, with the remaining half coming from higher employer pension contributions. Higher pension saving comes at a cost to the exchequer because of the tax advantages attached to private pensions. These proposed changes would result in a short-term cost to the public finances of up to £3.7 billion per year, falling to (at most) £2.1 billion per year in the long run. With a gradual implementation, these exchequer costs would not be realised for a few years. Small broad-based tax rises, or carefully designed reductions in some elements of pensions tax relief, could – if desired – be implemented to make these reforms revenue-neutral.

Private pension saving – self-employed

18. Pension saving rates of the self-employed have declined dramatically over time, with only around one-in-five of the self-employed now saving into a private pension. This fraction is worryingly low. Even among those who are saving in a private pension, over a quarter make unchanged regular contributions (in cash terms) after five years. Most self-employed people are on track for an inadequate retirement income if relying only on their own pensions, although the picture is improved once we include incomes of partners, inheritances and other wealth.

19. To help the self-employed, more should be done to facilitate their pension participation, drawing on lessons from the success of automatic enrolment. We propose that at a minimum, the self-employed should be required to make an active choice about the level of pension contributions when filling out a self-assessment tax return. Going further, they could be automatically enrolled into a private pension, or potentially a Lifetime ISA, at the point of self-assessment, with the option to opt out. For those who set up direct debits for pension saving, these should by default increase automatically over time.

Small pots consolidation and managing retirement incomes

20. The number of small, deferred private pension pots is large and growing. In 2024, there were around 23 million deferred defined contribution pots worth under £10,000. The number of deferred pots worth less than £1,000 increased by almost one million between 2023 and 2024 (to 13 million). Low earners and women are particularly likely to accumulate small pots. This proliferation of small, deferred pension pots is burdensome for savers as they are difficult to keep track of, and uneconomical for pension providers, thereby reducing the net returns available within pensions.

21. It is welcome that the government has announced it will move forward with small pots consolidation. It will do this by introducing a ‘multiple default consolidator approach’ in which small deferred pots (£1,000 or less) are by default consolidated into one of a small number of nominated pension schemes, with the option to opt out. This is a significant improvement on the status quo. While only deferred pots of £1,000 or less will be automatically consolidated initially, the Pensions Minister Torsten Bell has described the reforms as ‘the starting point’, which we hope indicates an ambition to increase this limit over time. However, as the size limit for automatic consolidation increases, more and more pots would flow into a small number of approved consolidator funds. This anti-competitive effect might cap how high the size limit can be set. People should typically end up with one, or a small number of, defined contribution pension pots at the point of retirement. Many will still need to consolidate their own pots to achieve this, and it needs to be made as easy as possible for individuals to do this sensibly.

22. There are stark challenges for people managing defined contribution pension wealth through retirement, with risks over how long they are going to live (longevity risk), asset returns (investment risk), inflation risk, risk related to the loss of a spouse, and risk of becoming less able to make good decisions at older ages due to cognitive decline. Together, these mean people risk either drawing on their wealth ‘too slowly’ or depleting their pension too quickly.

23. Most people are likely to need more protection against longevity risk than is currently provided by the state pension alone, as their living standards would see sharp falls if they were solely reliant on this. The recently published Pension Schemes Bill would require many pension schemes to introduce default retirement income solutions. A ‘flex then fix’ product, where people have the flexibility of drawdown earlier in retirement and the security of an annuity later in retirement, is likely to be a good model for many. However, the defaults should be carefully designed. They should be ‘soft’ so that they are easy to opt out of, and there should be the potential for different defaults for

different types of individuals. The ability to deviate from the default will likely be particularly important for those with other annuitised income streams (such as defined benefit pensions) and those with a low life expectancy. For those who want to make a more active decision around decumulation, people should be able to receive high-quality information on their options without ongoing commitment to expensive financial advice, along the lines of the Financial Conduct Authority's proposals for targeted support.

24. It is also important that people view pensions as pensions, rather than just another accessible savings pot. To ensure this, the age at which people are able to start to access their defined contribution pension pots should be gradually increased over time so that it reaches age 60 by the time the state pension age reaches 68 in the mid 2040s. In addition, the way in which tax benefits of private pensions are described should not accidentally encourage people to withdraw large amounts from their pensions early in retirement. The 25% tax-free element is invariably described as a 'tax-free lump sum'. This risks inadvertently – and inappropriately – steering people towards taking 25% of their pension up front as a lump sum. It would be better if it were instead called the 'tax-free component' or 'tax-free element'.

Implementation

25. There is a strong case for urgent action. Reforms to encourage more private pension saving can do more to support the future retirement incomes of those who are younger as they will spend more time under the improved system. Each year that passes without policy changes to help people spend their wealth wisely in retirement means an extra set of retirees being more likely to make mistakes in using their pension wealth, with potentially long-lasting adverse financial consequences.

26. While reform is urgently needed, that does not mean it all has to be implemented immediately. Changes to automatic enrolment should first be consulted on with schemes and employers to ensure a smooth implementation. Piloting some changes with larger employers – as was the case with the initial roll-out of automatic enrolment – is an additional option. Reforms should be announced as soon as possible but with a gradual phase-in period to allow employers and individuals time to adjust. There is a good case for announcing the target goal of the state pension sooner rather than later. Other reforms, in particular to help people use their wealth sensibly in retirement, should come more quickly, as there are fewer near-term barriers to implementation and the problems are more acute.

Key themes for reforms

1 State pension: a secure and stable system

Challenge

An ageing population is adding to pressures on public finances. There is a lack of public trust in the state pension system.

Solution

A clear earnings-linked target level for the new state pension and a guarantee it will always increase at least in line with inflation are needed. State pension age should only go up when longevity at older ages increases.

2 Private pension saving: help many save more

Challenge

A substantial minority are not saving enough and risk falling short of an adequate standard of living in retirement. At the same time, there are significant pressures on working-age disposable incomes.

Solution

Minimum employer contributions should apply to almost all employees, and apply from the first pound of earnings. Minimum default total contributions should be increased for those who are able to save more. Saving in a pension should be made easier for the self-employed.

3 Means-tested benefits: additional support

Challenge

There are high rates of poverty just before the state pension age and among private renter pensioners.

Solution

Universal credit should be enhanced for those just under the state pension age. Housing benefit should be made more generous for the growing number of private renter pensioners.

4 Managing wealth in retirement: simpler decisions

Challenge

Many face difficult decumulation decisions with limited support and risk running out of private resources at older ages.

Solution

People should be guided towards sensible ways of drawing on their pensions, such as through 'flex then fix' solutions. Fragmentation across many small pots needs to be reduced dramatically.