smf

THE NEW DEMOGRAPHICS
Reshaping the world of work and retirement

Andrew Turnbull

Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist.

John Maynard Keynes, 1936[1]

SMF FORESIGHT

>>>

First published by
The Social Market Foundation,
May 2007

The Social Market Foundation
11 Tufton Street
London SW1P 3QB

Design www.jadedesign.co.uk

THE CONTEXT

For many years, the UK has looked across the Channel with a sense of smug satisfaction, comparing the strength of UK pension provision with the looming financial crisis on the Continent. This *schadenfreude* was based on two assumptions, both of which have proved fallacious.

The first took satisfaction from the UK's extensive reliance on funded, employer-backed Defined Benefit (DB) schemes, in contrast to the prevalence of Pay-As-You-Go (PAYG) schemes, mostly state-backed, in the rest of Europe. There were many who believed that a funded scheme was superior because, in some sense, the money had already been put aside and was earning a return, while those relying on PAYG schemes still had the burden of finding the money ahead of them.

This is, of course, a fallacy, as an elementary examination of the national income and expenditure identities will show. The consumption of the pension generation has to be matched by the denial of consumption of the working generation, which can only be achieved by savings or taxation (in practice, compulsory savings enforced by the state). Put another way, if the first generation saves and accumulates assets, it can only turn those into cash to spend in retirement by selling them to the following generation. If the following generation fails to save enough, the price it gets for its assets will be poor.[2] There are a number of reasons to favour funded schemes – as an incentive to save, as a transparent way of establishing rights, as a way of keeping rights adjusted to the underlying performance of the

1 J M Keynes, *The General Theory of Employment, Interest, and Money* (New York: Harcourt, Brace & Co., 1936), p. 383.
2 Except in the special case of net assets accumulated overseas.

economy, and to earn higher returns by investing in global markets. However, the pre-funding argument isn't one of them.

Furthermore, the alleged superiority of UK employer-backed funded schemes has placed too much reliance on the continued existence of the employer. There was a time when we emphasised that the pension fund was separate from the company, but all the current regulatory and accounting pressures are for the company to acknowledge the pension fund deficit as a liability on its balance sheet.

But if the deficit is a liability, the company will manage it like any other liability, analysing the risks (which have turned out to be much greater than expected) and then either controlling the liability or passing the risks on to a third party. This is precisely what has been happening, with the closure of DB schemes to new members, or even to the future service of existing members – an excellent example of how well-meaning regulation can accelerate the demise of the very thing it is trying to protect.

There has also been a failure to realise that the pension contract is effectively a 70-year one, from first contribution to last payment out. But few companies last 70 years. Already 68 of the first 100 names in the FTSE100 have disappeared since its inception in 1984. Some have failed; others have been taken over or broken up and the pieces sold. It may be argued that the new owners will take on the pension liabilities. Maybe, but what incentives do the new owners have to do anything but the minimum for pensioners of companies which have long since disappeared or which have passed through many hands? There are examples of longstanding companies, such as BAE Systems and British Airways, which are retaining their DB schemes by negotiating reduced benefits or risk sharing with the beneficiaries, but such negotiations have proved complex and contentious.

The second source of comfort in the UK has been the observation that the rest of Europe faces a serious crisis of public finances, with the cost of public provision of pensions rising to 10–15% or more of GDP, whereas in the UK this figure was never projected to rise much above its current 6.2%.[3] But even this has proved misleading because, while there is indeed a crisis across much of Europe, we in the UK also face one, though of a different kind. While the PAYG schemes of the rest of Europe face a crisis of over-promising, we face a crisis of under-provision. It is unrealistic that we could hold public provision to the current level when the number of pensioners is projected to rise by 50%, and private provision is in retreat. And holding public spending down by heavy reliance on means-testing merely undermines the incentive to rebuild private saving.

Fortunately the penny has now dropped in the UK, helped by the excellent work of Lord Turner's Pension Commission, and a major rethink is now underway. This includes dropping the dearly held commitment to price-only indexation and biting the bullet of increasing the state pension age, though the danger remains that politicians will implement the popular part of the deal but, under pressure, will fail to carry through in full the rise in the pension age.

THE DEMOGRAPHICS

But pension provision is not the only area of life that will need to be substantially rethought as the implications of longevity and the new demographics sink in. Even something as fundamental as our picture of the family will change radically. Take the following example.

3 The Second Report of the Pensions Commission, *A New Pension Settlement for the Twenty-First Century* (London: The Stationery Office, November 2005); for projection of future increase, see graph on p. 119 (http://www.pensionscommission.org.uk/publications/2005/annrep/main-report.pdf).

SMF FORESIGHT

A woman in her late 40s is looking forward to spending time with her first grandchild, but knows she will find it difficult. Her own mother, at 73, is becoming frail. She has also got her 95-year-old grandfather to look after. And her great-grandmother, still alive aged 118, requires constant care. Instead of just two generations below her, she has in addition three older generations to care for.

This example may seem fanciful, but such a six-generation family existed until quite recently in Philadelphia. Four- and five-generation families will not, in the future, be uncommon. Domestic arrangements, family relationships, inheritance, pensions and healthcare are all going to require rethinking as new multi-generational families tip from being dominated by the young to being focused on the old.

We need to face these demographic changes directly. With a rapidly ageing population, it is essential that we understand the consequences of how we act – or fail to act – in relation to living longer.

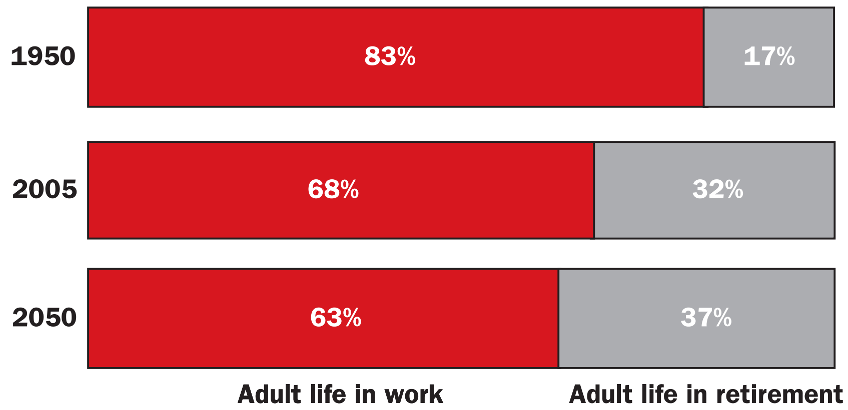
The changes brought about by increased longevity pose a serious challenge both to individuals and to society as a whole. The proportion of our lives we spend working is rapidly diminishing, and the dependency ratio of old to young is becoming worse.

SMF FORESIGHT

Individuals

For individuals, there has been a dramatic swing in the ratio of years spent at work versus those in retirement. In 1950, 83% of one's adult life in the UK was spent working and 17% spent in retirement.[4] By 2005, 68% of one's adult life was spent working. By 2050, if the retirement age remains the same, only 63% of one's adult life will be spent working. The ratio is even more extreme for professionals.[5]

Adult life – ratio of work to retirement



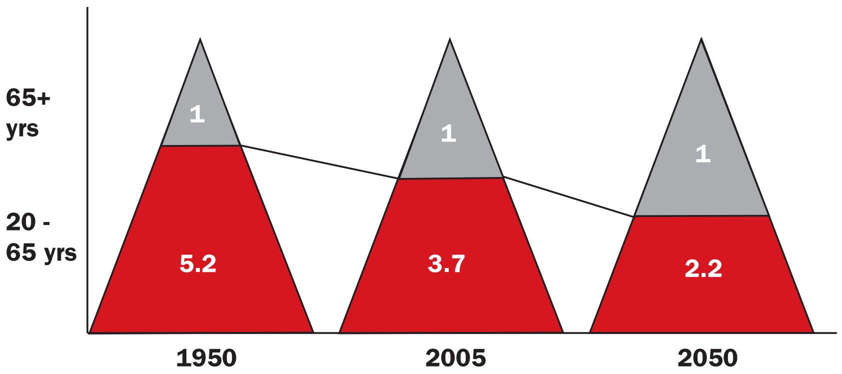
This shift in the work:retirement ratio can be attributed in part to work life starting later (from age 16 on average in 1950 to age 21). But it also reflects both increased longevity and earlier retirement. In economic terms, we have moved from five years of work per year of retirement to two years. By 2050, this is likely to be reduced to 1.7 years of work per year of retirement.

4 *Ibid.*
5 *Ibid.*

Society

A second set of statistics is of equal concern. The declining birth rate in the West means that the dependency ratio is worsening. There are variations from country to country and the UK is by no means the worst affected. Nonetheless, the following figures show a stark change in the last half-century. In 1950, the dependency ratio was 1:5.2 – for every person aged 65 and over, there were 5.2 people between the ages of 20 and 64. By 2005 this dependency ratio had fallen to 1:3.7. By 2050, it is estimated that for every person aged 65 and over, there will be 2.2 people aged 20–64.[6]

Dependency ratios



While there is general awareness about our ageing population, we have not yet fully grasped the significance and size of this demographic shift. The implications are vast, from the patterns of work and retirement to the way companies are run. The most successful companies in the future will be those whose goods and services, and how they market them, take advantage of long life expectancy.

6 *Op.cit.*, pp. 94-95.

FLAWED THINKING

Unfortunately, a number of flawed assumptions mark our present thinking about work and retirement, the key relationship at the heart of negotiating ageing and affordability.

1. We will spend long enough working to pay for our retirement.
2. As society gets richer, we can afford to retire earlier.
3. It is a good thing to retire people early, as there are not enough jobs for everyone.
4. Income and status at work rise linearly and you retire from the organisation at your most senior position – and when you retire, you leave the organisation entirely.
5. Our standard of living in retirement will be constant.
6. We acquire assets while working and decumulate them during retirement, with a sharp distinction between the accumulation and income phases.
7. During retirement, we won't move house more than once.
8. The state will provide social and healthcare services for us in our latter years, allowing our children to inherit our estate without it being significantly depleted.
9. Marketing is best focused on young people and families.

Work and retirement

Assumption 1: We will spend long enough working to pay for our retirement.

As the work:retirement ratio is decreasing rapidly, employees may not earn enough to pay for their retirement. As longevity increases, they will in fact need to spend not less time in work but more, just to maintain the current ratio.

A number of studies have shown that people systematically underestimate the length of their retirement (though by the time they reach 75 the reality becomes apparent).[7] Perhaps this is because many make the error of deducting the retirement age from life expectancy at birth rather than looking at life expectancy once one has reached the age of retirement.

Assumption 2: As society gets richer, we can afford to retire earlier.

Retirement is generally viewed as a reward for our prosperity. As society gets richer, we assume that we can retire earlier and use, in effect, our increased wealth to buy more leisure.

The basic flaw in this argument is that people are not taking into account increasing longevity and its associated higher costs. We may be wealthier, but retirement is more expensive. The adverse price effect is swamping the beneficial income effect.

7 'Attitudes to retirement and pension planning', *Pension Trends: 2005 Edition,* chapter 5, pp. 3-4 (available at: http://www.statistics.gov.uk/downloads/theme_compendia/pensiontrends/Pension_Trends_ch05.pdf), drawn from V Mayhew, *Pensions 2002: Public attitudes to pensions and saving for retirement* (Department for Work and Pensions Research Report No. 193, 2003).

The world of work

Assumption 3: It is a good thing to retire people early, as there are not enough jobs for everyone.

Born out of the pessimism of high unemployment in the mid-1980s was the view that it is good to retire people early, as there are not enough jobs for everyone. To create job opportunities for the young, the work of the old must be displaced, either by working fewer hours or taking early retirement. It is a French-inspired thesis more popular in Europe than the UK, and regrettably one still being pursued by the European Commission's Social Affairs Directorate through the Working Time Directive.

The 'lump of labour' fallacy was bad economics in the 1980s, and it is even worse now. Increased output generates more income and expenditure, and thus creates more jobs. To view the free market as having fixed borders with a set number of available jobs is to limit what it can do. The consequences of such bounded thinking are serious: prosperity is reduced and there is a loss of output for society as a whole. Worse still, it fosters an ageist agenda in the workplace. Workers over 50, deemed less valuable as they near the end of their careers, are not given adequate training, and encouraging them to leave results in a premature loss of skills from the organisation. It has also depleted the reserves of pension funds, contributing to the current deficits.

Assumption 4: Income and status at work rise linearly and you retire from the organisation at your most senior position – and when you retire, you leave the organisation entirely.

The dominant employment model is that income and status at work rise linearly. You depart from the organisation at your most senior position, and when you retire, you leave the organisation completely.

SMF FORESIGHT

Yet as people work longer the consequences of this assumption are already under strain. Such a structure lacks flexibility, and endemic ageism reinforces a lack of variety in working patterns. The leadership model, likewise, appears outmoded, inaccurately assuming that companies should continue to be led by their oldest employees.

It is evident that these models are breaking down. Yet retirement planning and workplace schemes such as final salary pensions cling to work-retirement patterns that are increasingly being overtaken.

Living in retirement

Assumption 5: Our standard of living in retirement will be constant.
It is assumed that one's standard of living in retirement can be held constant, with the help of retirement products such as price-indexed annuities and indexed pensions. Yet it is not hard to see how this goes wrong: as the rest of society continues to get wealthier, those in retirement become relatively poorer. With a growth of real incomes of 2.5% a year, someone retired for 30 years will find that the working population will be nearly twice as rich, or, put another way, if their pension was about half average earnings at retirement, it will be only 25% 30 years later. Their purchasing power will have taken a severe knock.

We ought to be measuring separate cost of living indices for different age groups, especially for the very elderly in the last 10–15 years of their life. The price of goods will tend to rise more slowly than that of services, but this is no comfort to those who have bought their last fridge or car. Worse, the things older people do spend their money on, such as services, become relatively more expensive. To protect their lifestyle the elderly end up having to pay for tasks they can no longer perform themselves, such as gardening, decorating and other personal services. And these services will be paid for at the current market

rate, which, relative to their income, will have increased significantly over the course of their retirement.

Assumption 6: We acquire assets while working and decumulate them during retirement, with a sharp distinction between the accumulation and income phases.
A second assumption about life in retirement concerns personal asset management. We tend to acquire assets while working and decumulate them during retirement, with a sharp distinction between the accumulation and income phases. Investment tends toward equities in the accumulation phase, then shifts towards annuities backed almost exclusively by bonds.

The effect of this shift is that we move abruptly from growing our pension pot to safeguarding it. It seems a sensible thing to do. Protecting our income when we are no longer working is understandable. Yet as we live longer, it is increasingly evident that we stop growing our income base too soon. A secure income at 65 is unlikely to be able to accommodate a long decline in relative income over 30 or so years. The money we are not drawing on in the early years of retirement still needs to be grown, particularly if the size of the pension pot at retirement was inadequate – as it will be for a lot of debt-ridden baby-boomers.

This model is based on a work:retirement divide that is needlessly absolute. Much employment regulation forbids any blurring of the categories, making it difficult to continue working once you reach the age of retirement or have officially retired from the organisation. In public sector schemes, in order to draw your pension without abatement you must not have any form of job with your former employer, part-time or otherwise. Yet income could be increased past the age of 65 if employees, although 'retired', continued to work in some fashion, supplementing their pensions (or part-payment of their pensions) while they are still able to work.

Many pension schemes have offered incentives for early retirement, such as added years, while penalising those who want to continue working by setting caps on the number of years that pension rights can be earned or by giving less than the actuarial value of deferment. The incentive structure should be precisely the opposite.

Private and public provision in retirement

Assumption 7: During retirement we won't move house more than once.

Housing is a key area where assumptions about living conditions for older people are seriously flawed. We tend to think that during retirement we will not move house more than once. We may stay in the family dwelling with more space than we need or retire to the country, the coast, or to Spain. Often, the envisaged 'retirement home' is somewhere that may be ideal for fit, car-driving 60 year olds, but which could well become a liability in later life.

If you live to be 100, the idea that, at 60, you will choose a single retirement abode appropriate to the final 40 years of your life does not hold true. The house we require in our 60s is likely to be a very different place from the one that will suit in our 90s.

The consequences of such thinking result in inadequate accommodation for the aged. The UK housing stock is poorly configured for different age groups of the elderly and the choice is inadequate. Given few options, many old people continue to live in houses that are too big, too expensive to maintain, and poorly adapted in terms of facilities. Housing becomes a financial burden on those unable to find an adequate alternative. Care homes too are often poorly configured, mostly being conversions of oversized family dwellings. The sheer number of the elderly, and the very different stages of old age, of mobility and independence, have yet to infiltrate planning for extensive and varied housing for the old.

Assumption 8: The state will provide social and healthcare services for us in our latter years, allowing our children to inherit our estate without it being significantly depleted.

In a society that sees old age as a problem, the onus is generally placed on the state to put it right. A lingering assumption in relation to old age is that the state will provide social and healthcare services for us in our latter years, allowing our children to inherit our estate without it being significantly depleted.

The idea is prevalent, but unsound. Government is in fact trying to reduce its commitment and is therefore insisting on the use of personal assets, including property, to pay for care before help from the taxpayer kicks in.

What the state ought to pay for is open to debate, and solutions differ even between England and Scotland over healthcare and personal

SMF FORESIGHT

care for the elderly. With no clear understanding of the role of state provision, individuals resent moves to make them pay for what they see as an inalienable right to care. There is little recognition that those who hope to inherit their parents' estate in full are often wealthier than the generality of taxpayers being asked to fund the care. A franker admission of this problem is required.

Assumption 9: Marketing is best focused on young people and families.

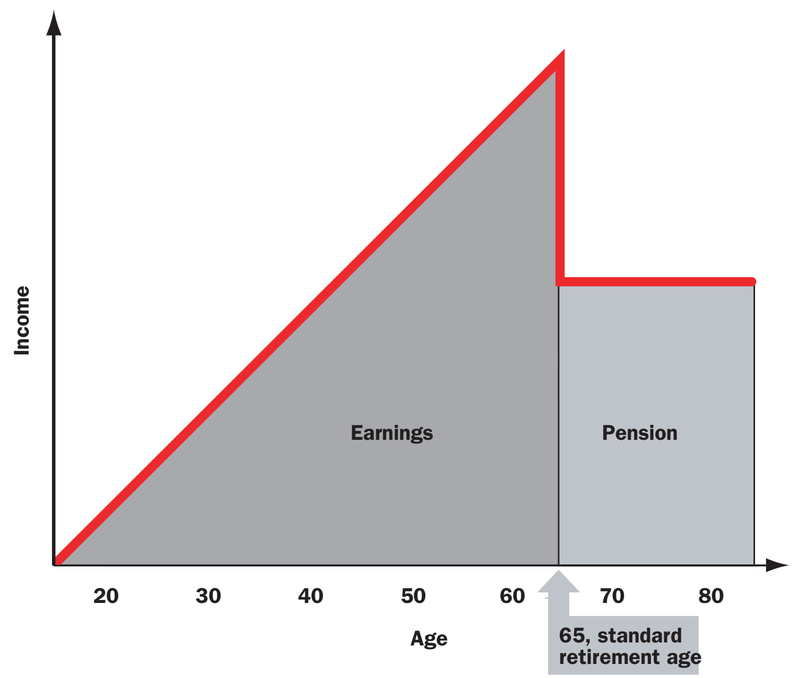
The provision of goods and services is an area significantly undermined by pervasive ageism. Corporate marketing is almost invariably focused on young people and families. Targeting mature consumers is often seen as an add-on and rarely a profitable end in itself. One rarely sees anyone over 40 in marketing or advertising campaigns.

The consequences of this assumption are twofold: companies fail to segment the market accurately, and different cohorts of the elderly are provided for inadequately. Yet the elderly are a growth market, increasing in size and demand every year in our longer-lived society. The over 50s hold over 80% of personal wealth. Age as a market indicator is insufficiently explored and is underdeveloped.

THE FLEXIBLE YEARS

The basic model of work and retirement can be characterised as 'the cliff'. Your working years are the ascent: as you rise higher through an organisation or through your career, your income increases until you reach your most senior position and salary. From this summit, there is a sudden drop: you retire and your income falls to, say, 50% of your pay.

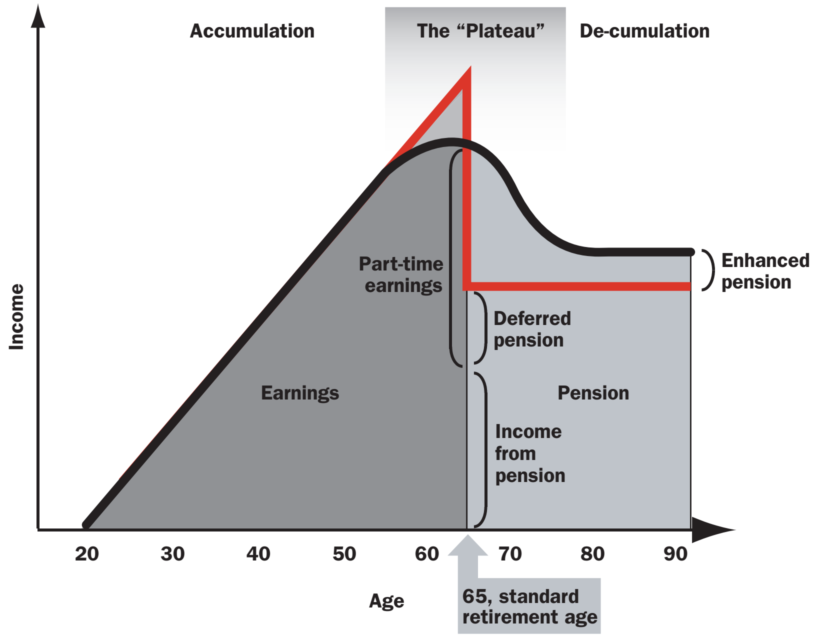
Existing model – the cliff



The impact of changing demographics on the cliff model is huge. For one, we are starting work later and living longer, so our earning years are shorter while our expenditure stage living on a pension or our assets is lengthening. Moreover, increasing longevity means that retirement will not feel as we expect it to. An extended old age will make retirement qualitatively different over time, especially in the costly later years of greater need and possible infirmity.

We need to alter fundamentally our assumptions about work and retirement and the transition between the two. Rather than a cliff, we need to move towards more of a ‘plateau’ where we remove the sharp distinction between work and retirement.

New model – the plateau



Doing so would allow people to carry on working past the current retirement age, though not necessarily full-time or in the most demanding or highest paid jobs. It would also allow people to defer their pension, or to take only part of it. Reinvesting the unused portion would earn employees a higher pension later on. A profitable decade of mixed working and retirement ought to be the dominant model of how to make the most of our flexible years, easing ourselves into a restricted income rather than plunging into it.

WHAT NEEDS TO CHANGE?

Demographics

We need first and foremost to make everyone accept that the current individual and collective assumptions about work and retirement are no longer valid. There is a large education task here for government, employers, pension providers and pensioner groups. A couple who reach the age of 65 have a 50% chance of one of them surviving to the age of 90, a 25% chance of one reaching 97, and a 17% chance that one will reach 100. We must begin to recognise that such long lives are not unusual. With several older generations ahead of us, families will have to plan extensively for the future.

Individuals and families

Even something as fundamental as our picture of the family needs to be rethought. In terms of the individual, it is evident that we need to save more. Here too there is a large education task for government and financial service providers. We have to acknowledge what the last decade of our lives will really be like, and that we cannot rely on state care and pensions. Nor will we be able to count on corporate pension schemes (which can collapse when companies disappear) or inheriting one’s parents’ estate in its entirety. Government needs to settle the unresolved argument about how the costs of care in later life will be shared between the state, the elderly and their families.

We will also have to be prepared to work longer, to keep learning and be flexible in the roles we take on. This may mean handing over one’s senior position for something less demanding, without loss of respect. It is also likely to mean deferring all or part of one’s pension in order to reap a better pension later on when one’s need for it is greater.

Organisations
To do so requires organisational change. Leadership models need to be reconfigured so that business management can be transferred to younger staff. New advisory or client-facing roles could be created for senior staff to profit from their experience, but with no fear of 'backseat driving' that might interfere with new management.

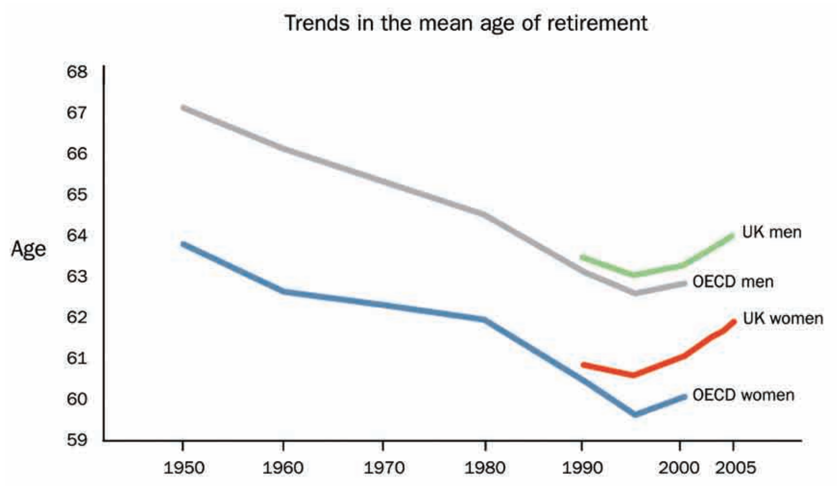
Flexible working models for older people would help to break down ageism by demonstrating more clearly the advantage of having older staff. Better recruiting and training for older employees and an ongoing role for them would prevent the loss of valuable skills through early retirement. Final-salary pension schemes will have to change if employees no longer retire at their highest salary, but rather downsize in their latter years.

Markets
How we solve the problem of our ageing population is clearly a matter not just for individuals and employers, but for society as a whole. We need to establish a continuum of housing types and, equally, resolve arguments over the provision and funding of care for the elderly. Pensions schemes and governments must work together to remove restrictions on how pensions are drawn while still working. Products better suited to the new demographics will be required to provide annuities, and to fund care via insurance. Pension schemes must cut back the incentives for early retirement and should offer true actuarial value for deferment. Annuities need to build-in provision for growth after retirement while using financial markets to control risk. Better products will be required to fund care via insurance, equity release and other measures. Companies need to redirect their products and their marketing towards the growing elderly market.

CONCLUSION

Although many of the issues discussed are illustrated with UK examples, the issue of changing demographics affects all industrialised countries. The problem, however, may manifest itself in different ways. In Italy and Japan, for example, the demographic shift is more severe than in the US, but in the latter the now retiring baby-boomers face retirement with a severely inadequate financial provision.

Progress towards the plateau



The agenda is challenging, but progress is already being made. In the UK the age at retirement, having fallen steadily for many years, has now begun to rise again. The pension age in many OECD countries, including the UK, is starting to increase.[8] Legislators in the United States and the European Union are under constant pressure to tackle age discrimination. Removing the restriction on compulsory retirement will foster – or force – changes in work culture. We may not have fully grasped the implications of longevity, but changes are now afoot.

8 The Second Report of the Pensions Commission, *op.cit.*, p. 333.

ABOUT THE AUTHOR

Lord Andrew Turnbull joined HM Treasury in 1970, was seconded to the IMF between 1976-78 and during 1983-85 he was Economic Private Secretary to the Prime Minister. In 1988 he returned to Number 10 as Principal Private Secretary. Lord Turnbull was Permanent Secretary to the Department of the Environment from 1994-98 and to HM Treasury from 1998-2002. In 2002 he was appointed Secretary of the Cabinet and Head of the Home Civil Service. After retiring from the Civil Service he was made a Life Peer and joined Booz Allen Hamilton as an adviser.

SMF FORESIGHT

£5