A home of one’s own?

THE ECONOMICS OF LONG-TERM SAVINGS

There has been a fundamental transformation in how we save for retirement. Long gone are the days when most employers provided their workforce with a near-guaranteed pension income. Instead, young people today need to save for themselves. Given rising longevity, they have to put aside enough to support many years of retirement. They must also navigate far more difficult savings choices, with the cost of home ownership at historically high levels. We explore how current policy, particularly automatic enrolment, addresses these challenges and what economics might tell us about the ‘right’ savings choices.

Over the last few decades, the UK has moved away from a system whereby employers effectively guaranteed pensions to one where employees need to actively save and ensure they have enough for their retirement. Policymakers and individuals struggled to respond to such a deep-seated change, and the numbers of those saving for retirement gradually declined. The low was plumbed in 2012, when fewer than half of employees saved into a pension scheme.[1]

The eventual policy response was automatic enrolment, a system implemented from 2012 that defaults eligible employees into a pension scheme and has them save 8% of income between £6,136 and £50,000. The result: 10 million more people now saving into a pension.

In many ways the new system puts those just entering the workforce on a better footing than their immediate predecessors. Individuals in their 30s, 40s and even 50s are more likely to have little or no pension savings. They missed out on the golden era of defined benefits yet started to save through automatic enrolment only later in life.

But younger people still face significant challenges. Two of particular importance that we focus on in this bulletin are:

- The **long-term savings gap** that remains because automatic enrolment is insufficient to provide a good retirement income. People are living longer than ever. A typical 20-year-old can expect to live until their mid to late 80s and has a 1 in 4 chance of living to nearly 100.[2] Retirement could stretch into decades. For an average earner, automatic enrolment is unlikely to provide enough income for a good quality of life. For example, an average earner over their lifetime might only save £160,000 by 68. At current annuity rates that’s only about £5,500 of income a year.[3]
- The **increased complexity of savings choices,** with young people facing a tough decision **whether to save generally or** put money aide for **a deposit on a home**. The cost of a typical home today is nearly ten times median income, compared to around 6.5 times in 2002, forcing first-time buyers to save more and for longer.[4]

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1 Data from ASHE, Office for National Statistics

2 Office for National Statistics

3 Based on an individual earning £25,000 a year and under automatic enrolment. We assume 2% real investment growth and an annuity rate of 3.5%.

4 Based on median earnings data from ASHE, Table 8 and median house prices from House Price Statistics for Small Areas (HPSSAs).

These are central and intertwined policy challenges for long-term savings. We explore what economics can say about the solutions.

Mind the (savings) gap

'Engagement' is a long-standing mantra in the world of pensions. We want people to take an interest in their pensions and make active choices. This is sensible, insofar as it goes. It clearly doesn't work when it comes to trying to get large numbers of people to save more. Hence the idea of automatic enrolment, which has been so successful because it is the default option. Do nothing, and you are enlisted in the scheme. To opt out, you need to take action.

Behavioural economics points to multiple reasons why it is so difficult to get people to actively save more. For example:

- **Little attention is paid** to how much we currently save as the consequences will not be felt for many decades, which also means there is **no tangible reward in the present** for sensible savings behaviour.
- The link between current behaviour and future outcomes is complicated and uncertain and many have **no ready rules of thumb to help them judge** how much they should save.
- **It has not been easy to engage** (actually or in perception) and actively change how much is being saved into a pension, meaning people rely on employer defaults, or to open a pension where none was automatically available.

The original intent of automatic enrolment was that it would act as a minimum baseline. It was always expected that people would need to save more for a good retirement income. In retrospect this decision seems like a mistake. There is little indication that people are saving much more than is automatically deducted from their salary, and little reason to believe they would. Indeed, automatic enrolment may be self-defeating in this regard as people assume the default deductions are set at the right level.

Still, given everything we now know, the solution to insufficient savings has to lie with automatic enrolment. If we want young people to save more for their old age we need to be acknowledge that the only way to do that on any scale is to (gradually) but materially increase how much is automatically taken from monthly paychecks.

Home ownership: a bad pipe dream?

Raising savings rates might be the right thing to do, but realistically it will create extra pressures for young people, many of whom naturally focus on saving for a home.

They do so usually knowing that the hurdles to home ownership are higher than ever. That is why less than 40% of 25- to 34-year-olds own a home, a major decline from over 60% in past decades.[5]

Given the need for more retirement savings, how much does this potential tension matter, and is it really sensible for young people to want to own rather than rent?

To answer that, let's first take a look at what home ownership means for retirement. We can see that:

1. Housing acts as a **store of savings**. Equity release (albeit unpopular) and downsizing are mechanisms by which savings in a home can be tapped as income.
2. Home ownership **generates returns** through an individual's working life in the form of **reduced costs** (interest on a mortgage compared to paying rent) and capital appreciation. These returns can be put toward future retirement income.
3. Assuming the house is paid off by retirement, **living costs are substantially lower than renting**.

There are, of course, some drawbacks to home ownership relative to other typical investments (e.g. stocks and bonds):

- **Accessing the savings** in a home, especially via downsizing, is relatively **costly and time-consuming**. A home is, to be a bit technical, a fairly illiquid form of savings.
- Ownership entails additional **maintenance costs** that renting does not.

[5] English Housing Survey

- There are **opportunity costs** to investing in a home: the returns you might otherwise have earned from other investments.

Taken in the round, we can see home ownership as an (imperfect) substitute for other investments for retirement. In practice, though, we would not want anyone to have only a home to rely on after they stop working. Diversification is important, as is ready access to savings to draw on as income.

That places home ownership as a reasonable and legitimate *complement* to other long-term savings. Indeed, common rules of thumb such as the need to have two-thirds of your working income in retirement are predicated on the assumption that you own your own home.

Implications

There is a strong cultural desire in the UK to own your home. The logic that we have set out suggests that desire is entirely compatible with a reasonable long-term savings strategy. But what does this mean for individuals' savings decisions and for policymakers, especially when combined with the wider challenge of trying to raise long-term savings?

In our view it points to a few key things:

- **If we want people to save more for their old age, change will realistically have to come through policies that use defaults, such as automatic enrolment**. Expecting people to make active decisions to save more for retirement has not worked and will not work.
- **The increases required are potentially sizeable, meaning there is a risk of more opt-outs.** The default savings rate may have to go up by half from 8% to 12% - or even higher. The risk of opt-outs will inevitably rise, especially among people with competing priorities, such as saving for a home. High opt-out rates are a real problem, as they probably mean less saving overall and the loss of valuable tax reliefs and employer contributions.
- **There is therefore value in exploring whether higher default contributions should be paired with greater flexibility in the use of pension pots**. Possible ways of drawing on pension savings to cope with short-term financial difficulties, another important reason why people opt out, are already being considered. There is equal merit in looking at whether some pension savings could be used to support a deposit for a first home.

These ideas are not necessarily easy. There is much to be worked through to allow people to fall back on some of their pension savings to buy a home. What restrictions would need to be put in place? But there is a precedent in the form of the current Lifetime ISA. Putting a pension pot to the same use would be a natural, simplifying extension. More importantly, it would motivate younger people to remain opted-in to their pension, even if they have other savings goals, and thus make a habit of saving through their employer.

Conclusions

Automatic enrolment has radically reformed UK long-term savings policy. But young people today still do not enjoy the clarity and simplicity that were the hallmarks of pension arrangements in the past. Previous generations could go to work safe in the knowledge that provisions for a good retirement were being taken care of. Minimal decisions or engagement were required of them.

The world of guaranteed pensions is gone for most, but the building blocks are in place to provide a simple mechanism for the majority of young people to save enough for their retirement. To do so effectively requires us to address the competing pressures for savings, particularly housing. Failure to do so might lead to widespread opt-outs from automatic enrolment in the face of higher default contributions. These can be reconciled by recognising the complementary role that home ownership plays in retirement, thereby legitimising the use of some of the extra pension savings as a deposit on a first home. An expectation of higher contributions must go hand in hand with new flexibilities and freedoms.

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