



ROYAL LONDON POLICY PAPER

4. Britain's "Forgotten Army": The collapse in pension membership among the self-employed – and what to do about it

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BRITAIN'S "FORGOTTEN ARMY":

THE COLLAPSE IN PENSION MEMBERSHIP AMONG THE SELF-EMPLOYED – AND WHAT TO DO ABOUT IT

Executive Summary

Automatic enrolment will give around ten million employees the opportunity to join a workplace pension, benefiting from tax relief on contributions and an employer contribution. Whilst the amounts going in to such pensions are typically relatively low, the policy will at least lead to much higher levels of pension scheme membership amongst employees, reversing a decades-long decline.

Britain's 4.6 million strong 'army' of self-employed people are generally not included in automatic enrolment and have therefore not been part of this huge growth in pension scheme coverage. In fact, coverage amongst the self-employed has plummeted in recent decades and is now at crisis levels. For example, the limited data available suggests that in the mid 1990s around 62% of self-employed men were members of a pension scheme, but by 2012 this proportion had fallen to less than one quarter.

At the same time, the number of self-employed people has been rising and the nature of self-employment has been changing. In the past, a self-employed person might have expected the sale of their business or business assets to be part of their retirement planning. But the 'new self-employed' are increasingly doing very similar jobs to many employees and are much less likely to have a business to sell at retirement. Although the self-employed will benefit from improvements to the state pension, many self-employed people are facing retirement on a very modest income unless urgent action is taken.

The lack of pension provision among the self-employed has been a source of growing concern over many years and a number of important reviews have been undertaken. But nothing has been done to address the large and growing problem of declining private pension provision among the self-employed.

This paper offers a way forward. Whilst it may be thought politically unfeasible to force self-employed people to save for a private pension (judging by the lack of government action in this area), this paper proposes a very strong 'nudge' in that direction, building on the lessons of automatic enrolment. The key elements of what is proposed are as follows:

- The main rate of National Insurance paid by the self-employed (Class 4) would be increased from its current level of 9%; given that the employer contribution under automatic enrolment will be 3%, it is suggested that the rate of Class 4 NICs would be increased by 3% to 12%;

- Self-employed people would be able to elect to have those additional contributions diverted into a pension, provided that they also contributed at a specified level; again, based on automatic enrolment legislation, a minimum gross contribution of 5% (including tax relief) might be required;
- Consideration could be given as to whether the contribution could be diverted instead to a 'Lifetime ISA'; this might be more attractive to some self-employed people with fluctuating incomes who might prefer a savings vehicle which offered the possibility of 'early access' (albeit with a penalty); care would be needed however to ensure that this did not fatally undermine the goal of improving retirement provision for the self-employed.

From the point of view of the government, the main costs of the scheme would be the administrative costs of diverting the additional NICs to a specified pension scheme and the tax relief on the additional private pension contributions of the self-employed. On the other hand, given that take-up of such schemes is seldom 100%, the net additional NICs revenue would at the very least help to cover ongoing administrative costs.

Additional NICs are unlikely to be warmly welcomed by the self-employed, but the experience of automatic enrolment has been that many workers are relieved that someone has taken the initiative to get their pension saving started. It may be that over time self-employed people who have never got round to starting a pension would come to accept this process as the 'new normal' when self-employed.

No scheme is perfect, but in a world where legislating for mandatory saving by the self-employed is thought impossible and where extra government support is unlikely, this scheme may be the best compromise. Otherwise, millions of today's self-employed people seem set to experience a standard of living in retirement which neither they nor society as a whole would want for them.

1. The current system of pensions for the self-employed

a) State pensions

At present, the only mandatory system of pension provision for the self-employed is the state pension scheme¹. But until April 2016, the self-employed were effectively second class members of the state pension system.

Under the pre 2016 system, an employed earner paid Class 1 National Insurance Contributions (NICs) and their employer also paid Class 1 NICs. This entitled them to a basic state pension (around £119 in 2016/17 prices) and an additional state earnings-related pension, often known as SERPS or the 'second state pension'.

The self-employed (or at least those with profits above certain minimum thresholds) paid two classes of National Insurance - a relatively low weekly flat rate of Class 2 contributions and a profit-related Class 4 contribution. Only Class 2 contributions generated entitlement to state pension and, crucially, only to the basic state pension². This meant that under the old rules, someone who was self-employed throughout their working life could only build up a state pension of £119 per week – the rate of the basic state pension. This is well below the level of the means-tested pension credit 'guarantee' which is the minimum level that the Government believes people in retirement need to live on.

The situation for the self-employed has improved somewhat with the advent of the new state pension in April 2016. Under the new system, all contributions, whether Class 1 (employee) or Class 2 (self-employed) are of equal value. A self-employed person with 35 years of Class 2 NICs will therefore be able to get the full new state pension of £155.65 per week, the same rate as an employee with 35 years of full rate Class 1 NICs. This is something of a windfall gain for the self-employed who will generally have paid far less NICs into the system than their employed counterparts, especially if account is taken of the value of employer NICs. However, £155.65 still represents a very basic level of income in retirement and most self-employed people will need more than this if they aspire to maintain their pre-retirement standard of living when they are no longer working.

¹ We are assuming throughout that people are exclusively self-employed. If they also work as a paid employee, they will, of course, be covered by any workplace pension provision relating to that employment.

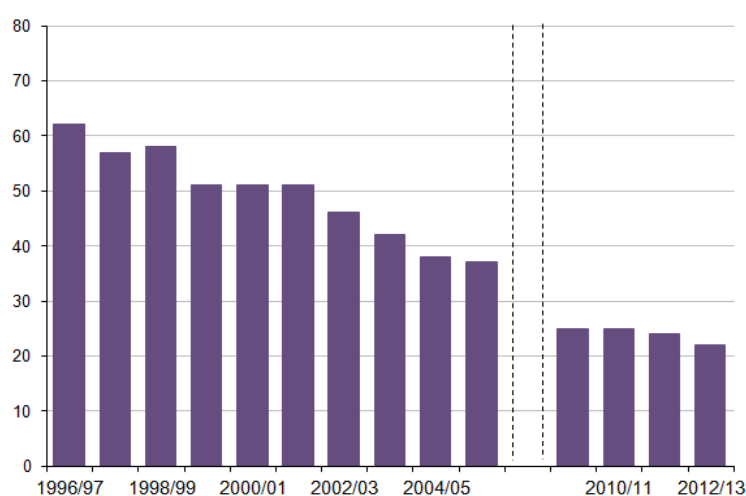
² From April 2018, Class 2 contributions will be abolished altogether and Class 4 contributions will be used instead to establish state pension entitlement.

b) Private pensions

Whereas workplace pension coverage amongst employees is currently increasing sharply because of automatic enrolment, private pension coverage amongst the self-employed has shown a shocking rate of decline.

Figure 1 uses data from the Department for Work and Pensions and shows private pension scheme membership amongst self-employed men since the mid 1990s:

Figure 1: Self-employed, working age men, by whether currently contributing to a personal pension, 1996/97 to 2012/13 (percentages)



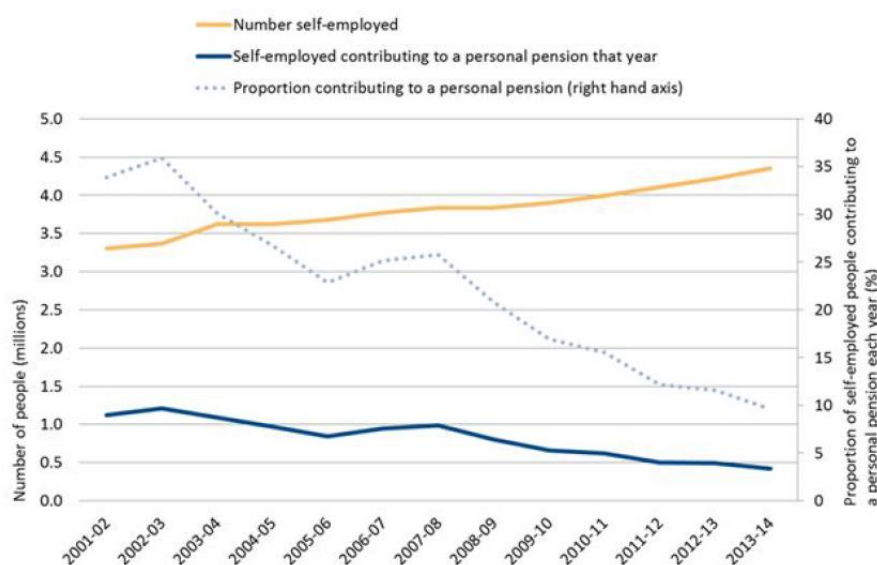
Source: Family Resources Survey, Department for Work and Pensions[data not available for 06/07 to 08/09]

As Figure 1 shows very clearly, scheme membership amongst self-employed men has fallen by almost two thirds over a period of less than two decades. Three out of four self-employed men are not saving for a pension. Some of these people will have built up pension savings in other years, but the Deane review³ found that around one in five self-employed people expect to rely exclusively in retirement on the state pension.

Estimates for self-employed men and women for the period 2003/04 to 2013/14 have been published by Citizens Advice and are shown in Figure 2. This shows very clearly that whilst the number of people who are self-employed has been growing steadily, the proportion with pension coverage has plummeted.

³ *Self-employment review: an independent report*, Julie Deane for the Department for Business, Innovation and Skills, February 2016

Figure 2. Number of self-employed contributing to personal pensions (stakeholder and non-stakeholder) 2003/04-2013/14



Source: NPI analysis for Citizens Advice: Labour Market Statistics and DWP Personal Pensions Statistics 2015.

To some extent, these charts mirror the pre automatic enrolment trend in pension scheme membership amongst employees, although the decline is rather more dramatic. A number of factors may be at work:

a) The changing nature of self-employment

Figure 3 shows a summary of recent trends in the composition of the self-employed, and a number of these trends will affect levels of pension scheme membership.

The 'new' self-employed are more likely to be on more modest incomes. Just as pension coverage amongst lower paid employees was low and declining before the advent of automatic enrolment, the same is likely to be particularly true of the low income self-employed, especially with no employer prompt to join a pension scheme and no employer contribution to encourage them to do so.

Figure 3: The changing nature of self-employment

- In the UK the self-employed account for a growing proportion of the labour force. There are now roughly 4.6 million self-employed people, an increase of over 1 million since 2000, and accounting for around 15% of the workforce. Self-employment has accounted for around half of the total growth in the workforce since the start of the last recession.
- In general, the self-employed tend to be older on average than the employed workforce, with nearly half over the age of fifty. Much of the recent growth in self-employment has not been due to a rise in the rate at which people start becoming self-employed but rather a reduction in the rate at which people *stop* being self-employed. In other words, people are now remaining self-employed for longer than in the past.
- Though the majority of self-employed people are men, the proportion of women is rising.
- The self-employed are more ethnically diverse than the employed workforce with, for example, 24% of Pakistani workers being self-employed compared with the UK average of 15%.
- The incomes of the self-employed are more diverse than those of employees. Whilst average incomes of the self-employed are generally lower, there is also a much bigger range between the highest earning self-employed people and the lowest earning, compared with their employed counterparts.
- Growing numbers of people will experience one or more period of self-employment at some point during their working life.

b) The financial pressures on the self-employed

Recent survey evidence published as part of the 'Deane Review' found that not being able to afford to save for retirement was a 'big problem' or 'something of a problem' for half of the self-employed. In other words, a large part of this group recognise the need for more retirement provision but do not feel that they can afford to put money by.

Whilst affordability might be expected to be an issue for lower-paid employees as well, the self-employed may face additional pressures because of more unpredictable income streams and the pressures of financing their business. Self-employed people may be reluctant to lock up their money until age 55 or beyond in the form of a pension if they need 'working balances' to help smooth their business through the peaks and troughs of the business cycle.

For this reason the Deane review placed considerable emphasis on the need to provide "more flexible financial solutions" including in the pensions sphere. It may be that the new Lifetime ISA could be of some benefit to the self-employed in this context. Whilst employed earners should think carefully before renouncing a workplace pension with an employer contribution, a self-employed person might find a Lifetime ISA with a government top-up to be a more attractive option. Whilst there are still considerable limits on the potential for penalty-free withdrawal before the age of sixty, the scope for emergency access (with penalties) might be a better compromise for some self-employed people.

c) How do the self-employed view pensions?

Analysis by Citizen's Advice⁴ suggests that levels of understanding of pensions are relatively low among many self-employed people. Nearly seven in ten self-employed people surveyed by Citizen's Advice did not correctly understand the tax advantages of pension saving and many assumed that if they took out a pension they would be obliged to maintain a regular monthly contribution, regardless of the state of their business. The research found that pensions were also not well trusted and that self-employed people with spare cash to invest for the future would prefer a savings account, cash ISA or property to investing in a pension.

The situation is made worse by the lack of an employer. Not only does an employer have an obligation to contribute to a pension, but the employer is often a source of information about pensions and provides a prompt to take action.

Given the above evidence, it is perhaps not surprising that a policy of simply hoping that self-employed people will sort out their own pension arrangements seems doomed to failure.

⁴ "Shy of retiring - addressing under-saving among self-employed people", Citizen's Advice, January 2016

2. Approaches to reform

A range of ideas have been considered in the past for improving pension coverage among the self-employed.

More than fifteen years ago, the (then) Department of Social Security was looking seriously at proposals by the Pension Provision Group to make sure that all self-employed people had a second pension. This would either be a state second pension or a private sector equivalent. Press reports at the time said:

“The Government is considering compelling all the country's self-employed to pay into a second pension as part of its wholesale review of pension policy, it emerged yesterday. Responding to a report by the independent Pensions Provision Group, the DSS said it was looking at bringing the UK's 3.25 million self-employed into a revamped system of compulsory second pensions”.

But despite the good work done by the Pension Provision Group at the time and the willingness of the government of the day to move towards ‘automatic enrolment’ for employees, extending the principle to the self-employed remained in the ‘too difficult’ box.

Arguably, the 2016 state pension reforms at least partially implemented this proposal. Now that there is only one state pension, both employees and the self-employed build up equal rights to the state pension rather than having a lower rate in respect of the contributions made by the self-employed. But the level of provision remains minimal and most self-employed people will seek a retirement income of more than the £8,000 or so per year offered by the state.

The Deane Review recommended more flexible financial products and it may be that the ‘Lifetime ISA’ proposed in the recent Budget will encourage more self-employed people to engage with long-term savings. However, it is still far from clear that a system which relies on an ‘opt-in’ from the self-employed will overcome the inertia which has bedevilled efforts to promote pension saving amongst workers and the self-employed for many decades. Something more is needed, and the top-up to low earners could be more generous than the current system of tax relief.

3. A proposal for reform –auto enrolment through the National Insurance system

a) How would it work?

When the system of 'automatic enrolment' is fully implemented for employees in October 2019, employers will be required to contribute into a workplace pension for anyone earning more than £10,000 pa at a rate of 3% of a band of 'qualifying earnings' from £5,824 to £43,000 per year. Workers will have to contribute 5% of their wages in the same band of earnings. For the self-employed, there is no equivalent scheme.

Our proposal is to mirror the automatic enrolment scheme for employees by increasing the rate of Class 4 National Insurance Contributions, but allowing the self-employed to specify that this money should be directed into a nominated pension.

As noted earlier, the self-employed are required to pay National Insurance Contributions if their profits are above certain minimum thresholds. The modest weekly Class 2 rate is payable above a 'small earnings exemption' of £5,965 per year, whilst the Class 4 rate is 9% on profits between £8,060 and £43,000 (with a 2% charge on profits above this level).

Given that the separate Class 2 rate is to be abolished in 2018, it would make sense to build on the Class 4 system if we are to mirror automatic enrolment going forward. The full rate of the new state pension is around £8,000 per year, so a self-employed person with profits at this level or less will find that the state pension provides an adequate level of income replacement. This is also roughly the floor for Class 4 contributions.

So it would be logical for any additional NI contribution made by the self-employed to start at this level. Given the mandatory 3% contribution by employers under automatic enrolment, the obvious parallel would be to increase the main Class 4 NICs rate by 3% to 12% on the band of earnings between £8,060 and £43,000. For a higher earning self-employed person with profits at or above the £43,000 ceiling this would increase their annual NICs bill by around £1,000, whilst someone with more modest profits of £20,000 would need to find around £360 per year.

We propose that this would only be possible if the self-employed person then made their own direct contribution at a minimum rate of 5% of band earnings, gross of any tax relief. This would again be broadly analogous to the rules for employed earners, giving a combined contribution rate of a minimum of 8%. The resultant schedule of rates and contributions for employees and the self-employed is shown in Table 1.

The issue here is that if the rate of relief on employee contributions were restricted to (say) 25%, there would be a huge incentive for all pension contributions by higher earners to be diverted via the employer – even more so than under the current system. If workers only get tax relief at the standard rate but pay tax on their wage at the higher rate, then instead of putting their own take-home pay into a pension they would

Table 1. Automatic enrolment rates for employees and employers and proposed structure for the self-employed

a) Employed earners:
Band of qualifying earnings: £5,824-£43,000
Minimum contribution rate:
- Employer 3%
- Employee 5%
b) Self-employed
Band of earnings subject to Class 4 NICs: £8,060-£43,000
Proposed contribution rates:
- Addition to Class 4 NICs rate: 3%
- Direct contribution into pension: 5%
<i>Note: Assumes the phasing of employee and employer contributions to a combined 8% has been fully implemented</i>

b) *Implementation issues*

1. Availability of pension providers

It seems likely that pension providers would be very interested in a market of several million self-employed people engaging with pension saving for the first time. However, there will inevitably be some self-employed people earning not much more than the minimum profits level and who would therefore be making only very modest contributions. The self-employed with low profits might therefore find pension providers unwilling to take their business, especially if the automatic enrolment charge cap applied in its current form. For this reason it would probably be necessary to place a public service duty on the National Employment Savings Trust (NEST) to accept all requests by the self-employed to open an account, regardless of income, equivalent to their current public service obligation to serve all employers.

2. Access post 55

Under current legislation, a defined contribution pension can be accessed at age 55, subject to tax. For self-employed workers, many of whom are over fifty, our proposed scheme would take money from them in the form of Class 4 NICs, allow it to be redirected into a private pension and then – in principle – allow it to be accessed immediately as cash. This would clearly not serve the goal of promoting increased standards of living in retirement.

Whilst government would need to keep a close eye on this issue, this is unlikely to be a major problem. This is for a number of reasons.

First, although people can in principle withdraw all of their pension money at age 55, they have to pay tax as soon as they draw it, sometimes taking them into higher tax bands. But if they spread their withdrawals through their retirement, they are likely to face a smaller tax bill. Considerations of tax efficiency would therefore act as a brake on such withdrawals.

Second, as soon as someone takes more than their tax free cash at 55, their annual allowance for saving into a pension is cut sharply to £10,000 from the current £40,000. This provides an incentive for individuals to hold off taking taxable cash until they are sure that they have finished saving for retirement.

Third, and more difficult to quantify, is the fact that money in a pension is likely to be viewed differently to other sources of finance. The evidence from behavioural economics is that individuals operate various forms of 'mental accounting' and treat different pots of money differently. It may be that self-employed people would be much more reluctant to access cash earmarked for retirement in their fifties than cash held in a savings account or ISA.

If early access did undermine the policy it would be possible to impose further restrictions (for example, access to the 3% NIC levy could be held back until age sixty) but it would be preferable to avoid such additional complexities if possible.

3. Choice of retirement saving product

Given that self-employed people would have to actively choose a retirement savings vehicle to be a home for their contributions, it ought to be possible for those savings products to be relatively lightly regulated. On the other hand, given that there is an established regulatory regime for workplace pensions which provides for minimum standards of governance and for a charge cap on default funds, it is hard to see why the self-employed should enjoy less consumer protection than their employed counterparts.

One recent innovation proposed in the 2016 Budget is the Lifetime ISA, and government may wish to consider whether this could be an approved home for self-employed pension savings under this scheme.

On the positive side, the Lifetime ISA does offer greater flexibility on withdrawals than a traditional pension (albeit with penalties) and this may be a better fit with the financial circumstances of the self-employed if they have fluctuating incomes.

On the negative side, some of the broader concerns about the Lifetime ISA would apply in this case as well. These include:

- The majority of ISAs are invested in cash, and this is unlikely to be the best strategy for long-term savings for retirement by the self-employed;

- Beyond the age of fifty there is no government 'top-up' on contributions into a Lifetime ISA; although withdrawals are tax-free, a higher income self-employed person might do better instead to benefit from higher rate tax relief through pension saving;
- The exit penalties on 'early' access to a Lifetime ISA are considerable; as well as losing any government top-up, there is a 5% penalty on top; a self-employed person would need to think carefully about circulating money into and out of a Lifetime ISA if it was seen primarily as a retirement savings vehicle.

In sum, the Lifetime ISA offers an interesting variation on traditional pension products for the self-employed and it may appeal to some. But government would need to proceed carefully before allowing this product to be used as a home for redirected NI contributions, with the implicit government endorsement that would be associated with such a policy.

c) What would be the impact?

Not all self-employed people would be covered by the scheme, as not all have enough profits to come within the scope of Class 4 NICs.

The 2016 Budget 'red book' estimated that around 3.4 million self-employed people earn enough to pay Class 2 contributions and so have a profit level above around £6,000. Class 4 contributions only apply from a profit level of around £8,000 per year, so it seems reasonable to think that roughly 3 million self-employed people might be covered by this proposed scheme. Whilst this excludes the lowest earning one third of self-employed people, the full rate of the state pension will at least fully replace their self-employed earnings once they are no longer working. The main 'under-saving' problem is amongst the self-employed on middle incomes for whom the state pension will not provide adequate income replacement but who might not be expected to have a business of their own to sell in retirement.

As with automatic enrolment for employees, the 8% mandatory minimum level of contributions for the self-employed would only be enough to get someone started with additional pension saving. Beyond modest levels of self-employment income, individuals would need to save more than 8% to ensure that their standard of living did not drop in retirement, even allowing for the growing numbers of self-employed people who continue to work past traditional retirement ages. However, this would still be a big improvement on the current situation.

In addition, it seems reasonable to suppose that self-employed people who have actively selected a pension provider and are directly contributing each year are likely to be more engaged with pension saving than their employed counterparts and therefore more likely to be engaged with increasing the level of saving, particularly as they get nearer to retirement age.

4. Conclusion

The conclusions of our analysis are simple.

The problem of the self-employed and pensions is getting bigger each year. The self-employed workforce grows each year, but the proportion with any pension provision has fallen to historically low levels. Automatic enrolment is making a big difference for the employed, but the self-employed risk being left behind, notwithstanding recent improvements to their state pension rights.

A range of options has been talked about over the years to tackle this problem, but nothing has been done in the private pensions space. As a result, literally millions of self-employed people could face a retirement shock.

If we assume that outright compulsion is politically unviable and that significant government subsidy for the self-employed is also unlikely, options for action are limited. The best option seems to be to build on the success of automatic enrolment with a large 'nudge' to the self-employed.

An increased rate of Class 4 NICs which can be redirected into pension saving is likely to prompt large numbers of self-employed people to think about pensions again, not least so that they can 'get back' their increased NICs. They will still be free not to do so, and will therefore not have to make the 'employee' contribution that would otherwise be required. But many of the three million self-employed people likely to be covered by such a scheme could be expected to give serious thought to whether it is time to start saving for a pension. Unless there are better options on the table, it is time for this suggestion to be given serious consideration, if we are to avoid a generation of impoverished former self-employed people in retirement.