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BRIEFING

The self-employed and pensions

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The UK's self-employed populace is now 4.5 million strong. Although there has been a modest fall in their numbers of late after years of rising, the self-employed look set to continue being a larger part of the workforce than in recent decades. While much has been made of their poor earnings performance relative to employees, less attention has been given to the incomes the self-employed can expect upon retirement. A number of arguments are made for why low pension coverage is less worrying for the self-employed, for example the possibility of selling off their business to fund their retirement. This briefing note assesses these discussions and pension trends among the self-employed and asks whether it presents a genuine cause for concern.

Although there has been a modest fall in their numbers of late after years of rising, the self-employed look set to continue being a larger part of the workforce than in recent decades

We find that the self-employed have only fallen behind employees on pension membership since the turn of the century. Even as their numbers have swelled, fewer self-employed people have been contributing to pensions. But the self-employed are not a homogeneous group: those running businesses with employees (17 per cent of all self-employed people) appear more prepared for retirement than 'own-account' workers. Although the Single Tier Pension will benefit the self-employed, most will not gain from one of the biggest recent changes in the pensions landscape, automatic enrolment. Taken together, the evidence suggests there is a case for greater intervention to ensure the self-employed are adequately prepared for their later years.[1]

Overview

It is only since the turn of the century that the self-employed have had markedly lower levels of pension coverage than employees. Figure 1 overleaf compares membership in two of the primary forms of pensions for male full-time employees and self-employed, drawn from data in the General Lifestyle Survey (GLF). The steepest drop in membership among self-employed men was after 2008, although the share had been falling steadily since 1998. Over the same period, membership among employees has remained relatively stable, with the recession appearing to have had little impact.

The self-employed have only fallen behind employees on pension membership since the turn of the century

The exclusion of women and those working part-time (32 per cent and 29 per cent of the total self-employed workforce respectively) is an obvious weakness in these data. Another source, the Family Resources Survey (FRS), provides a more complete and up-to-date picture. It asks a similar question: do you have a non-frozen pension, regardless of whether contributions were made to it in the preceding year? As of 2012-13, 27 per cent of the self-employed had a non-frozen pension compared with 51 per cent of employees. Within both groups, that proportion has fallen slightly in recent years, from 33 per cent among

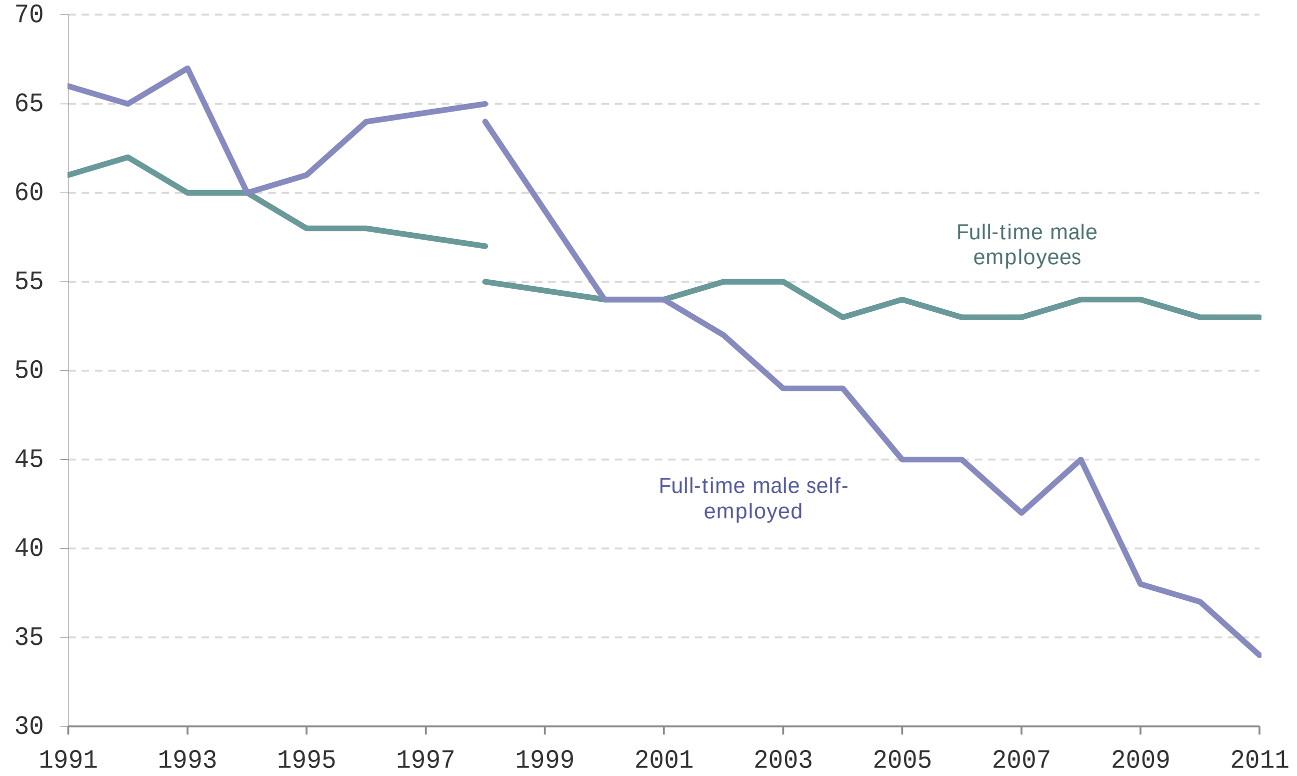
[1] We cannot say a certain amount of pension wealth or contribution level is adequate for the retirement of any particular group. That will depend upon a range of other considerations, for example whether they rent or own their home or whether they are single or in a couple.

the self-employed and 57 per cent among employees in 2006-07.

Breaking those statistics down by gender, last year saw a particularly sharp fall in the share of

Figure 1:
The gap in pension coverage between the self-employed and employees has widened

Membership of pension schemes by employment status (%)



Source: General Lifestyle Survey 2011, ONS

Notes: Self-employed line indicates membership of a personal pension scheme for self-employed men working full-time, 1991 to 2011, Great Britain. A personal pension is defined to include personal pensions, stakeholder pensions and retirement annuities; personal pensions may include SIPPs. Employee line indicates membership of current employer's occupational pension scheme: 1991 to 2011, Great Britain. For full notes see General Lifestyle Survey 2011.

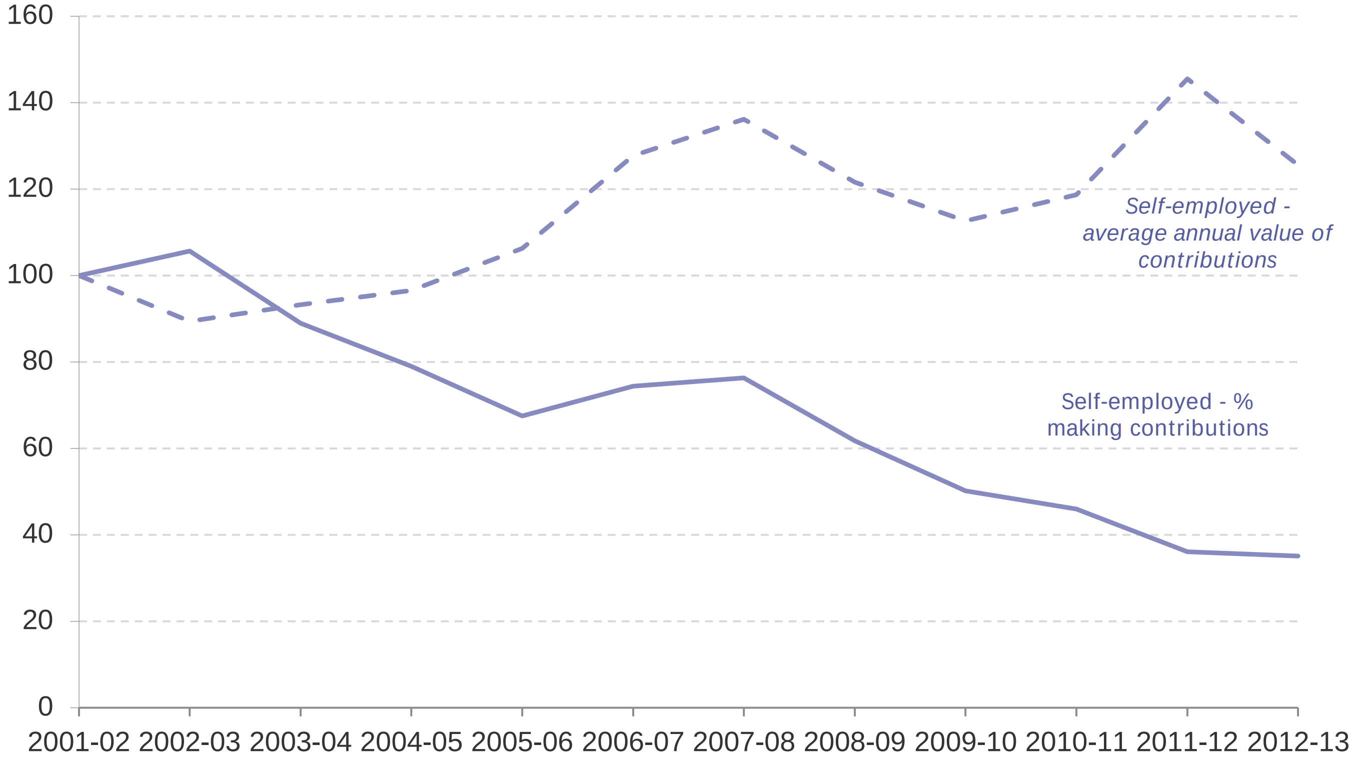
self-employed women with a non-frozen pension, from 25 per cent in 2011-12 to 19 per cent in 2012-13. The shifting composition of the self-employed as a whole will explain part of this change with more women, who as a group are more likely to earn less and work part-time, and therefore often less able to afford to save, entering self-employment in recent years.

While these two datasets give us a sense of how pension *membership* has declined in recent years, they do not tell us how many people are *actively contributing*. Data collected from pension providers by HMRC help to fill that gap. Supporting the overall trend from the GLF and FRS data, between 2001-02 and 2012-13 the number of self-employed individuals actively making pension contributions fell from 1.1 million to 0.5 million with most of that decrease coming post-2008. This halving of the number contributing is all the more surprising given the ranks of the self-employed swelled by 900,000 during those years. The inflation-adjusted (RPI-J) value of their total contributions fell from £3.4bn to £1.9bn over the same period. More revealing is that the inflation-adjusted average value of their individual contributions actually increased from £2,994 to £3,760.

Although other explanations are possible, one plausible interpretation of this development is that among the approximately 600,000 who have stopped actively making contributions, many were low-earning and making smaller contributions. Their dropping out has caused the value of the average contribution to rise as the better off self-employed who make higher contributions were able to continue doing so.

Figure 2:
The share of self-employed making annual contributions has halved

Index of % actively contributing and average real annual value of contributions to personal pensions (2001-02=100, contributions RPIJ adjusted)



Source: HMRC, Personal pensions: estimated number of individuals contributing and average contribution by status

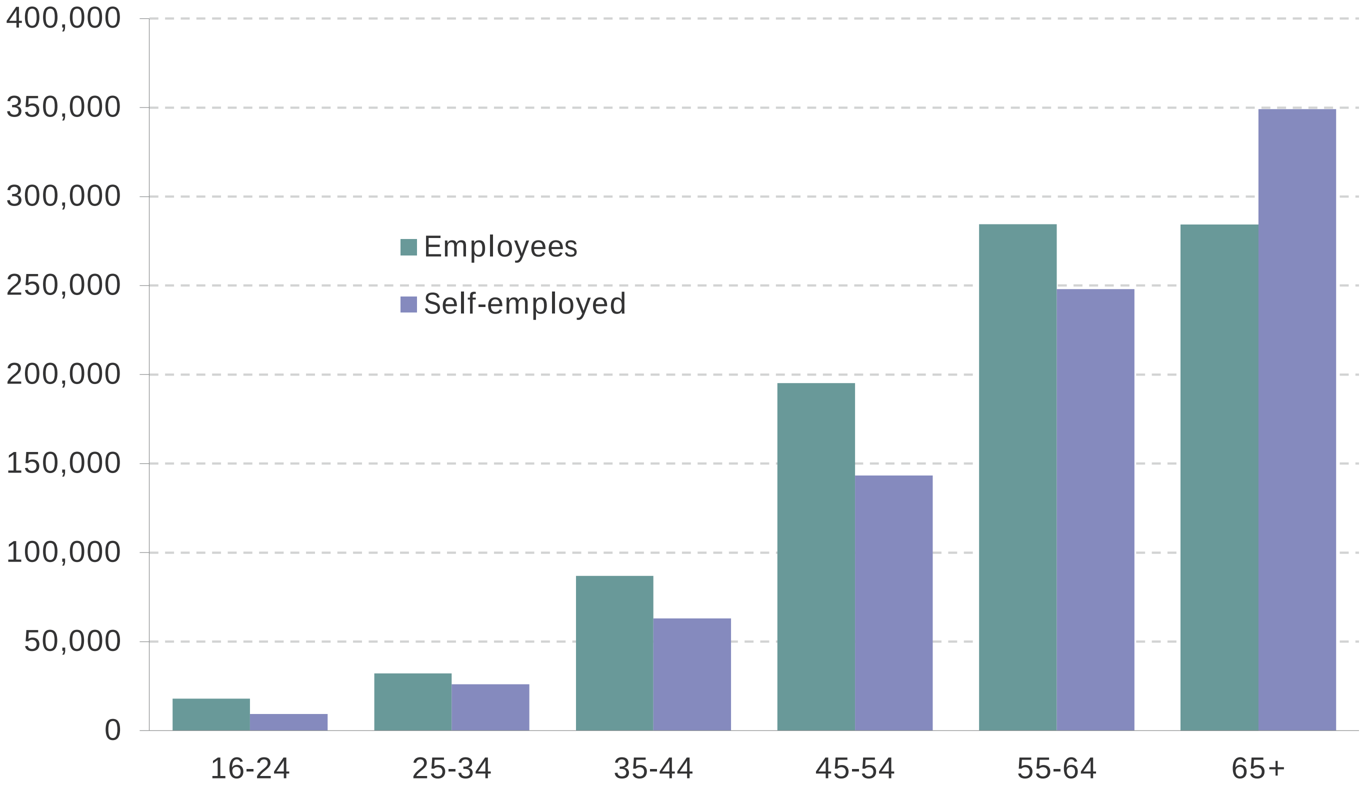
Notes: Data refer to the number of individuals whose personal pension (including stakeholder pension) has received a contribution during the year. Employment status is based on what is reported to the provider by an individual when making their original application so may include individuals who were self-employed and have since become employees. Average contributions include individual, employer and government minimum contributions, plus any basic rate tax relief that a pension provider has been able to claim on an individual's contribution. For full notes see: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/358121/PEN3.pdf

We know the self-employed are less likely to be a member of or contribute to a pension but among those who do have a pension, how does their worth compare to employees? Average pension wealth among the self-employed is lower in every age group than employees, apart from the over-65s. When we include financial wealth, as shown in Figure 3, the gap narrows somewhat but on average, other than among the over-65s, employees have more wealth to fall back on. There are a number of potential explanations for this over-65s anomaly, including the self-employed choosing to work longer and delaying taking their pension or high-income employees moving into self-employed semi-retirement. In terms of income, it is only among 16-24 year-olds and over-65s that the self-employed have a higher income.

As shown in Figure 4 overleaf, employees are much more likely than the self-employed to say an occupational or personal pension will provide the largest part of their retirement income with close to half (48 per cent) pointing to this as their main source of post-retirement funding. In contrast, just one in four (23 per cent) of the self-employed without employees say they will rely primarily on occupational or personal pensions, with the same share instead saying the state pension will form the largest part. Looking solely at property wealth, 16 per cent of self-employed people without employees have some form of other property or land other than their main residence compared with 8 per cent of employees. 8 per cent of the own-account self-employed say selling or renting out a property will form the major part of their income. Overall, the self-employed are more diverse in terms of the variety of sources which will be relied upon, with a slightly higher share than employees saying earnings from work, selling or renting out a property, or downsizing to a less expensive home,

Figure 3:
Other than among the over-65s, employees have greater average pension and financial wealth than the self-employed

Mean pension and financial wealth by age



Source: Wealth and Assets Survey, Wave 3.

Notes: Data for employees and self-employed people with pension and financial wealth greater than £0.

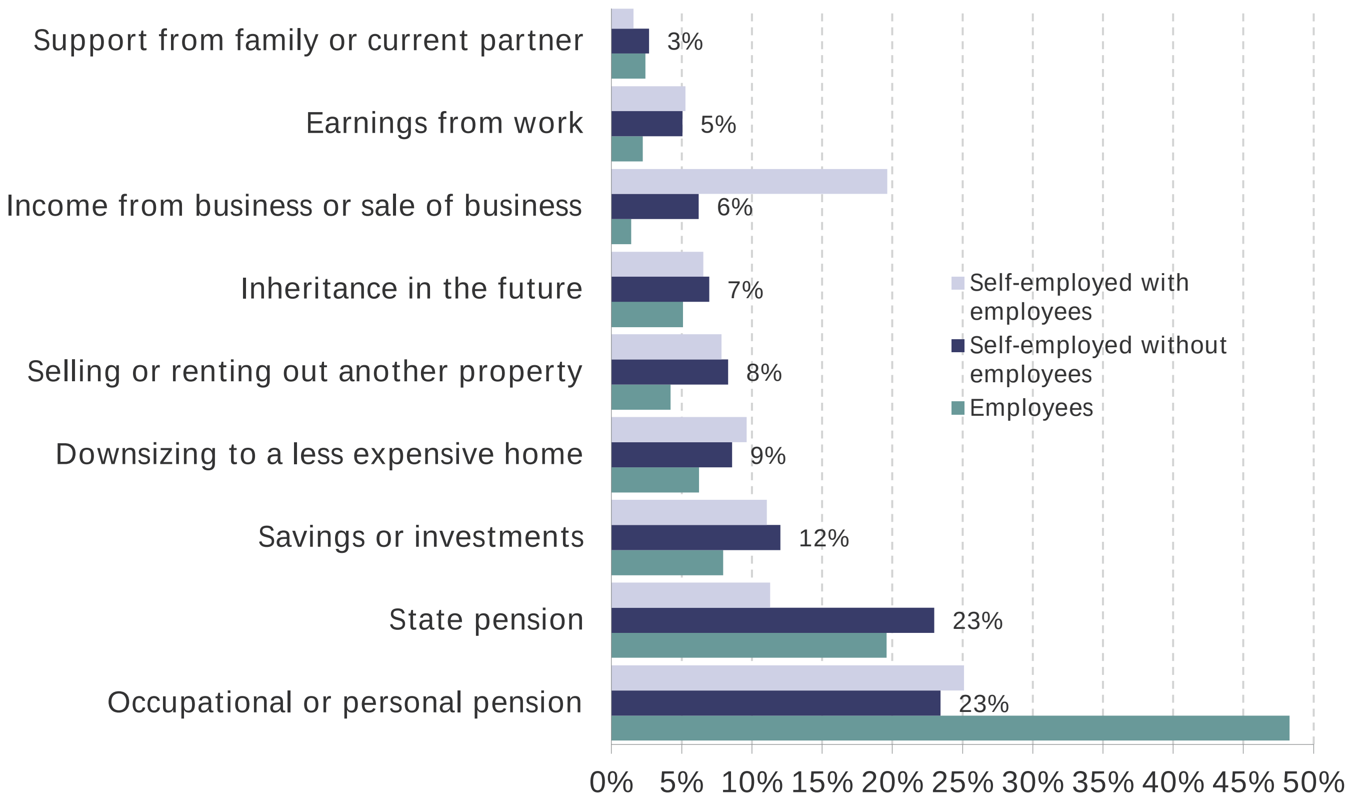
will provide the majority of their income.

A cause for concern?

The evidence above suggests there is a pension gap between employees and the self-employed. A variety of explanations have been put forward for this. The rest of this note explores what evidence there is for each of these, primarily using the Wealth and Assets Survey (WAS) 2010-12.[2] The analysis also separates out the self-employed who have employees (17 per cent of all self-employed) from those without (83 per cent). That balance has shifted in recent years, with 27 per cent of the self-employed having employees in 2000.

Figure 4:
Only a minority will rely upon selling their business to fund retirement

What will form the largest part of income during retirement? (% within group)



Source: Wealth and Assets Survey, Wave 3

First though, it is important to note that the self-employed will be one of the main beneficiaries of the introduction of the Single Tier Pension from April 2016. The move will mean their National Insurance contributions are treated the same as those of employees for the purposes of calculating pension entitlement. This should mean a self-employed person who was previously only entitled to the Basic State Pension but has made at least 30 years of Class 2 contributions will receive £144 per week rather than the current £113.10. While this represents a welcome boost to the retirement incomes of the self-employed, it will not provide enough for many people to have a standard of living similar to that of their working life, meaning additional income sources will be required.

[2] The time period during which the WAS was conducted means the responses will have been given at a time when household incomes and wages were being squeezed which may impact upon the answers given. We know for instance that self-employed incomes fell further during the recession than those of employees though the extent to which this will influence responses is unknown. It is worth remembering however that self-employed participation and contribution rates began falling prior to the downturn which may mean the issue is not merely cyclical and has more to do with the changing composition of the self-employed workforce.

1. The self-employed prefer other savings products

One regularly heard explanation for the self-employed's lower participation rates in pensions is that they prefer to keep their savings in a more accessible vehicle, such as an ISA. In terms of the money saved in an ISA, analysis of the WAS shows there is little difference between the self-employed and employees among those aged between 16 and 54. A more significant gap does open up among those aged 55 and above where the overall average amount saved in ISAs is £28,377 for the self-employed aged over 65 compared with £19,514 among the same age group in employees. While this can certainly help supplement other retirement income, on its own it is unlikely to provide enough for most workers to meet the recommended replacement rates set out by the Pensions Commission and as an average figure will conceal much variation. It also excludes those, whether an employee or self-employed, without any financial wealth.

There is scant evidence to suggest there has been an uptick in other savings which would compensate for falling pension participation and contributions in recent years

That small gap between employee and self-employed ISA savings is also seen in the reasons given for not contributing to a pension. 10 per cent of the self-employed without employees say they don't use pensions because they prefer other forms of saving or investment. This is only slightly higher than the proportion among employees, at 8 per cent, and lower than the 14 per cent of the self-employed who employ staff. 12 per cent of the self-employed with no employees expect savings or investments to be the largest part of their income upon retirement, compared with 8 per cent of employees.

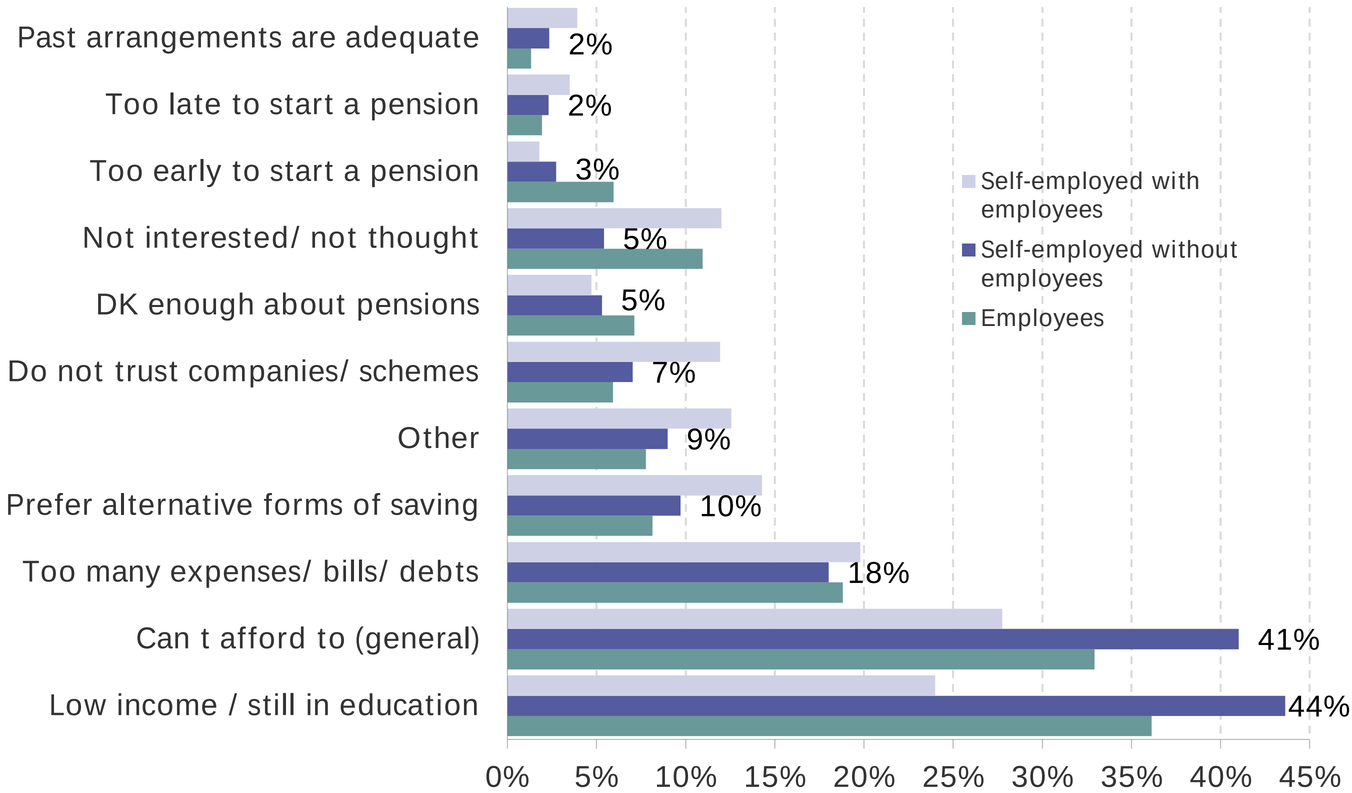
In any case, there is scant evidence to suggest there has been an uptick in other savings that would compensate for falling pension participation and contributions in recent years. Analysis of the FRS shows that although a higher proportion of self-employed households have savings above £1,500 – 55 per cent versus 48 per cent of employee households – that share and the share with savings above £20,000 (23 per cent) is almost unchanged since 1997-98.

The strongest counterpoint to the argument that the self-employed avoid pensions out of principle is provided by asking them why they don't currently contribute. The difference between the two groups of self-employed workers is stark. Having a low income or being in education (44 per cent) or being unable to afford to contribute (41 per cent) are the most popular explanations given among the self-employed without employees, with a higher share answering in this way than among employees. Being unable to afford to save is much less of a problem among the self-employed with employees; 24 per cent say having a low income or being in education is the main barrier while 28 per cent say they can't afford to.

The feeling that they cannot afford to do so or that their income is too low however persists further up the earnings distribution among the self-employed. For example, 30 per cent of the self-employed who earn between £20,000 and £25,000 report being on a low income as one of the main reasons they do not contribute to a pension compared with 23 per cent of employees within the same wage bracket. Taken together, this evidence suggests savings preferences play only a minor role in explaining the gap in pension coverage between the self-employed and employees.

Figure 5:
The self-employed without employees are most likely to say they cannot afford to contribute to a pension

Main reasons for not contributing to a pension (% within group)



Source: Wealth and Assets Survey, Wave 3

2. The self-employed can sell their businesses

The self-employed potentially have less need to save in pensions or other savings products because they own a business. Their retirement fund could be bulked up through selling their business outright or its assets and stock upon retirement. However, analysis of the WAS indicates that just 6 per cent of the self-employed intend to sell to keep the money or fund their retirement. Almost half (48 per cent) say their business will simply be closed down while a third (32 per cent) have yet to decide. 6 per cent of the self-employed without employees report it will form the largest part of their retirement income, indicating a lump sum from their business will be important for only a minority of the self-employed.

3. The self-employed are satisfied with their preparation for retirement

On the question of whether the self-employed feel prepared for retirement, despite their lower pension coverage, analysis of the WAS again highlights the split between those with and without employees. 40 per cent of the own-account self-employed are not confident their retirement income will provide them with their hoped for living standard. On this count they resemble employees (40 per cent of whom are not confident) much more closely than the self-employed with employees (29 per cent).

For those on incomes up to £20,000 there is little difference between the proportion of employees and (all) self-employed who feel they are not saving enough. Above £20,000 however, a gap opens up between the groups with, for example, 73 per cent of the self-employed earning between

£25,000 and £30,000 saying they don't save enough compared with 63 per cent of employees with the same income. This group, who would be expected to be able to afford to save but are not doing so, present a different cause of concern to those earning below the auto-enrolment threshold of £10,000 for instance. The issue here appears to be more about overcoming barriers to saving rather than increasing incomes.

Conclusion

The number of self-employed will continue to be monitored closely for evidence of a tightening labour market. But while recent months have seen their numbers fall, it is unlikely the majority of this group will disappear back into employee roles. The percentage of the self-employed who are contributing to pensions may rise slightly in the coming months and years as a result and the share who are contributing will likely rise again as the recovery strengthens. But overall, what is the outlook for their incomes in retirement?

Perhaps the biggest split in the self-employed is among those with employees, who seem reasonably well-prepared as a group, and those without employees, who resemble employees more closely

Each of the arguments discussed above have some merit: the self-employed are more likely to save in vehicles other than pensions, have greater potential income from financial products or housing and some will be able to sell their businesses. But perhaps the biggest split in the self-employed is among those with employees, who seem reasonably well-prepared as a group, and those without employees, who resemble employees more closely.

The primary barrier to saving more for this group is being on a low income or feeling unable to afford to contribute. A stronger economy as the recovery continues may help to address some of this concern, although lower incomes among the self-employed do remain a concern. But self-employed people earning typical full-time salaries are more likely to say they cannot manage the cost than employees on similar earnings. Given most will not benefit from auto-enrolment, this suggests more needs to be done to convince the self-employed of the value of pensions and the need to start saving now. Both government and the pensions industry have an important role to play in ensuring that these 4.5 million workers, but particularly own-account workers, are adequately prepared for their retirement.

Resolution Foundation

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- *developing practical and effective policy proposals; and*
- *engaging with policy makers and stakeholders to influence decision-making and bring about change.*

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