Quelling the Pensions Storm

Lessons from the past

Nicholas Hillman

edited by Oliver Marc Hartwich

policy exchange

Quelling the Pensions Storm

Lessons from the past

Nicholas Hillman
edited by Oliver Marc Hartwich

policy exchange

Policy Exchange is an independent think tank whose mission is to develop and promote new policy ideas which will foster a free society based on strong communities, personal freedom, limited government, national self-confidence and an enterprise culture. Registered charity no: 1096300.

Policy Exchange is committed to an evidence-based approach to policy development. We work in partnership with academics and other experts and commission major studies involving thorough empirical research of alternative policy outcomes. We believe that the policy experience of other countries offers important lessons for government in the UK. We also believe that government has much to learn from business and the voluntary sector.

Published by
Policy Exchange, Clutha House, 10 Storey's Gate, London SW1P 3AY
www.policyexchange.org.uk

ISBN: 978-1-906097-16-5

Printed by Heron, Dawson and Sawyer
Designed by SoapBox, www.soapboxcommunications.co.uk

Contents

	Foreword by Chris Lewin FIA	5
	Executive Summary	7
	Introduction	9
1.	The rise and fall of defined benefit pensions	11
2.	The rise and stall of defined contribution pensions	23
3.	The fall and rise of state pensions	32
	Conclusion	40
	Appendix: A note on contracting out	42

Nicholas Hillman is an Associate Fellow of Policy Exchange. Between 2003 and 2007, he was a policy adviser on pensions for the Association of British Insurers and a member of the Joint Working Group, which advises the Government on work-based pensions.

Dr Oliver Marc Hartwich is the Chief Economist of Policy Exchange.

Chris Lewin is a qualified actuary and was previously Head of UK Pensions at Unilever. He is the author of *Pensions and Insurance Before 1800: A Social History* (2003) and, in 2007, he co-authored the *Deregulatory Review of Private Pensions*, an independent report commissioned by the Department for Work and Pensions.

Acknowledgements

The author would like to thank Chris Cook, David Robbins, Nigel Waterson MP, Lara Welch, David Willetts MP and Stephen Yeo FIA. They do not bear responsibility for the views expressed or for any errors.

Foreword

By Chris Lewin

Most of us will need to rely on a pension for at least twenty years. So it is very important to ensure the pensions system is 'fit for purpose'.

Big changes to the system are necessary before that objective can be achieved. Even worse, one very important part of the system – occupational pensions – is currently going downhill. Millions of people are not saving enough and will have barely enough to live on in years to come, once they cease work.

We therefore need a strategy in which everyone has the opportunity to look forward to their retirement with confidence and in which they have the financial ability to enjoy the final phase of life. What should be the objectives of such a strategy?

The foundation stone will continue to be the benefits provided by the state. There is currently far too much means testing: it is degrading, expensive to administer, and a disincentive to save. Why not end means-testing for people aged over 85, and then extend the qualifying age downwards as and when we can afford it? As well as making people more content in their retirement, the announcement of such a policy intention would remove the main incentive for lower-paid people to opt out of personal accounts in 2012 in the belief that any pension shortfall will be made up by the state.

Occupational pensions (particularly defined benefit schemes) are being strangled by too much regulation, and this is deterring employers. A consensus is emerging about the changes which are needed, including a relaxation of the rules on surplus refunds and employer debt. As this report argues, the legal requirement to give cost-of-living increases to pensions once they come into payment should also be changed as this would permit new risk-sharing schemes where increases are targeted but not guaranteed. Regulations should be simpler and based on outcome-related principles wherever possible, leaving schemes free to achieve the outcomes in their own way. The window of opportunity is limited. The changes need to be in place by 2010, when employers will start deciding whether to continue with their own pension schemes or to leave their staff with nothing but personal accounts.

With these sorts of changes, defined benefit pension schemes are likely to attract renewed interest from employers, though on a risk-sharing basis rather than with a full guarantee from the employer. The expected cost of each £1 of pension is less in a defined benefit scheme than in individual accounts on a defined contribution basis. This is because, in the former case, the scheme can follow a diversified long-term investment policy throughout the employee's lifetime. Perhaps public sector schemes should also adopt risk-sharing, in order to reduce the cost escalation risks for taxpayers.

In this stimulating and sometimes controversial pamphlet, Nicholas Hillman puts forward his ideas for tackling the problems that continue to bedevil our pensions system, and he includes a wealth of supporting evidence. I welcome this, because debating these complex issues now gives us the best chance of finding optimal and sustainable solutions.

Executive Summary

Defined benefit pensions

Defined benefit pensions are more secure and more generous than ever before. But well-intentioned reforms and other changes have increased their costs. Most defined benefit schemes in the private sector are now closed to new members.

To date, policymakers have failed to respond effectively. If defined benefit provision is to survive, it needs to become more affordable. In particular, there should be:

> “The collapse of defined benefit pensions would not have been catastrophic if the slack had been taken up by other private pensions. This has not happened”

- more flexibility for schemes wishing to respond to changes such as rising longevity;
- a new regulatory regime for risk-sharing schemes; and
- closer alignment of the benefits available from public sector and private sector schemes.

Defined contribution pensions

The collapse of defined benefit pensions would not have been catastrophic if the slack had been taken up by other private pensions. This has not happened, at least not to the degree necessary to stop the overall decline. The proportion of the workforce whose principal second-tier pension was a private scheme fell from 55% to 42% between 1991/92 and 2003/04.

Defined contribution schemes tend to have lower contribution rates and lower take up than defined benefit schemes. The result has been a significant reduction in employer-sponsored pension provision. This has particularly hit younger people.

Ministers have responded by saying employees will be automatically enrolled into employer-sponsored pensions or a new system of centrally-administered personal accounts from 2012. This will extend coverage. But untested and inflexible state-controlled personal accounts are not the only possible solution.

Given the UK's starting point, it would be better to use existing expertise by automatically enrolling all employees into tried-and-tested products, such as stakeholder pensions, instead.

State pensions

The state pension system has faced grave problems in recent years. It is failing in its two main objectives of relieving poverty and providing a base for private saving.

The forthcoming state pension reforms offer some improvement. They will provide more equal outcomes, less means testing than if current policies continued and a higher State Pension Age.

But, even after the reforms, the system will be flawed. It will continue to be excessively complicated: there will still be two state pensions with different contributory conditions, accrual rates and indexation rules.

A Single-Tier State Pension would be more progressive and simpler, and it would provide a better base for private saving.

In short, all three elements of the UK pension system – defined benefit schemes, defined contribution schemes and the state pension – need further reform if future generations of pensioners are to be as well off as they could be.

Introduction

A vast amount has been written about pensions in the past few years. The Pensions Commission's reports cover 1,337 pages and the two Government White Papers (and accompanying documents) total a further 947 pages, not to mention the ensuing legislation.[1]

This outpouring of views has focussed especially on tackling the crisis in pension provision. The journalist Paul Lewis has shown how the term 'pension(s) crisis' was mentioned only 19 times in UK newspapers during the whole of 1999, but 1,104 times – or three times a day – six years later.[2]

> "The recent debate has too often taken place in an historical vacuum and has paid insufficient attention to the past"

Policymakers, lobbyists and journalists with an interest in pensions are unlikely to be out of work in the near future. Equally, there appears little need for yet another publication on the subject. But, in fact, there are good practical reasons for further discussion:

- the recent debate has too often taken place in an historical vacuum and has paid insufficient attention to the past successes and failures of UK pension provision;
- there has been a focus on individual elements of the pensions system, rather than on the system as a whole; and
- much of the commentary has promoted ideas that are impractical to implement, such as a residence-based Citizen's Pension.

This pamphlet seeks to tackle these shortcomings. On the basis of hard evidence, it concludes that the pension reforms currently being implemented do not go far enough. It is clear that many people will continue to face an uncertain old age. Even if we

1 Pensions Commission (PC), *Pensions: Challenges and Choices*, October 2004 (including Appendices); PC, *A New Pensions Settlement for the Twenty-First Century*, November 2005 (including Appendices); PC, *Implementing an integrated package of pension reforms*, April 2006; Department for Work and Pensions (DWP), *Security in retirement: towards a new pensions system*, May 2006 (including Regulatory Impact Assessment and consultation response); DWP, *Personal accounts: a new way to save*, December 2006 (including Regulatory Impact Assessment and consultation response)

2 Paul Lewis, Presentation to the Association of British Insurers (ABI), Saver Summit, 23 November 2006, p.1 (http://www.abi.org.uk/Display/File/Child/655/Paul_Lewis.pdf accessed 8 November 2007)

cannot solve every problem, we can devise smarter policies to help pensioners over the long-term.

It is worth stating at the outset that there is no need for a radical new blueprint that reshapes the pensions system from the ground up. Britain used to have an enviable reputation for high-quality pension provision and, despite some testing times, many of the underlying strengths persist. Moreover, where the Government have announced action, as on increasing the State Pension Age, they have tended to do so in the right direction and with cross-party support.

> “It is possible to provide future pensioners with a more secure and prosperous retirement than will occur under the Government’s reforms”

Instead, the problem is a lack of ambition. It is possible to provide future pensioners with a more secure and prosperous retirement than will occur under the Government’s reforms. There remains a need for further changes to each part of the system if we are to meet the best long-term interests of consumers, Government and the country.

Since 1997, there has been a damaging turbulence within Government over pensions. There have been eight Cabinet Ministers with responsibility for pensions, and three of the last four were in post for less than a year. The hope now must be that James Purnell, the new Secretary of State for Work and Pensions, recognises how much more there is to do and starts to tackle the remaining problems quickly.

1

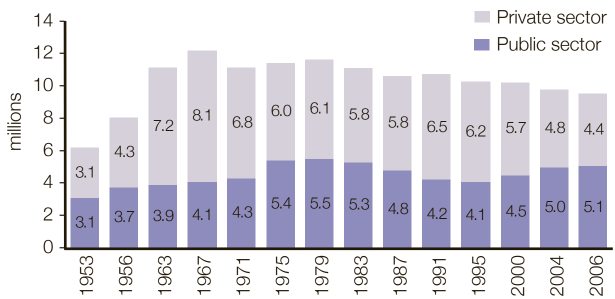
The rise and fall of defined benefit pensions

It is often argued that occupational pensions were in rude health until the late 1990s:

- Frank Field MP, the former Minister for Welfare Reform, has written, 'When Labour gained power in 1997, Britain's occupational pensions were the envy of the world.'[3]
- On the other side of the political spectrum, John Redwood's Economic Competitiveness Policy Group has described Britain's occupational pensions in 1997 as 'the envy of Europe, even of the world.'[4]

But, as the chart shows, the high point of active occupational pension scheme membership in the UK was 1967, not 1997.[5] Between 1967 and 2006, the total number of people in occupational pension

Occupational pension scheme membership, 1953-2006



Government Actuary's Department/National Statistics, *Occupational pensions schemes surveys*

3 Frank Field, 'The great pension swindle', *The Sunday Times*, 1 April 2007

4 Economic Competitiveness Policy Group, *Freeing Britain to Compete: Equipping the UK for Globalisation*, August 2007, p.50

5 'Active' refers only to people who are currently accruing new benefits.

schemes fell from 12.2 million to 9.5 million. The number of men in these schemes more than halved, from 9.9 million to 4.6 million, between 1967 and the end of the century. In the same period, the number of female members increased from 2.3 million to 5.5 million, but this was nowhere near enough to arrest the overall decline.[6]

The vast majority of people (89%) in occupational pensions are in schemes that are defined benefit in nature and these are the main focus of this chapter.[7] In this sort of scheme, the pension level is fixed in advance. It is most commonly calculated as a proportion of final salary, such as two-thirds of final salary for a long-standing member. (The other main type of occupational pension scheme – known as money purchase – is defined contribution in nature and so is covered in the next chapter.)

Defined benefit schemes

By 2006, the total number of employees in defined benefit pension schemes had fallen to 8.5 million, or 29% of the UK workforce. Critically, the decline was focussed on the private sector, where active membership of defined benefit schemes fell to just 3.4 million (or 15% of people working in the private sector).[8] In the public sector, in contrast, membership has been rising since the mid-1990s. The total number of people in public sector occupational pensions (which are all defined benefit) recently surpassed the number of people in all private sector occupational schemes – even though the public sector employs only one-fifth of the workforce.

There are various factors behind the collapse in private sector defined benefit provision, but the most important is a big increase in costs arising from:

- legislative changes which have increased members' benefits;
- reductions in inflation and to average rates of return; and
- increases in life expectancy.

6 Government Actuary's Department (GAD), *Occupational Pensions Schemes 2004*, 2005, Table 3.5

7 National Statistics (NS), 'Occupational pension schemes survey 2006', First release, 10 July 2007, p.4

8 NS, 'Occupational pension schemes survey 2006', First release, 10 July 2007, p.4. Proportions are based on Labour Force Survey data for mid-2006. (www.statistics.gov.uk/StatBase/Product.asp?vlnk=1944 accessed 1 November 2007)

Legislative changes

Originally, defined benefit schemes did not have to provide any inflation protection, nor a spouse's pension in the event that the member died before their spouse. And, when a member left employment before reaching normal pension age, they tended to lose all their pension rights.[9] Although some schemes provided more generous benefits, they were not obliged to do so.

From the 1970s onwards, this position changed. For example, in 1988 occupational pension schemes had to start providing some protection against inflation for benefits related to being contracted

9 They could, however, 'virtually always' take a refund of their own contributions, sometimes with interest. (GAD, *Occupational Pension Schemes 1975*, 1978, p.72)

Early leavers' benefits in private sector occupational pension schemes

1975	Newly-approved occupational pension schemes required to preserve the pension rights of early leavers aged 26 or over with at least five years' service
1978	On the introduction of SERPS, all early leavers with five years' service in contracted-out schemes became entitled to indexed 'guaranteed minimum pensions' (GMPs)
1980	Preservation of early leavers' rights extended to all occupational schemes
1986	All early leavers' benefits started to enjoy protection against inflation (future accrual only) – preserved pensions had to rise with inflation (capped at 5%)
	Early leavers given a statutory entitlement to transfer their preserved benefits
1988	Occupational schemes compelled to preserve the benefits of early leavers with at least two years' membership
1991	New early leavers had all their preserved benefits indexed to inflation capped at 5% (except GMP)
1997	Early leavers' pensions in payment accrued after April 1997 were indexed to inflation (capped at 5%)
2005	Early leavers' pensions in payment accrued after April 2005 received a lower statutory cap for indexation (2.5%)
2006	Early leavers with service of between three months and two years gained a statutory right to a cash transfer (including employer's contributions and tax relief) in addition to the existing option of a refund of their own contributions
2007	The Government proposed reducing the annual cap for the revaluation of deferred pensions from 5% to 2.5% (for future accrual)

out of the State Earnings-Related Pension Scheme (SERPS). In 1997, similar protection was extended to all defined benefit pensions in payment, and not just to contracted-out benefits.[10]

The table on the previous page shows just the main changes that have taken place to the benefits for early leavers. These were successful in extending good pension coverage: in 1986, Leslie Hannah noted that compulsory preservation of early leavers' benefits would increase the proportion of retirees eligible for occupational pension income from one-third to two-thirds or more.[11] However, over the longer-term, this is one of the factors that has encouraged schemes to close and the number of pensioners receiving occupational pension income fell by 500,000 to 5.1 million between 2004 and 2006.[12]

By the end of the twentieth century, the various legislative changes meant that a contracted-out defined benefit pension scheme in the private sector had to provide preserved benefits for early leavers, a spouse's pension and some inflation protection for both deferred pensions and pensions in payment. According to the OECD, the rules on indexation are much stricter than in other countries.[13]

Until 11th June 2003, however, schemes had a 'Get Out of Jail Free' card. If an employer found it hard to cover their pension costs, they could wind up their scheme and share out the remaining assets among members according to a statutory formula. Since then, it has been impossible for a solvent employer to do this unless the scheme is funded sufficiently to cover any commitments in full.

Inflation and rates of return

The relatively high inflation of past decades has been labelled 'the guilty secret of post-war occupational pensions'.[14] Because there was no statutory requirement to increase pensions in payment, they could gradually become meaningless.[15] This was 'catastrophic' for the individuals concerned but liberating for pension schemes.[16] Even if the current rules had been in force, it would have made little difference

10 The contracted-out element, known as the guaranteed minimum pension (GMP), had to be increased by inflation capped at 3% between 1988 and 1997 – increases above 3% were covered by the Government. Since 1997, the whole pension in payment has had to be increased with inflation (capped at 5% for accruals between 1997 and 2005 and 2.5% for accruals after 2005).

11 Leslie Hannah, *Inventing Retirement*, 1986, p.138

12 NS, 'Occupational pension schemes survey 2006', First release, 10 July 2007, p.2

13 Juan Yermo, 'UK occupational pension regulation in an international context', Presentation to the National Association of Pension Funds (NAPF), 19 September 2007

14 David Willetts, 'Tackling the pension crisis', Speech to the Enterprise Forum, 20 January 2004

15 GMPs have always had some limited protection against inflation, but until 1988 increases were paid by the Government as part of an individual's State Pension.

16 Leslie Hannah, *Inventing Retirement*, 1986, p.111. For public sector schemes, high inflation did not have the same impact as, by the mid-1970s, most pensioners with public sector pension rights benefited from cost-of-living increases. (GAD, *Occupational Pension Schemes 1975*, 1978, pp.59-60)

because inflation was so high. Statutory indexation of pensions in payment is now capped at 2.5% each year, but inflation was generally above 10% during the second half of the 1970s.[17]

When inflation fell, equities performed well. So, although the liabilities of pension schemes were no longer being eroded quickly, their assets grew significantly. This did not last. In the words of Lord Turner, promises such as indexation 'were based on assumptions about future equity returns which, in retrospect, were irrational.'[18]

The costly impact of low inflation and statutory indexation led Alan Pickering to recommend in a report for the Government in 2002 that compulsory indexation should be removed for pensions in payment that have not yet accrued: 'our proposal might be seen as reducing the quality of some pensions, but we believe that the net effect will be more people with decent pensions … indexation is only of use to individuals who have a pension to index'.[19]

While this recommendation makes sense in its own terms, if it were to be implemented it would make it easier for inflation once again to erode people's pensions. (That is why no political party accepted it in full, although the indexation formula was relaxed in 2005.[20]) On the other hand, the evidence suggests that if statutory indexation were to be abolished, pension schemes would almost certainly still pay annual increases where they could be afforded – in 1995, two years before statutory indexation began, 93.4% of defined benefit pensions in payment were increased.[21]

The Government's inability to decide policy in this sort of area led them to set up another review into the deregulation of pensions in December 2006. But the two reviewers, Ed Sweeney of the TUC and the independent consultant Chris Lewin, could not agree: 'We both recognise the strength of the arguments on LPI [Limited Price Indexation], but have been unable to agree on whether this change would have the desired outcome in terms

17 Jim O'Donoghue et al, 'Consumer price inflation, 1947-2004', *Economic Trends*, no.626, January 2006, p.41 and p.43

18 'Ask the expert: Adair Turner on pensions', FT.com, 27 November 2005 (http://www.ft.com/cms/s/fd2d3d18-5f85-11da-a628-0000779e2340,dwp_uuid=faefa616-4d25-11da-ba44-0000779e2340.html accessed 6 August 2007) The stock market has recovered since 2003, but schemes have increasingly invested in fixed-income assets and so are benefiting less than they would have done, while also suffering from the reduced interest rates of recent years.

19 Alan Pickering, *A simpler way to better pensions*, July 2002, p.12 and p.14

20 Benefits accrued between 1997 and 2005 have to be increased by the Retail Prices Index or 5%, whichever is lower, once they are in payment. Since 2005, the cap for indexation has been 2.5%.

21 GAD, *Occupational Pension Schemes 1995*, 2000, Table 9.1

of encouraging strong provision through workplace-based pension schemes.'[22]

Subsequently, the Government confirmed that they would not be altering the current rules on the indexation of pensions in payment.[23] This was a disappointment to many pension experts, including the National Association of Pension Funds, who had called on the Government to relax the rules.[24]

Longevity

Longer lives can have a dramatic effect on the cost of providing decent pensions, as illustrated by the examples in the box below.

The American Civil War (1861-1865)

Some of the first pensions were paid to former soldiers of the American Civil War. Because they included widows' pensions, there was a financial incentive for younger women to marry veterans. In 1927, Alberta Stewart, a 21-year-old woman, married an 81-year-old ex-soldier. Although he died soon afterwards, Alberta lived until 2004. She was receiving a pension linked to her deceased husband's war record at the time of her death.

Jeanne Calment

Madame Calment was born in France in 1875. When aged 90, she agreed with her lawyer that he would pay her an annual income worth one-tenth of the value of her flat. In return, the lawyer would inherit the property on her death. Madame Calment went on to enjoy the longest well-documented lifespan in history. She took up fencing aged 85, still rode a bicycle at 100 and released a rap album at 121. She died in 1997 aged 122. By then, her lawyer had died and his widow was making the payments.

22 Chris Lewin and Ed Sweeney, *Deregulatory Review of Private Pensions*, July 2007, p.21

23 DWP, *Deregulatory review – Government response*, 22 October 2007, pp.5-6

24 NAPF, *NAPF Submission to the DWP Deregulatory Review of Private Pensions*, 6 April 2007, pp.2-4

Overall, higher life expectancy is undeniably good news. But for pension schemes it poses a big problem.

The increase in longevity that has occurred in recent decades has been enormous: life expectancy at the age of 65 has risen by around 15 minutes every hour.[25] Crucially, however, the forecasts that pension schemes rely on when planning ahead have erroneously assumed that the rate of increase would decline.

- The Government Actuary's Department used to predict men aged 65 in 2050 would live to around 80 years. Today, their projections suggest that the same people will live, on average, until they are nearly 90.[26]
- The Actuarial Profession has warned its members that 'some [life expectancy] projections that have been in common use may no longer be considered reasonable assumptions, even though they have not been formally withdrawn or replaced'.[27]

There is a lively debate among academics about the 'limit-to-life' theory. Jim Oeppen of the University of Cambridge has said: 'One of the assumptions is that life expectancy will rise a bit and then reach a ceiling it cannot go through. But people have been assuming that since the 1920s and it hasn't proved to be the case. … I think there is a ceiling, but we don't know where it is. We haven't got there yet.'[28]

In the context of low inflation and compulsory indexation, rising longevity presents defined benefit schemes with large costs. In theory, they can make changes to take it into account, though these can be difficult to implement in practice. But there is, to date, little that schemes can do to reduce the longevity risk they have already absorbed. Many employers are paying for rising longevity by closing their defined benefit schemes to new staff and offering them inferior pensions instead.

25 http://www.gad.gov.uk/Life_Tables/docs/2004/20045yrUKcohort1981web.xls (accessed 15 July 2007)

26 http://www.gad.gov.uk/Life_Tables/docs/2004/20045yrUKcohort1981web.xls (accessed 15 July 2007)

27 Nick Dumbreck, President of the Institute of Actuaries, as quoted in 'Actuarial Profession highlights uncertainty in future mortality projections', Press release, 11 July 2007 (http://www.actuaries.org.uk/Display_Page.cgi?url=/pr-rels/2007/070710Projections.html accessed 15 July 2007)

28 BBC News, 'Life expectancy to soar', 9 May 2002 (http://news.bbc.co.uk/1/hi/health/1977733.stm accessed 15 July 2007); Jim Oeppen and James W. Vaupel, 'Broken Limits to Life Expectancy', *Science*, vol.296, 10 May 2002

The end of private sector defined benefit schemes

In addition to these changes, there have been other – sometimes less well-intentioned – sources of extra costs for defined benefit schemes. In particular:

- the National Insurance rebates for contracted-out members no longer match the value of the state benefits foregone (see the Appendix);
- punitive changes to corporation tax have cost pension schemes billions since 1997, both in direct costs and in lost investment returns; and
- the Pensions Regulator, the Pension Protection Fund and new accounting rules have increased administration costs and encouraged conservative investment decisions.

As a result of all the various factors bearing on defined benefit schemes, the average total contribution rate for private sector schemes has increased from 15.8% of earnings in 2002 to 28.7% in 2007. It is expected to stabilise in the future at 23.5%.[29]

The impact is clear. In 1995, there were 5.2 million people in private sector defined benefit schemes open to new members.[30] By 2006, the figure was officially just 1.63 million and the Association of Consulting Actuaries claim it has fallen since then 'to around 900,000.'[31] New changes, such as the introduction of automatic enrolment in 2012, will impose further pressure on those schemes that remain open to new employees, and could persuade many of them to reassess their position.[32]

In this context, the Government's announcement in December 2007 that there will be a cut in the cap for the revaluation of early leavers' benefits is small beer.[33] The change is expected to save £250 million a year (2007/08 prices), but regular employer pension contributions to defined benefit schemes were almost £19.7 billion in 2006, so this could amount to not much more than 1% of costs.[34]

29 Association of Consulting Actuaries, *UK 2007 Pension trends survey report…2*, July 2007, Figure 6

30 PC, *A New Pensions Settlement for the Twenty-First Century*, November 2005, p.122

31 NS, 'Occupational pension schemes survey 2006', First release, 10 July 2007, p.2; Association of Consulting Actuaries, 'ACA Chairman Calls on the Government to Remove Ban on Employers Offering Conditionally Indexed Pensions', 16 November 2007

32 Deloitte and Touche, *Employer Pension Contributions and Pension Reform*, ABI Research Paper 2, November 2006, pp.29-45. It is should be noted, however, that – prior to 1988 – occupational schemes were 'usually' compulsory with no opt outs. (GAD, *Occupational Pension Schemes 1995*, 2000, p.27)

33 DWP, *Deregulatory review – Response to consultation*, December 2007, p.5

34 NS, 'MQ5: Investment by insurance companies, pension funds and trusts', 3rd quarter 2007, 7 January 2008, Table 4.3

An alternative vision

Further reform is needed if private sector employees are to have continued access to pension schemes in which the employer takes on some of the risks. Inaction would be tantamount to admitting the era of private sector defined benefit provision is over for good.

The challenge is to ease the pressures on schemes while still providing protection to members. That way, the full value of defined benefit pensions may be somewhat less certain, but the costs will be more certain and employers will be more likely to offer them.

So the Government should consider again what scope there is for action to help existing defined benefit schemes and to encourage risk-sharing schemes.

1 Existing defined benefit schemes: The Government have said categorically that there can be no changes to the value of pensions that have already accrued.[35] Yet there has been insufficient debate on this issue to date. Given the increase in life expectancy that has occurred, much of which was unexpected, there are strong arguments in favour of allowing schemes to look again at the age at which full benefits can be received for past (as well as future) service. This would replicate what Governments of both hues have done to the State Pension Age, which is to rise for past and future accrual alike. It would also share the pain of cost-cutting between generations, rather than protecting the pension provision of older workers to an undue degree – it may be that an increase should only be allowed where individual employers can show the savings will be used to equalise pension provision across their workforce. And it could usefully encourage longer working lives. When benefits have been made more generous and secure in the past, this has often had an impact on accrued rights (as with early leavers' revaluation) – so it is at

35 DWP, *Deregulatory review – Government response*, October 2007, p.4

least worth considering whether the fairest way to implement any unavoidable economies is to include rights that have already accrued.

2 Risk-sharing schemes: A new regulatory regime for risk-sharing schemes could help revive defined benefit provision. In particular, early leavers' revaluation, indexation of pensions in payment and normal pension age could all be flexible, rather than fixed in advance. To ensure fairness to scheme members, such a regime would need to be underpinned by secure funding rules and we could learn from schemes abroad – for example Holland. This approach, which the Government have neither endorsed nor ruled out,[36] would provide employers with flexibility while still offering valuable benefits to scheme members.

Public sector schemes

This chapter has focussed primarily on private sector defined benefit occupational schemes, as they have felt the impact of recent changes most keenly. However, pension schemes for public sector employees are not immune from these forces. Most public sector schemes are unfunded, and so are insulated in the short-term against some of the immediate cost pressures. But they too will be affected by rising longevity, and they tend to be even more generous than private sector schemes in areas like indexation.

Figures from the Treasury suggest the annual cost of public sector pension schemes will rise from 1.5% of GDP in 2005/06 to over 2% by the 2030s[37] and some estimates put current total public sector pension liabilities at over £1 trillion.[38] So the costs of public sector schemes are rising yet they remain open to new members and are still growing in size. On average, public sector employees receive pension benefits that are over four times more generous than those of private sector employees.[39] Although the Government committed to some

36 DWP, *Deregulatory review – Government response*, October 2007, p.12

37 HM Treasury, *Long-term public finance report: an analysis of fiscal sustainability*, December 2006, p.39

38 See, for example, Neil Record, *Sir Humphrey's Legacy: Facing up to the Cost of Public Sector Pensions,* Institute of Economic Affairs, September 2006

39. Robert Chote, Carl Emmerson, David Miles and Jonathan Shaw (eds), *The IFS Green Budget*, Institute for Fiscal Studies, January 2008, p.172

changes in 2005, according to the Pensions Policy Institute public sector pensions will still typically be worth an extra 3% to 18% of salary compared to private sector pensions.[40]

There is a consensus of informed opinion that suggests major reform of public sector pensions is now necessary.

- Lord Turner has noted an asymmetry in the way that state pensions and public sector pensions have been discussed: 'the issue of public sector pension provision cannot be considered as fully settled by the limited reforms introduced in 2005.'[41]
- Lord Turner's successor as Director-General of the CBI, Digby Jones, now a Government minister, has put it even more bluntly: 'the Government has surrendered cravenly to their trades union paymasters and it's so irresponsible; it sets an awful example. … the country can't afford it. … All employees in the private sector are either having to put more in, have fewer benefits or work longer. Why should the public sector be different to that?'[42]
- The independent Institute for Fiscal Studies have said: 'The gap between [pensions in the] public and private sectors does not look sustainable. The case for further reform is strong.'[43]

There is little rationale for public sector schemes having more generous rules on issues such as indexation of pensions in payment and revaluation of deferred pensions, which – in contrast to the private sector – are uncapped and therefore more costly. Aligning the benefit rules in these areas would go some way to tackling the justifiable sense of unfairness that exists among those working outside of the public sector. There is also a case for raising the normal pension age from 60 to 65 for all staff, and not only new recruits as the Government have proposed.

40 Pensions Policy Institute, *Occupational pension provision in the public sector*, March 2005, pp.29-30; Pensions Policy Institute, *Public sector pension reform: what happened?*, November 2005

41 Lord Turner, Hansard (Lords), 14 May 2007, col.49

42 Interview available at http://news.bbc.co.uk/1/hi/uk_politics/4476922.stm# (accessed 15 July 2007)

43 Robert Chote et al (eds), The IFS Green Budget, IFS, January 2008, p.158

In the longer-term, there is a strong argument for scrutinising public sector pensions 'with the intensity with which the state and private sector pensions have increasingly been scrutinised'.[44] The Pensions Commission was not asked to consider public sector schemes. A new commission should be established to do so.

44 Lord Turner, Hansard (Lords), 4 July 2007, col.1071

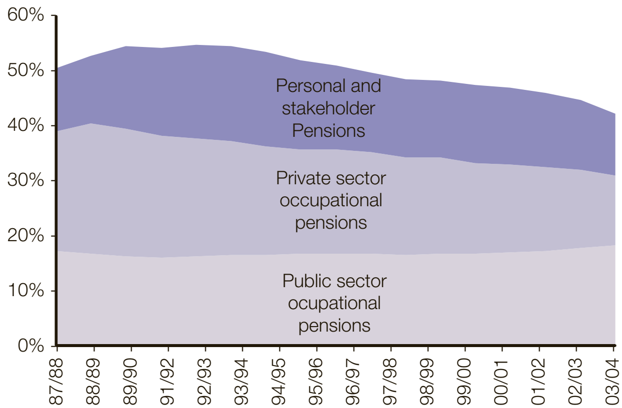
2

The rise and stall of defined contribution pensions

The decline in defined benefit occupational pensions would not have been a disaster if the slack had been taken up by other forms of retirement saving, such as personal pensions. Unfortunately, except during the heyday of personal pensions in the late 1980s and early 1990s, this has not happened.

According to the Department for Work and Pensions, the total number of people whose principal second-tier pension was any type of private scheme fell from 9.2 million to 6.3 million between 1991/92 and 2003/04 or from 39% of UK employees to 24%. If public sector occupational schemes are included, the proportion

Principal second-tier pension provision among employees, 1987/88 to 2003/04[45]



DWP, Second-Tier Pension Provision, January 2006, Summary Table

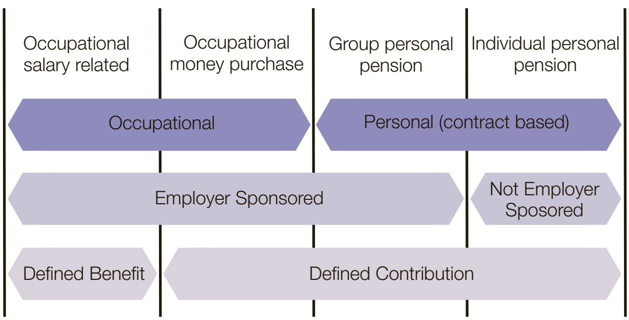
45 The figures in this chart are not directly comparable with the chart in the previous chapter, although both charts are based on official figures. This chart focuses on employees' principal second-tier pension and so does not include, for example, contracted-in money purchase occupational pension schemes, as the principal second-tier pension of members of these schemes is considered to be the State Second Pension (previously SERPS).

of the workforce with a (non-state) second-tier pension fell from 55% to 42% over the same period.[46] The Family Resources Survey and the Annual Survey of Hours and Earnings confirm this general trend, and show that it is has continued since 2003/04.[47]

The main alternatives to defined benefit pensions are two types of defined contribution pensions:

1. personal pensions (including stakeholder pensions) – these are based on private contracts between pension providers and individual members and are mainly provided via employers on a group basis or to individuals through financial advisers; and
2. money purchase occupational pensions – these are trust-based and provided by employers, as with defined benefit schemes, but the pension entitlement does not depend on a pre-determined formula.

The different types of pension scheme



Pensions Commission, *Pensions: Challenges and Choices*, October 2004 p. 80

Defined contribution schemes can be as valuable to people as defined benefit schemes – in fact, they can be better for some people, such as those who change jobs frequently.[48] However, the eventual payouts are more uncertain for they depend upon variables such as investment performance, the level of charges and annuity rates.

46 DWP, Second-Tier Pension Provision, 26 January 2006, Summary Table

47 Department for Social Security (DSS) and NS/DWP, *Family Resources Survey*, for the years 1994/95 to 2005/06, chapter 7; Chris Daffin and Bob Watson, 'Changes to Pension Statistics in the Annual Survey of Hours and Earnings, 2006' (http://www.statistics.gov.uk/articles/labour_market_trends/Changes_ASHE_PensionStats.pdf accessed 23 January 2008), p.6

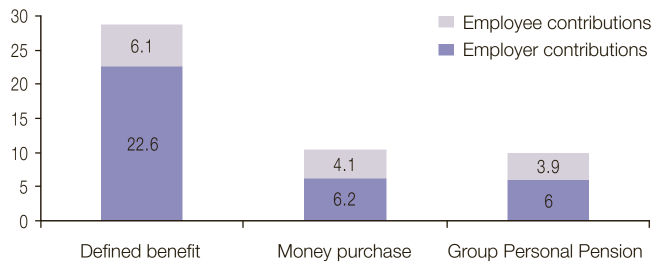
48 Robert L Clark and M Melinda Pitts, 'Faculty Choice of a Pension Plan: Defined Benefit versus Defined Contribution', *The Journal of Industrial Relations*, vol.38, no.1, January 1999, pp.18-45

Contributions and take up

On average, Group Personal Pensions and money purchase occupational pensions have employer contributions that are less than one-third of those flowing into defined benefit schemes. Defined benefit schemes also have higher employee contributions.

In total, defined benefit schemes have an average contribution rate of 28.7%, compared to 10.3% for money purchase schemes and 9.9% for Group Personal Pensions. The position of employer-based stakeholder pensions is worst of all, as many of these schemes have no employer contributions whatsoever.

Average total employer and employee pension contributions, 2007



Association of Consulting Actuaries, UK 2007 Pension trends survey report…2, July 2007, Figure 6

Unsurprisingly, given their lower contributions and the fact that their joining procedures are often more complicated, defined contribution schemes also tend to have relatively low take-up rates. A National Association of Pension Funds survey found 63% of private sector defined benefit schemes had a take-up rate of 90% or higher. The comparable figure for money purchase schemes was just 43%.[49] Around 8 out of 10 employer-designated stakeholder schemes have no members whatsoever.[50]

Employers who have closed their defined benefit schemes to new staff and provided a defined contribution scheme instead have

49 NAPF, *Annual Survey 2003*, November 2003, p.23.

50 ABI, *Stakeholder Pensions – Time for Change*, August 2003, p.10

shifted resources from their newer (usually younger) staff to their longer-serving (usually older) staff on a massive scale. Lower contribution rates and lower take-up rates have provided a double bonus for firms struggling to cover their past pension promises.

In 1982, the President of the Institute of Actuaries warned his contemporaries,

At the end of the day it is not actuarial guidance that will determine whether our children will be prepared to honour the state and occupational pensions we are promising ourselves. What matters is whether by actions, not words, we persuade our children to meet our claims.[51]

The protection given to defined benefit schemes and the inferior conditions of the replacement defined contribution schemes show older people have been very successful in persuading younger people to fund their superior pensions.

It is surprising that employers have found it so easy to reduce their pension commitments. However, this reflects the low value put on pensions by younger staff, who tend to have their minds on more immediate needs, such as paying off student debts and saving a deposit for a first home. It also reflects the fact that employers are wily enough to realise defined benefit scheme members would shout loudly about any changes, whereas potential future members are unlikely to make an equal fuss. This is why most defined benefit schemes have, to date, closed only to new members and still accept contributions for existing members.

A few enlightened employers have reacted by offering their staff help with short-term saving as an alternative to a pension. LogicaCMG found that employer pension contributions worth 8% of salary were insufficient to persuade even half of their younger staff to join their pension scheme. So they now help employees saving towards a deposit for a home as an alternative.[52] (New Zealand's KiwiSaver works on a similar principle, as people may dip in to

51 Colin Stewart Sinclair Lyon, 'The Outlook for Pensioning: Address by the President', *Journal of the Institute of Actuaries (JIA)*, no.110, 1983, p.13

52 John Greenwood, 'A pad, not a pension', *Sunday Telegraph*, 1 July 2007

their fund to buy a first home.) However, this option is currently open to very few employees within the UK.

Stakeholder pensions

Despite the lower pension contributions on offer to new staff, people who have joined any non-state pension can reasonably expect to be better off in their retirement than those with no such provision.[53] This was recognised in 2001 when employers with five or more staff and no decent pension had to start providing access to a stakeholder pension (a tightly-regulated and relatively low-cost personal pension plan). Employer contributions are voluntary, but employers must pass to the stakeholder pension provider any contributions their staff wish to make from their wages.

If all the eligible staff at the 350,000 employers affected by this policy had signed up to join the stakeholder pensions on offer, then everything would be comparatively rosy: millions more people would have benefited from private second-tier pension provision. In practice, however, the vast majority of eligible staff have not joined. These days, the Pensions Regulator is not even actively checking to see if companies have designated a stakeholder pension scheme in line with the law, as they do not believe it is a priority of the Government, and they are not working to persuade employers to encourage their staff to join the schemes on offer.

Stakeholder pensions have not failed as completely as is often claimed. Around 4 million stakeholder pensions have been sold since 2001.[54] The Building and Civil Engineering (B&CE) scheme, the most successful of all stakeholder schemes, shows it is possible to sell stakeholder pensions on a mass scale to the Government's target market of working people on lower incomes. But, B&CE aside, stakeholder pensions have failed against their original objective of spreading pension membership among lower earners

53 Unless they are adversely affected by the rules for means-tested benefits – see chapter 3 – or unless their only pension contributions are contracted-out rebates.

54 Statistics from the ABI show that 3.02 million regular premium and 0.93 million single premium stakeholder pensions have been sold (April 2001 to September 2007).

previously lacking access to a workplace pension. They have instead tended to supplant previously-existing saving – some employers have replaced their defined benefit pensions with stakeholder pensions – or have provided another tax-advantaged way of saving for relatively well-off people.

Stakeholder pensions have failed to hit their target market for various reasons. In particular, employers have failed to promote them, which is unsurprising given that they are forced to offer them whether they like it or not. Another problem is that the means testing rules can make it uneconomic for lower-income employees to save.

Personal accounts

Baroness Hollis, the minister in charge of pensions in the House of Lords when stakeholder pensions were introduced, has admitted:

There was the failure when we were dealing with stakeholders, and I was the Minister responsible. We chose not to go for a compulsory contribution from employers because of the argument about burdens on business. We were led to believe that employers would none the less do the decent thing. Not surprisingly, something like 85 per cent of them did not. They erected the schemes but did not contribute; they remained shell schemes. … we therefore have to have personal accounts and a brand new start again.[55]

This is admirably frank. But Baroness Hollis's conclusion is a depressing one. As her words imply, we will have reached the point in 2012 that we could have reached on the introduction of stakeholder pensions in 2001.

Moreover, while her *mea culpa* is welcome, Baroness Hollis's conclusion about how to proceed is illogical. If the main problem with stakeholder pensions has been the lack of compulsory employer contributions, then the best solution would be to introduce these. Instead, ministers have opted to introduce a wholly

55 Baroness Hollis, Hansard (Lords), 11 July 2007, col.1415

new system of government-run personal accounts that is going to take five years to implement and which is not based on existing expertise.

It is clear that the Government's personal accounts scheme is too little, too late. Even the Pensions Commission said this sort of initiative would not produce an overall increase in saving but would rather 'keep funded pension savings, as a percentage of GDP, roughly stable [at c.3.7%].'[56]

The idea of introducing personal accounts has some other flaws too compared with simply extending stakeholder pensions. For example:

1 Personal accounts will provide less sense of private ownership than stakeholder pensions, as the administration will be in the hands of a quango rather than a private company.
2 Personal accounts are designed to be simple rather than flexible: according to one expert, 'the personal accounts agenda is diametrically opposed to flex benefits. Its philosophy is take cash off staff so they cannot do anything at all with it until they are old.'[57]
3 Personal accounts will necessitate a vast new Government IT project of a type that has failed spectacularly in the past, yet stakeholder pension providers already have their own electronic collection methods in place.

Moreover, there is a risk that a future Government might seek to tamper with the personal accounts system, which will be more directly within the control of ministers than stakeholder pensions. For example, they could use the accumulated savings for redistribution, or to fund public works at a discount, or to raise revenue for the Exchequer. These are all acceptable public policy objectives in their own right, but they are not appropriate uses for individuals' personal retirement savings.

56 PC, *A New Pensions Settlement for the Twenty-First Century*, November 2005, p.286

57 John Greenwood, 'Personal sacrifice', *Money Marketing*, 26 July 2007, p.37

> **Auto-enrolment and personal accounts**
>
> From 2012, employees will be automatically enrolled either into their work-based pension, such as an occupational pension or a Group Personal Pension, or else into a centrally-administered personal account.[58]
>
> Individuals will be able to opt out, but anyone who does not opt out will find themselves contributing a minimum 4% of salary (between £5,000 and £35,000). In return, they will receive employer contributions of 3% and tax relief of 1% – a total contribution of 8% on the relevant income band.

Personal accounts are not entirely without merit, but they are a strange response to the UK's position: they take little account of the UK's relatively-successful history of non-state pension provision and the accumulated knowledge within the pensions industry, and they will be relatively inflexible. Professor Philip Booth has described a not dissimilar proposal for funded, state-administered second-tier pensions as suitable for 'those countries for which private pension schemes are merely "complementary" to an over-arching, all-embracing, unfunded state scheme.' He concluded that 'given the UK's starting point in pension provision … the proposals would be a step backwards.'[59] This even-handed verdict is equally applicable to the personal accounts model.

An alternative vision

The name 'stakeholder pensions' dates from Tony Blair's promotion of a stakeholder society as a new form of participatory politics when in opposition in the mid-1990s.[60] It is ironic that one of his last acts as Prime Minister should have been to abandon stakeholder pensions in favour of a monolithic and state-run system of personal accounts. There was no need. Stakeholder pensions not

58 It is currently not possible to enrol people automatically into a Group Personal Pension because of the EU Distance Marketing of Financial Services Directive. However, a solution to this problem should be found before 2012.

59 Philip Booth, 'Pension Provision: Liberalism or Corporatism?', in Alan Deacon (ed.), *Debating Pensions: Self-interest, citizenship and the common good*, Civitas, 2002, p.57

60 Tony Blair, 'The Singapore Speech', 7 January 1996 (http://www.psa.org.nz/library/psa/02%20partnership%20for%20quality%20materials/tony%20blair%20-%20the%20singapore%20speech%201996.doc accessed 25 January 2008)

only offer a simpler alternative to the proposed personal accounts, they also have plenty of positive characteristics of their own. In the words of the Government:

Stakeholder pensions are a flexible and portable product, with a limit on charges and no transfer penalties, and they allow individuals to contribute intermittently, thereby enabling people with irregular income patterns to build up a pension fund.[61]

One of the main reasons the Government lost faith in stakeholder pensions and adopted personal accounts instead is that they dislike the relatively high charges.[62] Stakeholder pension charges can in theory eat up as much as 1.5% of an individual's pension fund each year for the first ten years (and 1% thereafter). However, on a like-for-like basis, there is no reason why stakeholder pensions should cost any more than personal accounts. Where there are economies of scale provided by auto-enrolment and compulsory employer contributions, costs fall dramatically. At medium-sized employers, stakeholder pensions already sometimes have charges as low as 0.4%, which is in the 0.3% to 0.5% range expected for personal accounts.[63]

Using current infrastructure and expertise and adopting a system based around a competitive marketplace with a number of providers could, in the long run, offer better value for money, greater variety and a more consumer-friendly approach than a monolithic state system. The KiwiSaver was designed with a full range of public policy objectives (including low charges) in mind and a multi-provider model was chosen. If the UK were to follow this route, then the Government and the financial services industry could instead expend their energy on improving pension transfer processes, encouraging higher contributions, pushing for broader take up, engaging employers and spreading general financial understanding. This is a rich and challenging agenda all of its own.

61 DWP, *Personal accounts: a new way to save*, December 2006, p.142

62 DWP, *Security in retirement: towards a new pensions system*, May 2006, pp.59-61

63 Mike O'Brien MP, the Minister of State for Pension Reform, and Paul Myners, Chair of the Personal Accounts Delivery Authority, to the Work and Pensions Select Committee, 17 October 2007 (http://www.publications.parliament.uk/pa/cm200607/cmselect/cmworpen/uc1069-i/uc106902.htm uncorrected transcript accessed 2 November 2007)

3

The fall and rise of state pensions

One major problem with the UK's state pension system is its sheer complexity. The table below shows the main changes that have occurred over the past half a century.

Major changes to state benefits for pensioners, 1961 to 2003

1961	• Introduction of the Graduated Retirement Benefit, the first earnings-related state pension
1971	• Introduction of non-contributory Category D state pension for people aged over 80 with poor contributory records
1974	• Introduction of the 'earnings link' for the flat-rate basic state pension
1975	• Abolition of the Graduated Retirement Benefit
1977	• Married women stop being entitled to reduced NICs (existing cases are allowed to continue) and the married persons' State Pension starts to be phased out
1978	• State Earnings-Related Pension Scheme (SERPS) introduced
1980	• Abolition of the earnings link for the basic state pension
1988	• SERPS restructured – the target pension was reduced by one-fifth and 'the best 20-years rule' was removed
	• Income Support replaces Supplementary Benefit
1999	• SERPS calculation changed, further reducing entitlement
	• Income Support for people aged 60+ renamed the Minimum Income Guarantee and starts to be uprated annually in line with earnings
2002	• State Second Pension (S2P) replaced SERPS
	• Start of reduction in inherited SERPS for new pensioners
2003	• The Minimum Income Guarantee renamed the Guarantee Credit of the Pension Credit and a new Savings Credit introduced

When there has been a change, pension entitlement accrued to date has generally been frozen. As a result, the various elements of the state pension system have come to resemble complex archaeological layers that cannot be destroyed.

- New accruals to the Graduated Retirement Benefit ended in 1975, but it will continue to be paid out for many years to come.
- Married women have not been able to opt for reduced National Insurance Contributions since 1977, but millions of female pensioners still have their pension calculated on the basis of these lower contributions.
- The main cuts to SERPS were implemented in 1988, but they will not be fully implemented for new pensioners until the late 2030s and existing pensioners will retain some entitlement under the pre-1988 rules even after then.

In one sense, all the changes have been pointless. They simply take pensioners back to their original position: were the current system to be maintained, a median earner retiring in 2060 would receive an income from the basic state pension and the State Second Pension combined of around 20% of their previous income, which is roughly the same rate at which the state pension was paid when it was introduced in 1948.[64]

The Government's proposals

The next table shows the changes that the Government has announced for the future. In the short term, these include making the basic state pension more generous by re-linking its annual increases to average earnings growth, reducing the number of contributory years necessary to receive a full basic pension and providing more state pension entitlement to carers. Further in the

64 DSS, *The Changing Welfare State: Pensioner Incomes*, March 2000, p.17

distance, the changes will produce a flat-rate State Second Pension and a higher State Pension Age.

Major changes to state benefits for pensioners, 2010 to 2046

2010	●	State Pension Age begins to increase for women
	●	Reduction in the contributory years for a full basic state pension (to 30 for new pensioners)
	●	New Carer's Credit for the basic state pension and S2P
	●	Abolition of the minimum contribution conditions for the basic state pension and the Labour Market Attachment Test for S2P
	●	End of the reduction in inherited SERPS for new pensioners
2012	●	Restoration of the earnings link for the basic state pension
	●	Abolition of contracting out for defined contribution schemes
2020	●	Equalisation of the State Pension Age at 65 for men and women
2024	●	State Pension Age starts to rise above 65
2030	●	State Second Pension due to become wholly flat-rate
2046	●	State Pension Age to reach 68

After the changes, lower and higher earners will receive more similar payments than under the current rules. In other words, the state pension system, which has generally become more regressive (earnings-related) over time, will become more progressive (flat-rate) in the future. The amount of income that the average earner can expect to receive in 2050 from the state pension will rise from £100 to £135 a week, or from around 23% of previous earnings to around 30%.[65]

There will also be less means testing than if current policies were to continue: according to the Government, the proportion of pensioner households entitled to the Pension Credit in 2050, which was set to reach 70%, could instead be around one-third.[66]

After half a century in which various Governments have sought to provide earnings-related state provision, it has been recognised across

65 2005/06 earnings terms. DWP, *Security in retirement: towards a new pension system, Regulatory impact assessments and technical appendices*, May 2006, p.117, Figure 4.ii

66 DWP, *Security in Retirement: towards a new pensions system*, May 2006, pp.122-123. The Pensions Policy Institute (PPI) have argued that between one-third and two-thirds of pensioner households could be eligible for the Pension Credit in 2050 – PPI, *An evaluation of the White Paper state pension reform proposals*, July 2006, p.25.

the political spectrum that 'The Government cannot, in the face of an ageing population, hope to provide both a foundation for private savings and a good-quality alternative to occupational provision.'[67] It is difficult to argue with this conclusion: as other countries are discovering, Governments simply cannot afford to provide generous unfunded earnings-related pensions for evermore.

An alternative vision

But it is difficult to see why the Government has opted to retain the two separate layers of the state pension when the aim is a flat-rate income. Retaining the basic state pension and the State Second Pension as two separate elements is unnecessarily confusing, particularly when – as shown in the table – they will have different contributory conditions, accrual rates and indexation rules.

The State Second Pension is very poorly understood. The Pensions Commission's focus groups did not include a single person who had ever heard of it[68] and, as the Government has

67 DWP, *Security in retirement: towards a new pensions system*, May 2006, p.106

68 PC, *A New Pensions Settlement for the Twenty-First Century*, November 2005, pp.66-67

	Basic state pension	State Second Pension
Contributory conditions	30 years of contributions or credits necessary for a full pension	Current 49-year maximum to increase with State Pension Age
Accrual rate	Current value	£1.40 a week pension for each year worked or credited An earnings-related top-up until c.2030
Indexation of pension	In line with earnings growth	In line with price inflation

admitted, 'Many people are building entitlement to the State Second Pension without even being aware that they are doing so.'[69] Building a new system around such a poorly understood part of the current system seems unwise.

The Pensions Commission considered an alternative model in which there would be a non-contributory (or universal) single-tier state pension. They assumed this would be paid at £109 a week and linked to earnings once in payment. As a result, they concluded it would produce 'a total public expenditure profile above our guideline envelope'.[70] In other words, it would be unaffordable because, for example, people with broken contribution records would become entitled to a full pension for the first time and the whole state pension would rise with earnings. The Government followed the Pensions Commission by ruling out a single-tier universal state pension on grounds of cost.[71]

However, both the Pensions Commission and the Government conflated the idea of a single-tier state pension with the idea of a universal Citizen's Pension. Because a Citizen's Pension is unaffordable, this conflation led the Commission and the Government to rule out a single-tier pension altogether. This was a missed opportunity because there is a third option that sits between an over-complicated two-tier system and an unaffordable Citizen's Pension.

It would be possible to have a single-tier state pension that is contributory, rather than universal. This option has not been properly considered, yet it need cost no more than the Government's current proposals. For example, instead of having a contributory basic state pension linked to earnings and a State Second Pension indexed to prices, a new Single State Pension could be linked to a single index between prices and earnings. The contribution rules and the accrual rates could be harmonised in a similar way.

69 DWP, *Security in retirement: towards a new pensions system*, May 2006, p.116

70 PC, *A New Pensions Settlement for the Twenty-First Century*, November 2005, p.254

71 DWP, *Security in retirement: towards a new pensions system*, May 2006, p.116-119

Pensions Commission	Government	An alternative vision
Universal basic state pension with a contributory State Second Pension on top that would be earnings-related until 2030	Contributory basic state pension with a contributory State Second Pension on top that would be learnings-related until 2030	Contributory Single State Pension paid at a flat rate to all and with harmonised entitlement conditions
Ideally, a lower State Pension Age for the basic state pension than for the State Second Pension	State Pension Age to be increased in three bursts from 2024 – finally reaching 68 in 2046	State Pension Age to be increased gradually to 68 by the mid 2040s
Earnings indexation of the basic state pension and price indexation of the S2P	Earnings indexation of the basic state pension and price indexation of the S2P	A single indexation rate between earnings and prices

The table above outlines the changes between this proposal and the Government's plans. The main difference is that government would extract itself from earnings-related pension provision much earlier – in 2012 rather than 2030 – and that the two-tiers would be combined into one simpler layer.

In the table, it is also proposed that the State Pension Age should be increased to 68 more smoothly than the Government is planning. This would be in line with the increase in women's State Pension Age between 2010 and 2020, and would be fairer and more understandable than the three short bursts that have been proposed by the Government.

A Single-Tier State Pension

A Single-Tier State Pension has various advantages over the Government's proposals.

- It is simpler to comprehend. People would be better able to understand the pension they can expect from the state if it came from a single tier. As a result, the Government would receive more 'bang for their buck' and it would be easier for people to decide how much to save privately on top.
- It takes the Government out of earnings-related pension provision at the same time as automatic enrolment is introduced. Under the current proposals, the State Second Pension will not become fully flat-rate until 2030. Given that auto-enrolment into earnings-related pensions is planned to start in 2012, there is little rationale for waiting 18 more years to end accruals to the state's earnings-related pension.
- It is much simpler to administer. If the Government does not stop new accruals to the state pension from being earnings-related until 2030 and instead has a withdrawal process for the period 2012-2030, this unnecessarily adds a further complicated archaeological layer to state pensions.

In the long run, the cost and distributional impact of a flat-rate contributory Single-Tier State Pension is similar to the Government's proposals, as ministers are committed to having a wholly flat-rate system (made up of a flat-rate basic state pension and a flat-rate State Second Pension) by 2030. In the interim, a Single Tier State Pension would be simpler and more progressive as earnings-related accruals would cease in 2012, just as automatic enrolment into earnings-related funded schemes starts.

If National Insurance Contributions continue on the Government's plans after 2012, this reform could even provide extra revenue to the Government. This could be used to help poorer pensioners, for example by increasing the measly 25p a week Age Addition offered to pensioners aged over 80, or providing higher state pension increases to all pensioners, or helping pensioners with poor entitlements who retire before the changes are implemented.

Alternatively, it could be used to aid employers with the costs of auto-enrolment, or to build a buffer fund to pay for some of the future costs of the state pension.

Conclusion

In 1958, the President of the Institute of Actuaries said:

It would clearly be quite unconscionable for one generation to vote for itself luxury increases in pensions at half price to itself and the rest at the expense of following generations and then to speak of them as pensions "as of right".[72]

This is precisely what the baby-boomer generation, who are now approaching retirement, has done. They have passed a succession of laws to ensure their occupational pensions are secure and generous. The cost of these changes has fallen on younger employees in the private sector, who generally have access only to defined contribution schemes with lower employer contributions and more complicated joining procedures. They are paying for the occupational pensions of older workers and public sector workers. Until this is tackled, the pensions crisis will continue.

There is an alternative way ahead. The Government could reduce the regulatory burden on private sector occupational schemes, encourage risk-sharing schemes and make public sector schemes more affordable. This would provide more access to defined benefit schemes and more equity between different generations, as well as a more sustainable system.

The Government's main proposal for extending pension coverage is to introduce automatic enrolment for existing work-based pensions alongside a new system of personal accounts. But personal accounts may well turn out to be a poor solution to the problem of low saving. If existing products (such as stakeholder pensions) were used instead, automatic enrolment could be implemented much more quickly. It would have other advantages too – for example, it would encourage a more dynamic market in retirement saving.

72 Frank Mitchell Redington, 'Address, 27 October 1958', *JIA*, no.85, 1959, p.9

The Government's state pension reform programme is better than retaining the current system: it will reduce means-testing and help women and carers. But the changes will do little to simplify the system and the state pension will continue to offer an uneasy base for private saving. It would be better to introduce a more progressive and understandable Single-Tier State Pension now than to retain earnings-related state provision until 2030.

The past few years have seen an intense debate about the best way forward for UK pensions. The Government's proposals for the future offer an improvement on the status quo and opposition parties and the pensions industry are right not to oppose them outright. But, if the reform programme is to be as successful as it could be, it needs to be more radical.

Appendix: A note on contracting out

Contracting out refers to the option of leaving the state's earnings-related pension (though not the basic state pension). People who contract out receive a National Insurance rebate into a non-state pension instead.

When the idea of an earnings-related state pension first took root in the UK, the objective was to fill in gaps in coverage rather than to supplant existing private provision.[73] Contracting out became a key factor in the continuation and further development of Britain's private pension market. As Government officials had noted in 1964, 'if a [pension] scheme could not see a way to continue to be contracted out, it would have, in most cases, either to be severely cut back or abandoned altogether'.[74]

So, without contracting out, Britain's occupational pension schemes may have largely shut up shop. Additionally, personal pensions might never have been viable, for contracting out stimulated their demand.

73 J.A. Atkinson, 'The Developing Relationship Between the State Pension Scheme and Occupational Pension Schemes', *Social and Economic Administration*, vol.11, no.3, 1977, pp.216-217

74 Quoted in Stephen Thornton, 'Towards public-private partnership: Labour and pensions policy', in Peter Dorey (ed.), *The Labour Government 1964-1970*, 2006, p.300

75 See, for example, *Financial Times*, 13 March 2002, p.1

76 DWP, *Security in retirement: towards a new pensions system*, May 2006, p.92

Contracting out, 1997 onwards

2002	• New contracted-out rebate levels take effect, and are criticised as being too low to make up the state benefits foregone[75]
2007	• Rebate levels change again. For defined benefit schemes, they are lower than recommended by the Government Actuary and, for defined contribution schemes, the cap on rebates is reduced by nearly one-third, despite rising longevity
2012	• Contracting out due to end for defined contribution schemes
	• For defined benefit schemes, contracting out 'will be subject to ongoing review as part of the evaluation of the overall [pension] reform package.'[76]

Although the current Government's initial plans for the State Second Pension included continued encouragement for contracting out,[77] they have more recently reversed this. As shown in the table, ministers have repeatedly weakened the incentive to contract out. And they have now committed to abolish contracting out altogether for defined contribution pension schemes, as well as to review its future for defined benefit schemes.

Under the Single-Tier State Pension proposed in this paper, contracting out could:

- **either** be phased out altogether – contracting out makes less sense when the Government is no longer involved in earnings-related state pensions;
- **or** be revamped so that pension schemes and individuals could opt out of part or all of the new Single-Tier State Pension.

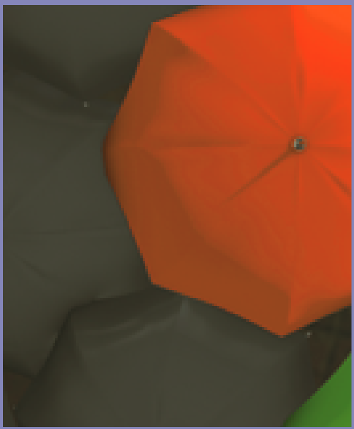
If contracting-out were to be phased out, this would have an impact on the cost of providing defined benefit pensions. This is because contracted-out defined benefit schemes can expect to continue receiving rebates under the Government's proposals, albeit at a falling rate. However, the impact could be reflected in lower accrual rates or, preferably, contracting out could be revamped as in the second option.

77 DSS, *A new Contract for welfare*, December 1998, p.40

Britain is in the midst of a pensions storm. Public sector pensions have soaring costs. Many private schemes have closed to new members, and stakeholder pensions have not hit their target. The state pension system is overly complicated and relies too much on means testing.

For a long time, politicians have struggled to find answers to these problems but millions of people still face a poor and uncertain future.

In this timely pamphlet, Nicholas Hillman argues that the Government should learn from the past and make additional reforms to every part of the system. They should make it easier for employers to provide good pensions, confront the risks in personal accounts and introduce a new Single-Tier State Pension. The goal is better pensions for all.



£5.00
ISBN: 978-1-906097-16-5

Policy Exchange
Clutha House
10 Storey's Gate
London SW1P 3AY

www.policyexchange.org.uk

policy exchange