SAVE OUR PENSIONS

Peter Lilley

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GLOSSARY OF TERMS

(See Annex A for a guide to the complexities of the British pension system)

ABI	**Association of British Insurers**
APP	**Approved Personal Pension**
ASP	**Additional State Pension** (Pension additional to BSP, was SERPS now S2P)
BPP	**Basic Pension Plus**
BSP	**Basic State Pension**
DWP	**Department for Work and Pensions** (formerly DSS)
DSS	**Department of Social Security**
GAD	**Government Actuary's Department**
HET	**Higher Earnings Threshold** (S2P accrues at 10% of earnings between LET and HET and at 20% between HET and UEL)
LEL	**Lower Earnings Limit** (Level of earnings - set roughly equal to BSP -below which employees neither pay NI nor accrue any entitlement to BSP and S2P)
LET	**Lower Earnings Threshold** (Set roughly equal to half national average earnings. Employees earning between LEL and LET accrue a flat rate element of S2P as if they earned LET)
MFSP	**Mandatory Funded Second Pension** (The pension generated by NI rebates invested in a fund to replace the unfunded S2P)
MIG	**Minimum Income Guarantee** (Level to which retirement incomes will be topped up by Guarantee Credit)
NI	**National Insurance**
NIC	**National Insurance Contribution**
NI Rebate	Element of employee's and employer's NICs paid into private pension fund of those who contract out of ASP
ONS	**Office of National Statistics**
Pay-As-You-Go	Scheme in which current taxes or NI contributions are used to pay pensions of people already retired rather than invested to pay future pension liabilities.
PC	**Pension Credit** (composed of two elements: Guarantee Credit which tops up retirement incomes to the MIG level and Savings Credit which partly compensates for impact of means testing on income from private saving)
SERPS	**State Earnings Related Pension Scheme**
SPA	**State Pension Age**
S2P	**State Second Pension**
UEL	**Upper Earnings Limit** (Level beyond which higher earnings accrue no extra S2P)

EXECUTIVE SUMMARY

Reform of Britain's pension system must address four key questions. They are:

Compulsion	how much should people be required to provide for their old age?
Funding	how much of that compulsory provision should be funded by genuine savings and how much left to future tax payers (by the state financing on a pay-as-you-go basis)?
Pension age	should people be required or encouraged to work longer before drawing their pension?
Costs	how can the portion of savings absorbed by the costs of running pensions and annuities be reduced?

Compulsion: How Much Pension Provision?

- Compulsion is undesirable. But it is unavoidable. Any civilised society is bound to provide at least a means tested safety net for those who reach old age without providing for their retirement. That creates disincentives to save which cannot be eliminated, only spread more thinly further up the income scale. It also means that the prudent, who voluntarily provide for their own retirement, are compelled through the tax system to pay for those who improvidently fail to do so. It is better to require everyone who can do so during their working lives to make provision for their own retirement. That will not be an extra burden on those who would save anyway. Indeed, they will then not be compelled to pay so much tax to support the improvident in the future.

- We already have a compulsory second pension. All employees are required to pay via their National Insurance Contributions either into the State Second Pension (previously SERPS) or into an approved occupational or personal pension scheme offering similar or superior benefits. The key issue is whether the level of this compulsory provision is sufficient.

- The level of compulsory provision should be sufficient to lift people clear of the means tested safety net. Means testing discourages people on low incomes from saving and it provokes resentment among those who nonetheless do save yet are little or no better off as a result. In Australia making everyone in work provide adequately for their retirement has been widely welcomed especially by younger people.

- Coverage of the compulsory second pension should be extended to the self- employed.

- The government is committed to raising the Minimum Income Guarantee in line with earnings during this parliament and projects it forward indefinitely on that basis. Yet state pensions are set to rise only in line with prices. If this continues the MIG is bound to overtake the level of state and compulsory pensions. To prevent this happening, the Basic State Pension and the MIG should be statutorily indexed to prices and, when resources permit, any real increases made by raising both the BSP and the MIG by the same cash amount.

- Once an adequate Second Pension is in place it will be possible to phase out the Savings Credit system whose complexities and withdrawal rates act as disincentives to save over a broad swathe of incomes.

Funding: Save Now or Tax Later?

- The UK has more investments to meet future pension requirements than the rest of the EU put together. Nonetheless these still only cover 40% of our future pension liabilities. The government has set a laudable target of raising that proportion to 60% by the middle of the century.

- This will only be achievable if more people contract out of the unfunded State Second Pension scheme into genuinely funded pensions.

- Sadly Stakeholder Pensions have had negligible success in persuading more people to contract out of the State Second Pension.

- Those who contract out receive a rebate from their National Insurance Contributions payable directly into their personal or occupational pension fund. The level of the rebate is set on the basis of the Government Actuary's estimates of the amount needed to fund a private pension broadly sufficient to replace the pension entitlement that employees would have accrued in the State system.

- But contracting out of the unfunded Additional State Pension system into a personal pension has never been attractive for those on low earnings. This is because the lower a person's earnings the smaller their rebate. Charges do not decline proportionately since there are fixed costs in setting up and running a fund. So charges absorb a disproportionate share of the small rebates received by those on low earnings.

- Consequently the option of remaining in the unfunded State Additional Pension system has been retained for the benefit of those on low and intermittent earnings.

- That problem was inevitable under SERPS since the accrual of pension and the corresponding rebate for contracting out were directly proportional to earnings. However, under S2P, employees with earnings below roughly half the national average accrue a flat rate entitlement to pension. Yet if they contract out they still receive a rebate proportionate to their earnings so it remains unattractive for them to contract out.

- Those on low earnings should be entitled to a flat rate rebate equivalent to the full value of the pension entitlement they accrue at present under S2P. That would be sufficient to justify the fixed costs of setting up a personal pension. It would then be possible gradually to replace the unfunded pay-as-you-go S2P by a Mandatory Funded Second Pension of equivalent value. Those on earnings above the Lower Earnings Threshold would receive a rebate comprising both the flat rate element for earnings up to the LET and an earnings related element for earnings above the LET as at present.

- This proposal would come in progressively with each cohort of young people entering employment. I envisage that everyone in work who was born, say, thirty years or less before the new system starts would be required to have a Funded Second Pension. They would receive a NI rebate equivalent to the value of the old S2P accrual which it would replace. That payable into their own personal or occupational fund. Those born more than 30 years before the start date would retain the choice, as at present, of remaining in the unfunded S2P or opting into a funded private pension.

– The government originally envisaged compelling some employees to have a private Funded Second Pension to replace the unfunded S2P. But only those with earnings above the Lower Earnings Threshold would have been required to contract out in this way. It now envisages that all those with earnings below the LET will lose the right to contract out of the S2P. Those above this level will be encouraged to contract out. If they do they will receive a rebate equivalent to the flat rate and earnings related elements of S2P but if not they will only accrue the flat rate of S2P. This would create an unfair two class system and difficulties for those whose incomes fluctuate above and below this level.

– My proposal would enable the government to meet its target of 60% privately funded pensions by mid-century; enormously boost committed long-term savings and investment; and dramatically reduce the long-term tax burden. More important, over time it would ensure that everyone had their own pension fund - the biggest extension of capital ownership since the growth of home ownership.

– Once people own a personal pension fund they can readily choose to save more than the minimum – and Australian experience suggests many will do so. Ownership of a pension fund will also give everyone a direct stake in national prosperity.

– The government should guarantee that if for any reason the element of anyone's Funded Second Pension derived from the flat rate rebates is not sufficient at retirement age to buy an annuity equivalent to the flat rate element of S2P the state will top up the annuity payments to that level. Earnings related rebates and voluntary additional contributions will not be covered by this guarantee.

– To prevent fund managers betting against the guarantee if the fund has underperformed they would be required to invest on a Prudent Person basis. These rules could be enshrined in statute as in Australia. Also fund managers would be required to invest the guaranteed and non-guaranteed elements of the funds on the same basis.

Pension Age: How Long to Work?

- Unless it moves to a Mandatory Funded Second Pension, the government could only reach its target of 60% funded pensions by 2050 by raising the State Pension Age to make people work longer.

- Given that the life expectancy of those aged 65 has increased by roughly one month every year for several decades there are strong pressures to raise the SPA annually by that amount simply to contain the cost of state pensions.

- As far as possible the government should avoid telling people when to retire or forcing them to work longer by raising the SPA. The most it should do is to raise, in line with average life expectancy, the age at which people can draw their tax free lump sum other than to buy an annuity.

- The great advantage of everyone having their own pension pot is that with ownership comes choice. People will be free to choose when to retire once their fund can provide an income sufficient to keep them from dependence on means tested benefits. At the same time ownership of a personal pension fund will give them a double incentive to work beyond the normal pension age – to save more for fewer years of retirement.

- Compelling people to work longer would bear hardest on those who work in stressful, manual and lower paid jobs. These are the very people whom the present pension system treats most unfairly. They pay in on the same terms as everyone else. Yet they have shorter life expectancy and so typically draw their pensions for fewer years. The less well paid subsidise the retirement of the higher paid and longer lived.

- Government should encourage providers to remedy this by relating pensions and annuities to the life expectancy of different income groups. This would mean that the lower people's earnings during their working life the less they would pay to buy a given annuity income. So the less well paid would not need to accumulate so large a pension fund before they can choose whether to retire or continue working (possibly part-time).

- To enable annuity providers to do this the government could make available, in a form equivalent to their tax code, a summary of each person's life time earnings from the National Insurance Recording System. The likely growth of affinity group providers once everyone has their own pension pot will also lead to provision of annuities more fairly reflecting the life expectancy of lower income groups.

How to Cut Pension Costs

- The costs of running pension funds typically reduce the value of the final pension pot by over a third. Over half of this is the cost of acquiring customers.

- Requiring everyone to have a pension fund would be the single most effective way of reducing those costs. Compulsion would eliminate costs of persuasion, largely remove the need for advice, simplify and standardise the product, and spread overheads more widely. So costs might be reduced by as much as a half, increasing the final pension by as much as 13%.

- Insurance is a good way to pool risks which are stable across a population. But there is no way to hedge the risk that average life expectancy might suddenly outstrip past trends – e.g. because of a magic bullet cure for cancer.

- Annuity providers have to make provisions against possible but unlikely developments in longevity. If those developments fail to occur and mortality is in line with central estimates pensioners will collectively have paid for more years of retirement than they receive. On the other hand if annuity providers fail to make adequate provision for future increases in longevity they may prove unable to pay pensions they have promised. The state would have to step in.

- Most of the uncertainty annuity providers must provide against concerns the number of people who may live well beyond current average life expectancy. So if the Mandatory Funded Second Pension was only required to cover the first twenty years of retirement and the State provided an unfunded S2P for the years beyond age 85 the state would be bearing much of the unquantifiable longevity risk.

- The cost of twenty year fixed term annuities should be disproportionately cheaper than full life annuities. Anyone wanting a retirement income above the Second Pension level would still have to buy an additional full life annuity

INTRODUCTION

The biggest domestic problem facing every developed country is how to finance pensions as people live longer and have fewer children.

Britain is better placed to cope with this than most of our European partners. They rely almost entirely on taxation to pay for pensions. So the growing burden of their aging populations will mean rising tax burdens on declining work forces. By contrast, we have encouraged people to contract out of the unfunded Additional State Pension and save in occupational and personal pension schemes. As a result we have built up more investments to meet future pension liabilities than all the rest of the EU put together.

Nonetheless, UK pension funds only account for 40% of future pension liabilities – the other 60% falling on future tax payers. The Labour government set a target to reverse those proportions so that 60% of pensions would come from savings by the middle of this century. That is an admirable target that a future Conservative government would, I hope, endorse.

Unfortunately, having set itself that target, the government has actually moved in the opposite direction. It has increased unfunded state pension promises enormously while imposing a £5 billion per annum tax on pension funds and creating disincentives to save by its Minimum Income Guarantee and Pension Credits.

At the same time private pensions have been plunged into a crisis. Defined benefit schemes are closing to new employees at an accelerating rate. Employers are changing from defined benefit to money purchase and often contracting their employees en bloc back into the state system. Insurers are urging many employees to opt back into the unfunded State Second Pension. The stock market fall has provoked a crisis at Equitable Life, caused other with-profits pension providers to cut their bonuses and hit even harder those invested in unsmoothed funds.

In the face of all this some commentators advocate retreat: abandon the 60:40 savings target, leave it to tomorrow's taxpayers to pay for our pensions and/or force people to work longer before they receive their state pension.

To retreat from funded pensions would be folly. Britain's funded pension provision is an enormous asset. We should see current problems as opportunities to strengthen it and build on it. But that needs new, imaginative and radical thinking. Sadly the government's Green Paper, though it contained some useful minor reforms, did not remotely match up to the scale of the pension crisis. It largely sidestepped the four key issues facing our pension system which are:

compulsion – how much people should be required to provide for their old age;

funding – the extent to which compulsory provision should be funded by genuine savings or left to future tax payers;

pension age – whether people should be encouraged or required to work longer before drawing their pension;

costs – how the cost of pensions and annuities can be reduced.

These are the issues addressed in the four sections of this report.

1. COMPULSION: HOW MUCH PENSION PROVISION?

Should the state compel people to make adequate provision for their retirement? And if so, how much?

In this chapter I do not address the issue of the extent to which any such compulsory provision should be financed by the state on a pay-as-you-go basis and how much by private savings. That is the question considered in the next chapter.

The importance of the issue of compulsion has been accentuated by the erosion of incentives to save (through the extension of means testing to the majority of future pensioners) and the limiting of any reward for persuading people to save extra (through the cap on charges for stakeholder pensions). Yet the government's Green Paper largely sidestepped it – instead setting up a Commission to monitor whether voluntary provision is sufficient.

Concerns about the adequacy of people's provision for retirement have been growing. The Association of British Insurers claims there is a "pension shortfall of £27 billion".[1] As the trade organisation for the providers of personal pensions, they have a vested interest in talking up the need for more pension provision.

Nonetheless, since that figure was calculated the stock market has fallen much further, more pension funds have closed and Equitable Life's problems have cast their shadow over other with-profits providers.

As a result, calls for the state to compel people to make greater provision for their retirement have multiplied. Often such calls take the form of demands that the state require people (or their employers) to provide for a "second pension".

A surprising number of commentators seem unaware that all employees are **already** compelled to provide for a pension in addition to the basic state pension.

Ever since 1978 all employees have been required to make payments via their national insurance contributions either into the Additional State Pension (called the State Earnings Related Pension System until April 2002 when it was restructured and renamed the State Second Pension) – or into an approved occupational or personal pension scheme offering equivalent or superior benefits.

People may be unaware of this because they never see the contributions they are making - since they are deducted at source from their pay and go direct to the National Insurance Fund or onwards to their pension fund.

Is the State Second Pension adequate?

The issue is not, therefore, whether a compulsory second pension needs to be introduced but whether the new State Second Pension or the rebates for opting into a private scheme will be adequate.

At first sight the amount of provision people should make for their retirement is a matter for them. Why should the State compel anyone to make a minimum level of provision for themselves? I am on the libertarian end of the political spectrum. So I started from a presumption that compulsion should be avoided if at all possible. But I concluded that if, as any civilised society must, we make provision for those who cannot provide for their own retirement, an element of compulsion is inevitable. Either we compel all those who can do so to provide sufficiently for themselves; or the prudent, who voluntarily provide for themselves, will be compelled also to support via the tax system the imprudent who fail to do so.

Virtually everyone would accept that, at very least, we must help those who simply could not afford to save for retirement whether through sickness, disability, caring responsibilities, unemployment or very low income when they were of working age. Not everyone would be so willing to help those who **could** have made provision for retirement but **failed** to do so. In practice it would be difficult to distinguish between those who would have saved but couldn't and those who could have saved but didn't. In any case, however much we may disapprove of the improvidence of the latter, they cannot be left destitute.

So, at the very least, any decent society must have some means tested safety net for those who reach old age with insufficient provision for their retirement. However, once the state effectively guarantees a means tested minimum income in old age it inevitably creates two problems. It discourages people on low incomes from saving and it arouses valid resentment among those who do nonetheless save yet are little or no better off as a result.

The only logical way to remove both disincentive and resentment is to require people of working age who can afford to do so, to provide for a pension at least equal to the minimum retirement income guaranteed by the state. Those who might otherwise have been improvident would then be forced to make provision during their working lives. So they would no longer arouse resentment among the prudent nor burden the taxpayer. **Those who would have made adequate provision for themselves anyway will not be directly affected by compulsion. Indeed, they will not be compelled to pay so much in taxation to support the imprudent in future.** Those who cannot make such provision in any year (e.g. because of caring responsibilities) would be given credits towards such a level of retirement income. Ideally those credits would score as accruals for pay-as-you-go funds and be paid in cash for funded pensions.

This was roughly the structure envisaged by Beveridge when he designed the welfare state. People were initially required to contribute during their working lives towards a basic state pension that was then set somewhat higher than the minimum level of income guaranteed by National Assistance. Over time, however, the minimum means tested income for the elderly (provided first by National Assistance and latterly by Income Support) has been increased to a level above the Basic State Pension.

So long as the gap between the two was small comparatively few people suffered means testing of their savings. This government has greatly exacerbated the problem by setting the Minimum Income Guarantee nearly one-third higher than the Basic State Pension. This has substantially increased the number of people facing disincentives to save and feeling resentment if they do. The Minimum Income Guarantee in 2003/4 is £102.10 pw against the Basic State Pension of £77.45 pw for a single person.

So someone with just the BSP of £77.45 will be entitled to claim Guarantee Credit of £24.65 to bring their total income up to the MIG of £102.10. A pensioner with a small private pension of, say, £10 pw on top of their BSP will currently get £10 less Guarantee Credit – just £14.65 – to top them up to the MIG level.

The MIG on its own thus renders voluntary saving towards a modest second pension of up to £24.65 pw completely pointless. Even a private pension somewhat higher than this represents a very poor net return for saving. For example, a pension of £34.65 on top of the BSP giving a total income of £112.10 leaves the pensioner only £10 pw better off than if they had not saved a penny. Most occupational pensions are quite modest. About half are less than £40 pw. They will barely lift pensioners above the level they could have got relying solely on the MIG.

Moreover, the government has promised that the Minimum Income Guarantee will rise in line with earnings. Yet the Basic State Pension is still only indexed to prices. So the gap between the two is set to widen making the problems of disincentives and resentment progressively worse. Even if someone has a pension sufficient to lift them clear of the means tested zone at the point of retirement they may well find themselves subject to means testing in the course of their retirement as the MIG increases in line with earnings and overtakes their pension which is indexed to prices.

The government hopes to mitigate the disincentive effect of means testing by introducing the Pensions Credit. This comes in from October 2003.

The effect of this is to restore some, but not all, of the reward for saving to those who previously would have done just as well to rely on the MIG. Unfortunately this comes at a cost. Those whose income takes them above the MIG level lose Pension Credit as it is phased out the higher a pensioner's income. This introduces a new disincentive to save for a far wider range of pensioners. And the very complexity of the new system is so bewildering that it is bound to undermine the savings culture. The summary of the state pension system in Annex A will give the reader a taste of this complexity.

The Pension Credit works roughly as follows. It will have two components. The first is the Guarantee Credit which is simply the new name for the benefit needed to bring a pensioner's income up to the MIG level. The second component is called the Savings Credit. Those pensioners whose private pension is less then the gap between the BSP and the MIG will get a Savings Credit of 60p for every £1 of their private pension. They will continue to forego £1 of Guarantee Credit for every £1 of pension income. So they face a net loss of benefit of 'only' 40p in the £1 for their saving income. In other words they still suffer the same penalty on marginal savings as someone paying the top rate of income tax.

Take a worked example: George has a Basic State Pension of £77.45 plus a private pension of £10 pw. He therefore foregoes £10 of Guarantee Credit and is entitled to the £14.65 pw to make his income up to the MIG level of £102.10. But from October 2003 he also gets £6 of 'Savings Credit'. So his take home income will be £108.10 pw. His £10 pension will make him only £6 a week better off than someone who has not saved a penny.

If George had a pension of £24.65 pw - equal to the difference between the BSP and the MIG - he would not be entitled to any Guarantee Credit but could claim the maximum Savings Credit. That would be worth £14.79 which is 60% of his additional pension.

To avoid giving that much Saving Credit to everyone with a pension higher than this the Credit is tapered out over higher incomes. For each £1 of income above that level the amount of Savings Credit to which a pensioner is entitled is reduced by 40p.

Suppose George had a pension of £34.65 pw - £10 more than the gap between the BSP and the MIG. His entitlement to Savings Credit would then be £4 less than the maximum. So he would receive a Credit income of just £10.79.

Entitlement to Savings Credit disappears entirely for those with additional pensions in excess of £61.62 pw. But anyone with a pension up to that level finds that every £1 of pension income that they have saved for has only made them 60p better off than if they had saved nothing.

The disincentive is even worse for those with incomes between £127 and £140 per week in 2003/04. They face a loss of both Saving Credit and 10 per cent tax amounting to a combined withdrawal rate of 46p in the £[2].

As a result of Savings Credit some 3.8 million pensioners will face a penalty on their pension or other income of 40% (plus any tax) in 2003/4. Some 1.3 million of them will have incomes above the MIG level. The other 2.5 million will have pre-benefit incomes below the MIG.[3] The number facing this disincentive will rise steadily as the MIG is up rated faster than the basic pension. The government's own projections show that by the middle of this century two thirds of pensioners will be eligible for Pension Credit.[4]

The only way to remove in the longer term the disincentives and resentments inherent in this system is to set the new State Second Pension, together with the Basic State Pension, at a level at least sufficient to lift people above the Minimum Income Guarantee. The need for a system of Saving Credits would then disappear. The ABI calculate[5] that the basic element of S2P will need to be over a third higher than it is currently set if the combined value of the Basic and Second State Pensions is to exceed the Minimum Income Guarantee. That means that the Lower Earnings Threshold, which is currently set at £11,200 per annum, will need to be set at £15,000.

Even this only ensures that people with BSP and the flat rate of S2P at retirement will have an income in excess of the MIG. As MIG is up rated in line with earnings it could soon exceed their compulsory pension income plunging them back into the means tested zone.

Should pensioners' incomes rise in real terms?

The government is committed to raising the Guaranteed Minimum Income (MIG) in line with average earnings during this parliament. It has indicated its intention to do so indefinitely by projecting the MIG forward on that basis.

By contrast, the government is only obliged to raise the Basic State Pension in line with the Retail Price Index (though it has chosen to make discretionary increases in excess of that in recent years). The value of each person's State Second Pension will reflect the average level of earnings during their working life. So the value of the S2P for each successive year cohort of people reaching retirement age will tend to be higher than those retiring the previous year.[6]

But once individuals retire their S2P (like their BSP) will only be up rated in line with prices. So the Minimum Income Guarantee will steadily overtake the combined value of the two compulsory pensions for those already retired even if they exceeded the MIG at the date of retirement. This will reintroduce the disincentive and resentment effects. The only way to avoid means tested benefits overtaking contributory benefits is to up rate both by the same amount.

The populist arguments – that pensioners should not be left behind and that they have a right to share in rising prosperity - naturally favour up rating both means tested and contributory pensions in line with earnings. However, since the early 80s governments of both parties have shied away from any such commitment on the grounds that:

– it would be hugely expensive and would therefore impose a significant tax burden on the productive economy,

– each generation is entitled to the standard of living that they have earned, they do not have a 'right' to the wealth created by the next generation,

– if people wished to have incomes rising in real terms during their retirement they could tailor their pensions to achieve this but nobody does so[7], and

– even if it were possible to up rate state pay-as-you-go pensions to reflect rising earnings it would not be feasible to up rate the supposedly equivalent private pensions of those who have opted out of the S2P.

It is therefore better that both compulsory pensions and state retirement benefits should be statutorily indexed to prices and any increases in excess of that should be made on a discretionary basis if and when government finances permit. In practice the Basic State Pension should be increased by the same cash amount as the MIG. Thus if the MIG is raised by £5 more than inflation then the BSP would also be raised by £5 and not by the same percentage. That would avoid the MIG getting out of line with the BSP plus S2P without needing to raise the S2P in real terms. It would be undesirable to make discretionary increases in S2P since that would be unfair to those who had contracted out into private pensions.

Should the coverage of S2P be extended?

At present S2P does not cover those earning below the Lower Earnings Limit (LEL) and the self-employed.

The LEL is set roughly equal to the Basic State Pension (BSP). It would be strange to force people earning less than the BSP during their working life to save in order to have a higher income than the BSP in retirement.

The self-employed have been excluded for two reasons. First, they often see their business as their provision for retirement and want to use any spare money they have to invest in it. In practice very few people fund their business out of current savings. Moreover only a minority of the self-employed do end up with a saleable business capable of funding their retirement. Second, reported incomes of self-employed people are a notoriously inadequate guide to their real disposable incomes. If true that merely means that the level of contributions they would be required to make would be too low to provide a commensurate standard of living in retirement. But an inadequate Second Pension would be better than no provision at all. At present only a minority of self-employed people do make sufficient provision to avoid reliance on means tested benefits.

So the time has come to require self-employed people to make provision for a second pension on the same basis as employees.

Should the second pension be earnings related?

It is easy to justify the state requiring people to contribute towards a pension sufficient to float them clear of means tested benefits. But why should people be compelled to provide for additional pension income proportionate to their earnings? The original Beverage system did not relate pensions (or any other benefits) to the level of earnings.

This came in with the Graduated Pension, then the State Earnings Related Pension Scheme and persists in the State Second Pension. Presumably the rationale is: the higher the standard of living people are used to during their working lives, the harder they will find it to make do on the Basic State

Pension. Yet most people are short sighted. They do not realise that until it is too late. So they must be compelled to contribute towards a pension proportionate to their earnings during their working life.

On the other hand all sorts of people face sharp falls in their standard of living during the course of their lives. Yet the state simply ensures a basic minimum level of income regardless of their previous income. It does not require anyone to insure for an extra cushion related to their previous earnings. By definition the better off people are the more they can afford to save. Arguably,[8] in a free country it is up to the individual to choose how much pension they provide beyond the mandatory minimum.

The Labour government has talked of the State Second Pension becoming flat rate once it has settled in. On closer reading, however, they envisage that those with earnings greater than the Lower Earnings Threshold (currently £11,200 pa) will continue to be required to provide for an earnings related second pension (financed by rebates from their national insurance contributions).

My proposals assume that the Mandatory Funded Second Pension includes an earnings related element based on the State Second Pension. However, it is not an essential part of the scheme. The key component is the flat rate element of the State Second Pension. This must be set at a level which, together with the Basic State Pension, is at least sufficient to avoid reliance on means tested retirement benefits.

1 "The Future Regulation of UK Savings & Investment", September 2001, Oliver Wyman & Co/ABI.

2 Department of Work and Pensions reply to PQ from Peter Lilley MP 24th February 2003 Hansard.

3 Figures provided to the author by DWP.

4 "Pension Credit: long-term projections" DWP January 2001.

5 "Adequacy, affordability and incentives: a better future for state pensions" ABI March 2003.

6 This is quite distinct from the fact that during the introductory generation successive year cohorts will have accrued additional years of entitlement.

7 To buy an annuity equal to the Basic State Pension increasing in line with prices would cost a 65 year old man £70,000. If it was increased by 1.5% per annum more than prices it would cost about £80,000. Estimates provided to the author by GAD.

8 Nigel Lawson did argue this when SERPS was reviewed. See "The view from No 11" by Nigel Lawson.

2. FUNDING: SAVE NOW OR TAX LATER

The previous chapter discussed the minimum pension provision people should be required to make during their working lives. An equally important question is how much of that provision should be funded by saving and investment and how much should be left to be paid by future taxpayers?

The government has recently reaffirmed its commitment that by the middle of this century 60% of all pension liabilities should be funded– against 40% at present. They stand no hope of reaching that target without decisive action to shift people from reliance on the state pay-as-you-go pension system to private fully funded pensions.

When the state provides pensions it invariably funds them on a pay-as-you-go basis. This year's taxes are used to pay for this year's pensions. Nothing is saved or invested for the future. That is the method adopted by most of our continental partners to pay for the bulk of their pensions. So as their populations live longer they face the nightmare of higher taxes falling on a declining number of people of working age to pay for their pensions.

By contrast, in this country we have encouraged people to save and invest for pensions beyond the basic minimum. We have enabled employees to contract out of the Additional State Pension into occupational or personal pension schemes. A majority of eligible employees have done so. When employees contract out, they receive rebates from their National Insurance Contributions which are saved and invested in industry to earn the profits that will eventually pay their pensions - without any further burden on taxpayers. Meanwhile this generates an enormous flow of committed long-term investment. As a result the total amount invested to meet Britain's future pension liabilities is greater - not just than that invested by any other EU country - but than all the rest of the EU put together.

Nonetheless those funds still only represent 40% of Britain's future pension liabilities. The other 60% will fall on future taxpayers. To meet the government's target of reversing those proportions by the middle of the century will require a substantial shift in the number of people contracting out of the Additional State Pension system.

At present employees are given the choice of whether to remain in the unfunded Additional State Pension or to contract out into a funded private pension scheme. Those who remain in the state system accrue rights each year to an additional pension when they reach the State Pension Age. Those who contract out receive a rebate from their National Insurance Contributions payable directly into their personal or occupational pension fund. The size of the rebate is set on the basis of the Government Actuary's estimates of the amount needed to fund a private pension broadly sufficient to replace the pension entitlement that employees would have accrued in the State system.

The most straightforward way to shift the proportion of employees with funded second pensions would be simply to withdraw, at least for new entrants to the labour market, the option of an unfunded State Second Pension. All new workers would then be required to join a Funded Second Pension scheme of equivalent value to the present S2P, financed by rebates from their National Insurance Contributions.

Encouraging more people to opt for a funded second pension by increasing the value of rebates relative to accrued rights would have two serious disadvantages. First, it would increase the cost to the exchequer. Second, it would put the government in the dubious position of offering what would be an inferior alternative bearing its imprimatur. If anyone else did this they would be guilty of misselling.

Given that the government wants more people to have funded private pensions it is odd to offer an alternative – an unfunded State Second Pension – which it no longer wants them to join.

The reason both this government and its predecessor have nonetheless continued to offer employees the option of an unfunded Additional State Pension is that contracting out into a personal pension has never been attractive for those on low and fluctuating earnings. This is because the lower an employee's earnings the smaller the rebate they receive. But the costs of running a fund do not decline proportionately since there are fixed costs in setting up and running a fund. So charges tend to absorb a disproportionate share of the small rebates received by those on low earnings. To avoid this unfairness to those on low earnings employees have been given the option of remaining within the unfunded Additional State Pension scheme.

The government sought to overcome the problem of costs absorbing too great a proportion of the rebates of low earners by introducing Stakeholder Pensions. Stakeholder charges are limited to a maximum of 1% p.a. of funds invested. So charges on small funds can no longer be increased beyond that

1% cap to reflect the higher proportionate costs of handling them. Unfortunately that means that there is little or no incentive for Stakeholder providers to encourage low earners, who would only have small rebates to invest, to contract out of the unfunded State scheme. Consequently the introduction of Stakeholder pensions has done little to encourage more people to contract out of SERPS/S2P. Instead there is a worrying trend for individuals to opt back into the State Second Pension. Moreover, companies are contracting their employees back in wholesale when they switch from direct benefit to money purchase schemes. This reflects the widespread perception that the value of the rebate is no longer adequate to fund a pension as attractive as the unfunded State Second Pension.

The problem of low earners' rebates being below the threshold necessary to justify the fixed costs of setting up a personal pension scheme was inherent in SERPS. As its name indicates the amount of pension accrued was directly proportionate to earnings and so therefore was the rebate for contracting out. The Conservative government consulted on withdrawing the option of remaining in the unfunded SERPS. But it concluded that there was no way round the problem of earnings related rebates and fixed costs. So it decided to retain the unfunded SERPS option for the benefit of those on low and fluctuating earnings. Most of those who have not opted out are indeed on low or fluctuating earnings.

As Secretary of State I reconsidered this issue. I concluded that SERPS could not be replaced by a Mandatory Funded Pension in a way that was fair to those on low earnings unless the unfunded Basic State Pension was also being replaced by a funded equivalent at the same time. Hence the radical plan called Basic Pension Plus – (see Annex B). This was based on the recognition that everyone paying National Insurance Contributions is accruing the same flat rate amount of Basic State Pension regardless of their earnings (unlike SERPS). To enable people to build up a funded pension equal to their Basic State Pension everyone would be entitled to the same flat rate rebate. This would need to be quite substantial – roughly £12 p.w. at today's levels – well above the threshold needed to justify the fixed element of the costs of setting up and running a personal pension fund. The same fund could also receive and invest, with no need for additional charges, employee's earnings related rebates - however small - to provide a funded equivalent of SERPS. So Basic Pension Plus involved giving everyone, as they reached working age, their own fund into which would be paid rebates from their National Insurance contributions sufficient to provide a pension at least equal to their Basic State Pension plus their State Earnings Related Pension.

This proposal was traduced during the election campaign which made it difficult for the incoming government to develop the idea despite adopting some of its rhetoric. However, when the Labour government replaced SERPS with the State Second Pension it changed the structure in a way that means the problem of low earners receiving rebates inadequate to justify setting up a personal pension is no longer inherent to the system. (See Annex A for a fuller explanation of the structure of S2P.) It is true that at present the rebates for employees contracting out of the new State Second Pension are proportional to earnings just as in SERPS. But this feature seems to have been carried over from SERPS even though the amount of pension accrued under S2P is no longer proportional to earnings for those on low pay. Under the S2P the amount of pension rights accrued does not decline if earnings fall below a certain threshold (the Lower Earnings Threshold which is set at roughly half national average earnings). Employees earning say £5,000 or £7,000 will accrue the same amount of S2P as someone earning £11,200 which is the current Lower Earnings Threshold. Yet if those with earnings below the LET contract out of S2P into a personal pension they still receive a rebate proportionate to their earnings. (They continue to accrue an element of S2P based on the difference between their actual earnings and the Lower Earnings Threshold.) The earnings related rebates mean that it remains unattractive for those on low earnings to contract out of S2P.

The Mandatory Funded Second Pension

The government could equally well have allowed employees earning below the LET to contract out of all the pension rights they accrue under S2P and receive a corresponding rebate. Since they accrue a flat rate amount of pension entitlement within S2P they should be entitled to a flat rate rebate in respect of earnings up to the LET. Such a rebate would be above the threshold level necessary to make it worthwhile to set up and handle a personal pension. The problem of minimal rebates being absorbed by the disproportionate costs of running small funds would therefore disappear. So it would no longer be necessary to provide the option of the unfunded S2P for those on low earnings. That option could then be withdrawn at least from new entrants to the labour market.

All new entrants would instead be required to join a Mandatory Funded Pension scheme. Those earning less than the LET would receive a flat rate rebate. Those earning more than the LET would receive the same rebate as employees who contract out get at present - comprising that flat rate element plus an element related to their earnings above the LET.

The MFSP compared with the government's plan.

The government does not appear to have considered this option. It has, however, considered ways of restricting employee's rights to choose between the unfunded state system and a funded alternative in Phase Two of S2P. This will come in once S2P has bedded down. The government did originally consider removing the right to remain in the unfunded S2P from all those earning above the LET and requiring them to join a funded private scheme.[9] Conversely, no-one earning below the LET would be allowed to contract out into a funded personal pension. They would stay within the unfunded state scheme accruing their flat rate entitlement to S2P.[10]

Those proposals seem to have survived a last minute rewrite of the White Paper. The rest of the White Paper left an element of choice at least for those earning above the Lower Earnings Threshold. They will be able to stay in the unfunded state system. But if they do so they will only accrue the flat rate component of S2P. By contrast those who opt for a funded private pension scheme will receive rebates equivalent both to the flat rate and earnings related elements of the S2P as at present. They will no longer be able to contract back into the state pay-as-you-go scheme.

Under these proposals there would clearly be a strong financial inducement for those earning significantly more than the LET to opt for a private pension. But they would not be required to do so. By allowing employees to stay in the unfunded state scheme on such disadvantageous terms the government will be guilty of blatant 'misselling'. This two tier system will also create a very odd situation for those whose earnings fluctuate above and below the LET. Moreover, it is rather offensive to treat those on low earnings as second class citizens. They will not have their own fund into which they could put any additional savings.

Yet someone earning say half the LET accrues exactly the same entitlement to S2P as someone earning the LET. The employee earning exactly the LET will either be permitted or required to have a pension fund and will receive a rebate sufficient to provide a pension equivalent to the flat rate element of S2P. The employee earning only half the LET will have to remain in the state unfunded system. Low earners are apparently deemed unsuitable to hold a pension fund or unlikely to use it to make additional savings.

I propose that everyone entering the labour market after a certain date should be treated equally. Over time the whole of the State Second Pension – both flat rate and the earnings related elements - should be replaced by an equivalent Mandatory Funded Second Pension. Everyone earning enough to entitle them to any S2P should receive a rebate equivalent to that entitlement payable into their personal or occupational pension fund.

Benefits of a Fully Funded Second Pension

The benefits of such a scheme would be six-fold.

i **Meeting the government's target**

It would enable the government to meet its target of reducing the unfunded element of the nation's pension liabilities to 40%.

How rapidly it did so would depend on the speed with which it was phased in.

To do so for all employees not currently contracted out would cost over twice as much as the rebates of those currently contracted out. See Tables 1 and 2. These figures reflect the current levels at which S2P accrues. If this flat rate element was raised as suggested by the ABI to lift everyone above the level of the Minimum Income Guarantee indexed to earnings, the rebates for the flat rate element would increase correspondingly. This would be partly offset by a reduction in the earnings related element unless the upper earnings limit was also raised.

It might be more feasible to introduce the scheme by age cohorts. The most gradual way would be (as proposed for Basic Pension Plus) to require all young people when they get their first job to have a personal fund into which their rebates would be automatically paid. That would involve additional rebates mounting initially at a rate of less than £200 million[11] p.a. cumulatively.

In practice it should be possible to include within the scheme from the start everyone below the age of, say, 30. The initial value of rebates to fund pensions at the existing level of S2P would then be £2.2 billion more than at present, mounting by an additional £350[13] million p.a. That compares with the current cost of rebates of £11.5 billion for everyone who voluntarily contracts out at present

Table 1:
Value of NI Rebates for those Voluntarily Contracted Out of S2P in 2002/03 (GB accruals - £billion)

	Age < 30	Age > 30	All Ages
People earning below LET[12]	0.1	0.5	0.6
People earning above LET	1.3	9.6	10.9
All earners	1.4	10.1	11.5

Source: DWP/GAD replies to author

Table 2:
Value of NI Rebates for All Earners whether or not currently contracted out (2002/03, GB accruals, uncapped APP rebates – £billion)

	Age < 30	Age > 30	All Ages
Those earning below LET			
– value of rebates for flat rate S2P	1.0	3.6	4.6
Those earning above LET			
– value of rebates for flat rate S2P	2.2	13.5	15.7
– value of rebates for earnings related accruals	0.7	6.4	7.1
	3.9	23.5	27.4

Source: DWP/GAD replies to author

ii Encouraging voluntary saving

As everyone within the scheme would have their own fund they would be able to make additional contributions into it as they wish. Nearly half of those who contract out of SERPS do save extra on top of the National Insurance rebate. The Australian experience suggests that since people have been required to have a fund it has become much easier to persuade them to make additional voluntary contributions. The proportion of those making voluntary contributions on top of the compulsory minimum has doubled to 40% compared to 20% previously. On average voluntary pension savings now amount to an additional 3 to 4% of income on top of the 9% compulsory minimum.

Automatic ownership of a personal pension fund would make it much easier for employees to make additional voluntary savings. But experience suggests that the proportion who do so is strongly influenced by advice and encouragement from their employer. Matching contributions from the employer are a powerful incentive to save more than the minimum. Research conducted by Watson Wyatt for Winterthur[14] shows that a programme of education in the workplace can have a powerful multiplier effect. Employers who offered to contribute an additional 25% of whatever voluntary contributions employees make to a 401k plan and backed this with a targeted communications programme achieved almost as high a take up as did companies who offered a 100% match but carried out no communications programme. In the USA full tax benefits on 401k plans are only available to company owners or top management if the plans are available on the same terms to all employees and a high level of take up among all employees is achieved. So managers have an incentive to carry out such communications programmes. It would be desirable to make similar provision in UK tax law. At present UK managers are reluctant to offer any advice to employees even to remain in the company pension fund for fear of falling foul of the Financial Services Act. This should be revised to give employers the clearest possible exemption from such liability.

iii Reducing costs

If people automatically have their own fund the costs of running these funds will be significantly reduced. The costs of persuasion are largely eliminated and a standardised, mass marketed product has lower running costs. Moreover, the running costs as a percentage of funds under management decline as the amount invested rises over time. The Association of Superannuation Funds of Australia estimates that the average administration costs would fall from 1.5 % when the average balance is US$10,000 to 0.5% when the average balance rises to US$30,000.[15]

A reduction in the annual cost of running a scheme from 1% of capital invested, which is the norm for stakeholder pensions, to 0.5% could increase the final pension by some 13%. The Vanguard Group in the US charge just 0.3% on their tracker mutual funds.

iv Spreading wealth

Every working person would eventually own his or her personal pension fund. This would constitute the largest distribution of wealth since the spread of home ownership. Working people who earn less than the Lower Earnings Limit (currently £11,200 pa) throughout their working lives would end up owning a substantial pension pot. If they put nothing apart from their automatic minimum rebate into their personal funds they would accumulate a fund worth some £65,000 in today's prices by the time they reached age 65.[16] Someone earning a salary just equal to the Lower Earnings Limit who put in additional voluntary contributions of 3% of salary – the average amount contributed voluntarily by their Australian counterparts – would accumulate a fund worth over £115,000. That would finance a second pension indexed for inflation equal to nearly two and a half times the Basic State Pension.

v Freedom of Choice

Once people have their own fund they have far more freedom to decide when they should retire. Yet they will also have the incentive to continue working (possibly on a part-time basis) since this will both enable them to continue building up their fund and increase the value of the annuity they can buy for the remaining years of their life. Studies show that those saving for pensions on a defined contribution basis work longer than those in defined benefit schemes or solely dependent on state unfunded pensions.[17]

vi Changing attitudes

Finally, widespread capital ownership would give people a greater sense of having a stake in the economy. Everyone would be more conscious of having a vested interest in policies that encourage profitability and growth. The sense of 'them and us', of capital versus labour, and the populist idea that we can profit by transferring burdens to some abstraction called "business", would all diminish.

Arguments against funding all State Second Pensions

Of course there also are arguments deployed against funding pensions.

"Funding is pointless" The IPPR[18], in particular, argues that there is no point in encouraging people to save and invest for their future. They say that people cannot squirrel away a proportion of today's goods and services like nuts. All they do is pile up paper claims on future flows of goods and services. In reality tomorrow's pensions will have to be paid out of the GDP then being generated by those then at work. So, they conclude, it makes no difference whether tomorrow's pensioners extract their share of tomorrow's GDP by exercising paper claims held in the books of pension funds or by the state imposing taxes reflecting rights accruing in a pay-as-you-go state scheme.

The key element of this argument – that tomorrow's pensions will be paid out of tomorrow's economic output – is of course true. But if the rest of the argument were valid it would follow that the level of saving in an economy is irrelevant to the future level of income of its inhabitants. There would be no point in saving at all. In addition to arguing openly against the need to encourage more saving it is proposed to divert the £11 billion of NI rebates currently saved in pension schemes and spend them on raising current pensions.

The fallacy of this argument lies in the supposition that because saving is done via financial instruments it has no effect on future resources available to pay pensions. Of course it does. The total level of saving in an economy must, by definition, equal domestic investment plus the acquisition of assets overseas. Prices and interest rates adjust to bring that about. So extra saving must result in more domestic investment or more overseas assets or both. Of course, this assumes that extra private saving is not offset, or financed by, an increase in public sector borrowing.

Even if the level of domestic investment were entirely unresponsive to more saving, extra savings would be invested abroad. That would mean that tomorrow's pensions could be financed by claims on foreign economies rather than taxing our own.

Finally, levying heavy taxes on the future British economy to pay for unfunded pensions may depress activity and drive it abroad whereas drawing dividends on investments across the world will not have such an effect.

"Funded investments are too risky". Some argue that recent stock market falls show that we should not encourage people to invest in the capital markets for their retirement. Saving for retirement is a long-term process. Even after the recent bear market pension funds show a good return over the long term. In any case, it is always a mistake to base policy on short-term movements in markets – still less on extrapolating recent trends. In fact the best time to start broadening reliance on investment in pension funds is after a stock market fall rather than at the top of a bull market. The Australians believe their compulsory saving scheme got off to a good start precisely because it started after the sharp 1987 stock market fall.

Nonetheless, the greater uncertainty pertaining to funded pensions may affect people at different income levels differently. Low earners might be expected to be more risk averse than the better off. That is why I believe the state should guarantee the flat rate element of S2P. If for any reason the portion of a person's fund built up from their flat rate rebates does not reach the level necessary to finance a pension equal to the S2P, the state will top up that person's second pension to the level of S2P they would have accrued. (The extra earnings related rebate which people get if they earn above the Lower Earnings Threshold would not carry a guarantee. So fund managers would notionally divide each person's fund into a flat rate and earnings related element.)

Two objections to such a guarantee have been put forward. The first is that the state could not afford the cost if markets did very badly. In practice, the guarantee would only be called in respect of part of the pension for some pensioners in a specific age cohort. By definition the cost to the taxpayer of supplementing part of the pension of a section of pensioners cannot be greater than the cost of paying the entire pension on a pay-as-you-go basis.

The second objection is more material. It is that, on its own, a guarantee of that kind could lead to investment in excessively risky securities. Fund managers would know that if the investments failed, their clients' pensions would be topped up by the state. Yet if the high risks produced high rewards they would get more than the standard pension.

I propose that fund managers would be required to invest on a Prudent Person basis, as if that guarantee did not exist. Such rules already exist. They can be enshrined in statute as in Australia which has largely prevented such imprudent investments. The guarantee would only apply to the part of each person's fund built up from their flat rate rebates. Fund managers would also be investing the earnings related rebates which would not be guaranteed. Managers could be required to adopt the same risk profile for both parts of the fund.

Means tested benefits already in theory provide a similar sort of guarantee and incentive to invest in high risk investments for people approaching retirement with a pension fund insufficient to lift them clear of the means testing trap. Yet there is no evidence that financial advisers or fund managers do put such clients' investments in high risk assets in practice. So this problem may be more theoretical than real.

"Pay-as-you-go reflects the contract between the generations". Continental politicians invoke this argument to justify their reliance on future taxpayers to pay for the pensions they have promised. They say, in effect, that parents bear the cost of raising their children and in return have always looked to their children to support them in old age. In mature societies each generation likewise looks to the next to support it in retirement. That argument no longer works. If such a contract ever existed this generation has broken it. They are having far fewer children and are living far longer than their parents. They have little moral claim on a diminished future work force to support them in retirement for far longer than they supported their parents' generation.

"One generation will pay twice". Some argue that, although it is desirable that everyone should save for their retirement, we cannot reach that goal without making the transitional generation pay twice. The current generation will have to pay for their parents' pay-as-you-go state pensions while also building up savings for their own funded pension. That was an issue I had to deal with in my proposal to move to a fully funded basic state pension (see Annex B). But it does not apply in the case of the State Second Pension. If anything, the reverse is the case. The S2P is a new benefit and is partly funded through voluntary contracting out (as was SERPS, which was still building up). If previous generations wanted to have a pension in addition to their Basic State Pension they had to save for it. They did not pass the obligation on to the next generation. That is what we are doing to the extent that we give people rights to an Additional State Pension without requiring them to make genuine savings and investments to pay for it.

"Means testing makes it pointless for the poor to save". The Institute for Fiscal Studies has highlighted this problem. But their point is that the current level of means tested benefits for retired people makes it uneconomic to save **voluntarily** for a small pension on top of the compulsory state pensions. I propose a change in the balance between **compulsory** minimum provision and means tested benefits that will eliminate that problem. Under the present arrangements people are already compelled to set aside a certain amount for a second pension. As far as this compulsory provision is concerned the disincentives are irrelevant. Nor do the disincentives affect whether the compulsory provision for a second pension should be via a state pay-as-you-go scheme or a private funded one.

[9] "the proposed system...compulsory funded pensions for those earning over [the LET]" page 105: A new contract for welfare: Partnership in Pensions Cmd 4179 December 1998.

[10] ibid "..we expect the new State Second Pension to become a flat rate scheme for those on lower earnings, with those on moderate and higher earnings joining a funded pension (with contracted out rebates continuing to be earnings related)."

[11] Estimated from figures provided by DWP/GAD for total costs of rebates for year cohorts of different ages whether or not currently contracted out.

[12] For people earning below the LET and for people contracted out through occupational schemes who earn below the HET (£24,000pa in 2002/03), the rebate does not reflect the full value of S2P. S2P top ups are paid in retirement in order to compensate for this. Expenditure on such top ups is excluded from the figures shown.

[13] See footnote 12.

[14] Response by Winterthur Life UK Ltd to DWP Green Paper "Simplicity, Security and Choice".

[15] Schieber SJ & Shoven JB: "Administering a Cost Effective National Program of Personal Security Accounts" NBER, Cambridge MA, December 4, 1998.

[16] Assumes earnings and thresholds rise 1.5% p.a. faster than prices.

[17] Prof Blake, The Pensions Institute.

[18] A New Contract for Retirement, R.Brooks, S. Regan & P. Robinson, IPPR.

3. PENSION AGE: HOW LONG TO WORK?

If the government chooses not to replace the pay-as-you-go State Second Pension by a Mandatory Funded Second Pension, the only way they can hope to meet their 60% funding target is by raising the State Pension Age.

They have already begun to debate this issue by pointing out the truism that the only solution to the pensions crisis is "either to save more, to work longer or a mix of both"[19] The government is also trying 'to lodge the idea in the public consciousness that retirement at 70 will mean a higher pension', as Alan Pickering has pointed out.

If the government goes down this route, the sensible approach would be to index the State Pension Age to life expectancy. On average, life expectancy of those aged 65 has increased by about 1 month a year over the last twenty years. If the government raises the State Pension Age at that rate in future, someone now aged 21 would have to work until they were aged 68 years and 8 months before drawing their state pension.

Ideally, however, the government should not be telling people how long they must work – still less that they must work ever longer. The great advantage of enabling everyone to build up their own pension fund is not just that it helps meet the government's funding target without raising the SPA. It also leaves people free to decide when to retire once their fund is adequate to provide a decent pension (i.e. greater than the Minimum Income Guarantee).[20] Moreover, it gives everyone a double incentive to work and save longer. Every extra year they work gives them a year longer to save and a year less retirement to finance, enabling them to buy a larger pension for a given sum.

Those advantages of working longer are substantial. Take a fairly typical man whose pay rises at 3% p.a. in real terms until he is 50 and then remains flat. If he wants to retire at 65 on an indexed second pension worth half his final salary he would need to save 12.1% of his salary each year throughout his working life. However, if he intends to keep working until age 70, he will need to save only 7.5% of his salary. Put another way, the cost of an indexed single life annuity worth £10,000 p.a. at age 65 is £195,000. Buying the same annuity at age 70 would cost £156,000.[21]

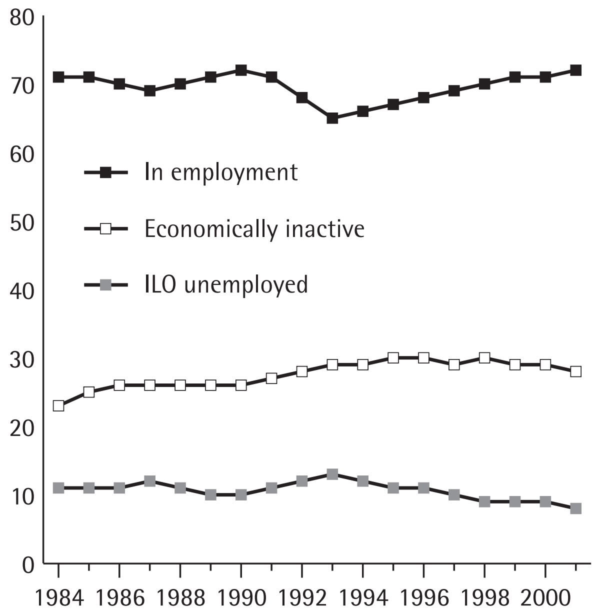
One way the government could reinforce that incentive to delay retirement, without altering the State Pension Age, would be to use the tax system. The major tax advantage of saving for a pension is what Nigel Lawson called "the anomalous but much loved lump sum". At present up to 25% of a personal pension fund (excluding that portion derived from NIC rebates) can be withdrawn tax free as a lump sum. The lump sum can be spent as the saver wishes. It does not have to be used to buy a retirement income. The age at which that valuable privilege may be exercised could be raised in line with average longevity. People would still be free to withdraw their funds, including the tax free element, before that age as long as they used all the money to provide an annuity or draw down income sufficient to avoid becoming dependent on means tested retirement benefits.

A number of criticisms could be made of simply leaving people free to decide whether to cease working once their fund is adequate to escape means tested benefits:-

i Most people will opt to retire and take their pension at the earliest permissible date even if their pension is meagre. Only 8% of men work beyond their State Pension Age of 65 though nearly a third of women retire after 60.[22] It is certainly true that very few people avail themselves of the current option of deferring the state pension even though they can thereby increase their future state pension. The increase is one seventh of 1% for every week deferred, which is about 7.4% for each year of deferral, up to a maximum of 5 years. The lack of interest is partly because this option is little known. Also the enhancement is not particularly generous. The current terms are roughly neutral on an actuarial basis. They will therefore be less than neutral for those with below average life expectancy. That is why I decided to improve the terms to one fifth of 1% per week (10.4% for each year's deferral) and to remove the limit on the number of years of deferral. The government's decision to bring that forward is welcome.

   The experience of the self-employed suggests that when people own their personal pension fund the double incentive to work longer is effective. Most self-employed people own a money purchase pension fund. In recent years their average age of retirement has increased relative to that of members of Defined Benefit Schemes, including those relying on SERPS.[23]

Fig 1. Employment, unemployment and inactivity rates for men aged 50-64; UK; spring 1984 to spring 2001



ii People in manual/stressful/low paid jobs do not want to, and often cannot, work past the State Pension Age. To those engaged in stimulating jobs the idea of working beyond 65 might be positively appealing even if it had no impact on their eventual pension. But is it reasonable to expect the man operating a pneumatic drill to go on working into his late sixties? Nearly half of all men have ceased to work by age 62.[24] Early withdrawal from the labour market is particularly prevalent among the less skilled. 41% of men aged 50 to 64 with no qualifications were inactive compared with 22% of those with GCSE-level or higher. Three quarters of men aged between 50 and 64 who are economically inactive say they do not want a job. 62% of plant and machine operatives gave their reason for inactivity as being long-term sick. By contrast less than a quarter of managers and professionals were long-term sick and over 55% said they had retired – often with an early occupational pension.[25]

Even if the manual groups had possessed a personal pension fund, the prospect of adding to it would have been unlikely to persuade many of them to work longer to build up a better pension. However, the reluctance of lower earners to work up to, let alone beyond, the State Pension Age is already a problem under the present system. The changes I have proposed so far would not solve that problem but nor would they make it worse. The solution is to improve the working of the labour market so that people in their 50s can find jobs which are neither physically stressful nor demanding of lengthy experience.

There are signs that this is happening both in the USA and the UK.

In the USA, the decline in participation rates among men aged between 60 and 64 halted in the early 1990s and has begun to reverse since then particularly among 'high school drop outs' – the group with the lowest participation rate[26].

Likewise in the UK the employment rate among men aged 50 to 64 has risen by 5 percentage points since its nadir in 1993.[27]

Given appropriate job opportunities, the possession of a personal pension fund may well encourage people to defer retirement or to take on part-time jobs to supplement an early retirement pension.

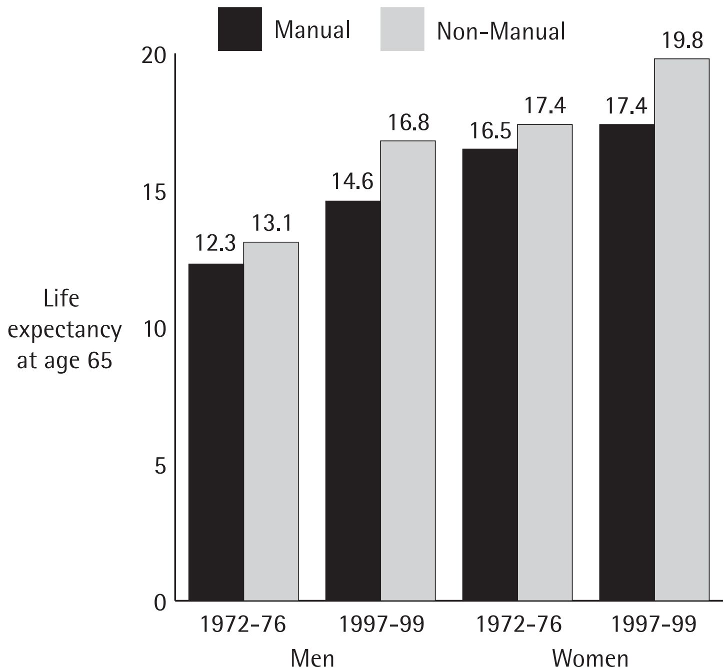
iii Lower income/manual workers have lower than average life expectancy so they subsidise the pensions of longer-lived, higher income groups. This is true of the pay-as-you-go state scheme as well as private funded pensions. At age 65 the life expectancy of an unskilled male manual worker is over four years less than that of a male professional.[28] If both types of employee pay premia into the same fund over their working lives, the typical professional will draw out four years more pension than the manual worker.

That is not merely inequitable, it is positively perverse. The less well off are subsidising the rich.

The situation is accentuated at present by the fact that the annuities market is dominated by the better off who happen to be longer-lived.

Annuity rates reflect this since they are calculated on the basis of the mortality of actual annuitants rather than the average population. As a result an average member of the population would have to pay 7 or 8% more for an annuity than their average life expectancy warrants.

Fig 2. Life expectancy for manual and non-manual groups



Making personal pensions universal and mandatory would automatically help remedy this. It would do so by bringing the characteristics of those buying annuities into line with the total population. However, the fundamental problem of the less well off subsidising the longer-lived better off would persist.

Funded pensions would also make it possible to do something about that. In the first place annuity providers could be encouraged to relate annuity rates to the life expectancy of different income or social groups.[29] At present "insurers in the UK rarely use socio-economic factors in pricing" annuities.[30]

Those who have lowest life expectancy – generally those on lowest incomes – should get the best annuity rate when converting their fund. Annuity providers do offer advantageous annuity rates to smokers and higher 'impaired life' annuities to individuals with specific life threatening conditions. Some providers also vary their rates according to the size of fund converted into an annuity – because wealthy people with larger funds tend to live longer. Anecdotal evidence suggests that the cost per £10,000 in the fund of buying a large annuity (say £50,000 p.a.) can be up to 19% more than for a small annuity (£2,000 p.a.).

Some 10% of the total annuity market (20% of the open market business) is already written on special bases like these. This element is rising rapidly.

However, annuity providers do not yet offer differential annuity rates related to past earnings or socio-economic group. It is not clear why they do not. It may partly be that the providers do not have information on individuals' life-time earnings. To obtain and verify it would involve disproportionate cost. The government might be able to overcome this by making available information on historic earnings from the National Insurance Recording System. This could possibly be in a form equivalent to a tax code.

Another option would be to encourage the development of pension funds limited to members of particular occupations. Some funds limited to people employed in a specific industry already exist – notably the Buildings and Civil Engineering Benefit Schemes (B&CE), and also the Heating and Ventilation Engineers. The B&CE is the largest supplier of stakeholder pensions. It guarantees zero charges on these policies up to 2006. The Australian system is largely based on industry-wide funds. These pool the contributions of all employment levels within each industry. Pooling of investment funds on an occupational basis will only be advantageous for members if the average life expectancy is below that of other insured lives and if the scheme provides annuities which reflect that. B&CE for example can offer its members annuities some 18% higher for a given sum than is the norm in the open market.

Schemes limited to manual workers could result in them receiving an annuity perhaps 30% higher per £1,000 of savings than a manager. It is not at all clear why such annuities are not on offer. This may be because the providers have felt that such provision would be politically unacceptable. If so they need to be persuaded otherwise.

A third option is for the State to relate employees' rebates to the life expectancy of their income group. That would mean paying larger rebates to those on low incomes. Under the State Second Pension accrual rates are biased in favour of those with earnings below the lower earnings threshold (currently £11,200). However, this is not fully reflected in the rebates available for the few who contract out of the state scheme in that income bracket.

[19] Hansard col 403 13 Jan 2003 Andrew Smith Secretary of State for Work and Pensions.

[20] Anyone wishing to use their fund to retire before the SPA would be required to buy a fixed term annuity for the period up to the SPA equal to at least the MIG followed by an annuity equal to the difference between the MIG and the BSP. Legal & General have advocated permitting purchase of such fixed term annuities: L & G's response to "Modernising Annuities" 9th April 2002.

[21] The calculation assumes net real return on savings of 4% per annum; earnings rise by 3% in real terms between age 21 and 50 then remain stable in real terms until retirement at 65, or 70 if the individual continues working. Typical annuity rates are taken from the FSA comparative tables for a male non-smoker single life: £100,000 buys £5,124 p.a. at 65 and £6,429 at 70.

[22] "The Dynamics of Retirement: Analyses of the Retirement Surveys" by Richard Disney, Emily Grundy and Paul Johnson. DWP Research Report No. 72.

[23] Also see "The Impact of Wealth on Consumption and Retirement Behaviour in the UK", David Blake, The Pensions Institute.

[24] Hansard 13th May 203 DWP written answer to Peter Lilley MP.

[25] "Patterns of Economic Inactivity Among Older Men" Catherine Barham, ONS Labour Market Trends June 2002.

[26] 'The Puzzle of Later Male Retirement' Richard Johnson Economic Review, Q3 2002, Federal Reserve Bank of Kansas City.

[27] "Patterns of Economic Activity among Older Men" Catherine Barham, Office of National Statistics in Labour Market Trends June 2002.

[28] The gap between Social Classes I and V widened from 2.6 years to 4.1 years between 1972-6 and 1997-9. "Trends in Life Expectancy by Social Class" ONS 18th February 2002.

[29] Annuities purchased with the compulsory element of pension savings must be priced on a unisex basis. I do not propose any alteration in this.

[30] ibid page 5.

4. HOW TO CUT PENSION COSTS?

The recent gloom about the cost of providing pensions has focussed on the fall in the stock market and the increase in longevity. There is little the government can do about the former or would want to do about the latter. Remarkably little thought has been given to reducing the non investment costs of providing pensions. Yet this is the one area where improvements could be made which could ameliorate the position.

Pensions involve two stages: the accumulation of a pension fund and the subsequent payment of an annuity or pension. The first stage has by far the highest costs. But there are also opportunities to improve value in annuity provision to which very little attention has been paid.

Costs of accumulating pension funds

The costs of accumulating pensions can be surprisingly high – especially on personal pensions. A study in 1999[31] put the total cost at some 36% of the accumulated balance over a working lifetime. A significant proportion of this cost came from the cost of transferring accounts, opening duplicate accounts and ceasing to contribute to paid up accounts. Even the 1% per annum cap on costs which providers of stakeholder pensions are permitted to charge can still reduce the accumulated balance over a working life by between 20% and 25%. Put another way, a charge of 1% per annum on funds in a personal pension would absorb nearly a quarter of the real return of 4% per annum projected by the Government Actuary.

The factors which have tended to swell the costs of personal pensions are the costs of persuasion, advice, compliance, risk of lapse and/or switching to another provider all on top of the actual cost of managing the fund and administering each account. An analysis[32] of Life Office expenses showed that two thirds of their costs are accounted for by the cost of acquiring customers – especially paying commissions. Even mutual funds with commission free sales spend half their expenses on acquiring customers. One reason occupational funds have lower costs[33] is that they do not need to attract members. Australian figures suggest that the costs of running occupational schemes are typically half those of personal pensions. Preliminary results from a study[34] of British occupational schemes suggested that their costs, though lower than those of personal pensions, are not far below the 1% annual limit set for stockholder pensions.

The government has recently indicated that, rather than reducing the 1% cap on stakeholder fees, it is prepared to consult about raising it. Is there any scope for reducing those costs? The last Conservative government initiated a number of steps to bring about greater transparency, simplicity and competition to bear down on costs. These have been carried forward with the Pickering Report, the Sandler Report and the Inland Revenue report on Tax Simplification. These make many welcome recommendations but at best they will bring about marginal reductions in costs and fees.

The simple truth is that there is only one way to cut costs 'at a stroke'. That is to make it compulsory for everyone to have their own pension fund throughout their working lives. Compulsion reduces the need for persuasion – the most costly element in the process; dramatically reduces the need for advice; means that the product can be standardised and increases the volume of investment over which costs can be spread.

The Australian experience[35] is revealing in this respect. Even though there is no cap on costs they are coming down steadily as a proportion of funds under management. And they are expected to fall significantly further as the average balance rises. The Australian experience is one to learn from - not to copy slavishly. They have paid remarkably little attention until recently to the level or structure of costs and charges. Their costs could well have come down further and faster if they had done so earlier – for example by automatically merging the multiple accounts which arise when people move jobs or by imposing a cap on charges.

Over time it might be possible to reduce the charges on the compulsory element of saving in UK Stakeholder type funds from 1% to as low as 0.5% per annum. That sounds a small saving. In fact it could boost the value of the pension accumulated over a working life by 13%.

Costs were coming down substantially in the UK even before the cap on stakeholder costs was introduced. Table 3 shows that they fell by nearly half between 1989 and 1997. It also indicates that very significant scope remains for further reductions given that the quarter of companies with lowest costs have an expense ratio less than half that of the quartile with the highest costs.

At the same time, the cap could be retained at a higher level (or conceivably removed entirely) on any extra savings above the mandatory level that people were encouraged to put into their personal funds. This would restore the 'reward for persuasion' which has largely disappeared at the present level of stakeholder provision.

Table 3

Life office expenses

	1997	**1994**	**1989**
Average expenses ratio* (basis points)	130	192	236
Expense ratio – first quartile* (basis points)	62	123	174
Expense ratio – third quartile* (basis points)	156	171	270
Average share of business acquisition in total costs* (percent)	65	69	73
Average share of commissions in total costs* (percent)	31	32	33
Sample size	146	157	173

*weighted average ratio of expenses to funds invested.

Source: Murthi, Orszag & Orszag March 1999 based on Synthesis Life analysis of statutory returns to DTI.

Reducing the Cost of Annuities

There has been great resentment among those reaching retirement in recent years about the decline in annuity rates. In 1993 £10,000 would buy a 65 year old male a lifetime income of £1245 p.a. In 2003 it buys just £741 p.a.[36]

This is partly due to falling interest rates reflecting declining inflation. So it means retired people who choose a cash annuity, as most do, will not see the purchasing power of their incomes eroded so rapidly.

The other reason is the sharp increase in assumptions of life expectancy. Insurance companies are very good at pooling risks across a population with stable characteristics. They are less good at predicting trends in the characteristics of the whole population – still less at coping with possible but unpredictable events like a magic bullet cure for cancer.

All they can do is make provision against trends and events which are possible though unlikely. Those provisions have to be factored into the cost of annuities. So it is more likely than not that annuitants will have paid for greater longevity than they will collectively enjoy.

The uncertainty about future mortality rates is greatest in relation to the more distant future and the later stages of life.

In pricing an annuity for those currently retiring, the providers can assume that the proportion of those aged 65 who will die in the next five years will reflect recent mortality rates and trends among 65 to 70 year olds. Any significant medical advances affecting the period are likely to be in the pipeline and therefore identifiable. But it becomes progressively harder to be certain about future mortality rates for older ages. The ages showing greatest improvements in mortality seem to be steadily rising.

The Insurance Regulations 1994 require that the price of annuity liabilities "be determined on the basis of prudent rates of mortality". So annuity providers should err on the side of caution – which increases the cost of annuities. Some argue that they may nonetheless be significantly underestimating the risk of mortality rates improving.[37] If so they risk being unable to pay the annuities they have promised, should the proportion of people living to a great age increases beyond what they have provided for. Either way annuitants will lose out.

There is therefore a plausible case for government bearing the 'risk' of financing pensions for the later years of retirement.

The situation is analogous to that of financing residential care. When the last Conservative government was considering how to encourage greater private provision we discovered that the average period spent in residential and nursing care was fairly short. But that average included a minority of elderly people who spent many years in residential care. The insurers faced an unquantifiable risk that this minority and their duration of stay would increase. We found that if government accepted the responsibility for funding residential and nursing care for those who stayed well beyond the average term, insurers could reduce their premia disproportionately and more providers would enter the market.

By analogy, the government could assume responsibility for paying S2P for the most elderly – say, those living beyond 85.[38] People would then only need to accumulate a fund to buy a 20 year fixed term annuity at their S2P level to cover their retirement between 65 and 85. If they wanted a retirement income higher than the S2P level they would have to buy an open ended annuity for the whole period of their retirement.

In Chapter 3 I postulated that the government may decide to raise the State Pension Age (SPA) by about a month each year in line with the rise in average life expectancy. In that case the state should be committed to start paying S2P to each cohort 20 years after their SPA, rather than specifically at age 85. Everybody would then be required and enabled during their working life to build up a Mandatory Second Pension fund to provide for a fixed period annuity for the first 20 years of their retirement.

It is hard to calculate the cost of such fixed period annuities relative to full life annuities. The mortality tables suggest that 87% of the cost of an ordinary annuity for a 65 year old covers the period to age 85. But the funding need should be reduced by more than 13% since providers will no longer need to build up a 'provision' for the major uncertainty relating to the later years.

It is difficult to tell the actual level of annuity companies' costs and provisions against risk. A number of studies have suggested that annuities are quite keenly priced. These studies are based on comparing the cost of purchasing an actual annuity with the cost of government bonds necessary to provide that income stream for a population using published mortality projections.

This methodology suggests that costs (including provisions) amount to about 5 or 6% of the price of an annuity. However, the annuity providers may be investing partly in corporate bonds and equities and using the higher yields to offset a higher level of costs. If so, the cost margin may be substantially higher than 6%.

So there may be significant scope for cost reductions if government takes on the cost of S2P for the over 85s.

[31] 'The Charge Ratio on Individual Accounts: Lessons from the UK Experience' by Murthi, Orszag & Orszag (March 1999).

[32] Ibid page 44.

[33] This is well-documented in Australia in 'Superannuation Fees and Competition' by Michael Rice and Ian McEwin of Phillips Fox (9 April 2002).

[34] Appendix II of Murthi, Orszag & Orszag (March 1999).

[35] ibid.

[36] NAPF.

[37] "...the new Continuous Mortality Investigation projection basis significantly underestimates likely future mortality improvements ... Life Offices writing annuity business on competitive terms may be making significant losses ... some pension scheme liabilities may be underestimated by as much as 30%." 'Mortality in the Next Millennium' by Richard Willets FFA.

[38] An alternative way for government to bear this risk would be to issue bonds whose annual coupons reflect the proportion of the population of retirement age on the issue date who remain alive in each subsequent year – as proposed by David Blake and William Burrows in "Survivor Bonds: Helping to Hedge Mortality Risk" The Journal of Risk and Insurance 2001 vol 68 no 2.

CONCLUSION

Compulsion

Both employees and the self-employed should be required to contribute to a Mandatory Funded Second Pension at least sufficient, in conjunction with their Basic State Pension, to lift their retirement income above the means tested benefit level – the MIG.

The Mandatory Funded Second Pension should provide a flat rate element at least equal to the difference between the Minimum Income Guarantee (MIG) and Basic State Pension (BSP). It could also provide an earnings related element of pension mirroring that currently included in S2P.

It would be virtually impossible for the BSP and Second Pension to keep pace with the MIG if government continues to raise the MIG in line with average earnings and the BSP only in line with prices. Instead both should be statutorily up rated in line with prices and any increases above that should be the same additional cash amount for the BSP as for the MIG as and when the public finances permit.

Funding

Ultimately everyone in work should have a Mandatory Funded Second Pension – either a personal or occupational pension - into which would be paid NIC rebates sufficient to fund a pension/annuity equivalent to the S2P during the first twenty years of their retirement. Thereafter the S2P will be paid on a pay-as-you-go basis by the State.

However, this move to compulsory funding could be phased in. Those born less than 30 years before the start of the scheme would be required to have such a fund from that point or when they entered employment. Those aged over 30 when the scheme starts would retain the current option to remain in the state pay-as-you-go second pension or contract out into an equivalent funded scheme.

Cutting Costs

Requiring everyone to have a pension fund is the most effective way to cut the costs of running those funds. It eliminates the cost of persuasion, dramatically reduces the need for advice, simplifies and standardises and spreads costs far more widely. It should eventually be possible to reduce the cap by up to a half.

That would increase the value of final pensions by as much as 13%.

The cost of annuities can also be cut disproportionately if government assumes responsibility for paying the Second Pension from age 85. That would transfer 13% of the cost of expected longevity to the state. But the cost of annuities for a maximum 20-year period are likely to be reduced by significantly more than that amount because it would no longer be necessary to make provision for unlikely but possible increases in longevity beyond that age.

Pension Age

People would be free to draw an income from their compulsory second pension fund earlier than the State Pension Age (SPA) if it is sufficient to provide an income above the MIG. They would, however, have a double incentive to go on working and saving beyond the SPA.

Should the government fail to adopt these proposals it will be forced to raise the SPA. If it does so the logical approach would be to raise it roughly in line with life expectancy, i.e. by one month each year. It could, instead, raise in this way the age at which people can draw their tax free lump sum unless they are using it to buy an annuity.

These proposals would make it unnecessary to change the SPA though the government might decide to do so anyway. In which case it would be logical to increase the age at which the state takes over funding the second pension on a similar basis.

To remove the unfairness whereby those on lower incomes who have shorter life expectancy subsidise the better off, longer-lived groups the terms of annuities should reflect the relationship between life expectancy and earnings.

To make this possible, the Government should make available to annuity providers information from National Insurance records summarising people's lifetime earnings in a form similar to their tax code. Alternatively National Insurance rebates could be adjusted to reflect the relationship between earnings and life expectancy.

Funds or annuities which more fairly reflect that relationship will make it easier for lower income groups to exercise genuine choice over the age at which they retire.

ANNEX A:
HOW THE UK STATE PENSION SYSTEM WORKS

This summary of how the present system works may at least convey to the reader how complex it has become. Much of that complexity arises from recent attempts to mitigate the disincentive effects of means testing. Unfortunately that very complexity itself undermines the savings culture and causes many otherwise prudent people to shy away from making any pension provision at all.

STATE PENSION PROVISION

The state system for retirement income has three components: means tested retirement benefits; the Basic State Pension; and the Additional State Pension or rebates to obtain an equivalent private pension.

Means Tested Retirement Provision (MIG & PC)

Minimum Income Guarantee (MIG)

There has been a means tested safety benefit since the welfare state was established. Originally it was called National Assistance, then Income Support. In 1999 Income Support for those above the State Pension Age (SPA) was re-named the Minimum Income Guarantee (MIG) and set at a level higher than the Income Support level. In 2003/4 its basic value was £102.10 per week for a single person and £155.80 for a couple.

Anyone over the SPA with income below the MIG is entitled to have their income topped up to the MIG level (subject to an assets test). Every extra £1 of pension, up to this level, therefore results in £1 less of means tested benefit.

Pension Credit (PC)

To mitigate this disincentive, Pension Credit is being introduced from October 2003. It will have two components – the Guarantee Credit which tops people's income up to the MIG level and the Savings Credit to partly compensate those whose retirement income (additional to the BSP) results in a loss of entitlement to Guarantee Credit. Retired people will be entitled to Savings Credit equal to 60p for every £1 of extra pension in the range between the value of the full Basic State Pension and the MIG. For those whose extra pension income takes them somewhat above the MIG level their entitlement to Savings Credit is reduced by 40p for every £1 by which their pension exceeds the difference between the BSP and the MIG. So instead of losing £1 for every £1 of extra pension in the range between the BSP and the MIG people lose 40p for every £1 in a range two and a half times as great.

Basic State Pension (BSP)

Everyone in work pays National Insurance Contributions (NICs) towards their Basic State Pension (BSP) if their earnings are above a minimum threshold called the Lower Earnings Limit (LEL).

The LEL is by convention set at about the same level as the BSP (since it would be odd to force people to save to have a higher income in retirement than they have in work). The LEL is £4,004 in 2003/4.

Entitlement to BSP builds up on the basis of the number of periods in which people make NICs or receive NIC credits (regardless of the amount of NICs they pay in any period). It takes 44 years of contributions and credits for a man, and 39 years for a woman, to earn full BSP. (The number of years required for full pension can be reduced for periods caring for young children or disabled relatives.)

The BSP in 2003/4 is £77.45 per week for a single pensioner and £123.80 per week for a couple. It is up rated each year by at least the rate of inflation.

Additional State Pension (ASP)

The first Additional State Pension (ASP) – additional to the BSP – was the very modest Graduated Retirement Pension introduced in 1961. It was replaced by the State Earnings Related Pension Scheme (SERPS) in 1978 which was replaced by the State Second Pension (S2P) in 2002.

State Earnings Related Pension (SERPS)

The State Earnings Relation Pension (SERPS) covered only employees (not the self-employed) who earned above the LEL and were not contracted out.

Each year employees' earnings between the Lower and Upper Earnings Limits were taken into account. That element of each person's earnings was up rated in line with rises in an index of average earnings until they reached the State Pension Age.

The rules for calculating the SERPS pension entitlement have changed over time. Originally the SERPS pension was to equal 25% of the average of the best

20 years of these re-valued earnings. Subsequently the pension was to equal 20% of the re-valued relevant earnings averaged over a full working life (44 years for men, 39 for women).

Once in payment a SERPS pension is increased in line with prices.

Contracting Out of SERPS

Employers running an occupational pension scheme offering benefits equivalent or superior to SERPS can contract out of SERPS all their employees who are members of the scheme. Likewise any individual employee who takes out an Approved Personal Pension (i.e. one offering roughly equivalent or greater benefits) can contract out of SERPS. In both cases rebates from employer and employee NICs will be paid directly into their pension funds. The rebates are calculated by the Government Actuary to be sufficient, when invested over a working life, to pay for a pension or annuity equivalent to the SERPS rights foregone.

Rebates payable into Approved Personal Pension Funds were related to the employee's age.

On average rebates are equivalent to nearly 5% of relevant earnings.

State Second Pension (S2P)

Like SERPS, S2P covers only employees (not the self-employed) earning above the LEL who are not contracted out. Pension entitlement is also based on each year's earnings between the Lower and Upper Earnings Limit, re-valued in line with average earnings up to State Pension Age.

However, the pension entitlement is not simply proportionate to this element of earnings. S2P is very redistributive towards those earning less than the Lower Earnings Threshold (LET). This is set at £11,200 in 2003/4. It is intended to be roughly half national average earnings and to rise in line with them.

Everyone earning between the LEL and LET is treated as if they earned the LET. So they accrue the same amount of S2P. The accrual rate for that element is 40% (i.e. twice the previous SERPS accrual rate). The accrual rate for earnings above the LET up to the Higher Earnings Threshold (HET) is only 10%. The HET is set each year so that the average accrual rate at that point is 20%. That is £25,600 in 2003/4. The accrual rate is 20% for earnings above the Higher Earnings Threshold (HET) and up to the Upper Earnings Level (LEL). The UEL is the limit beyond which higher earnings do not attract higher contributory benefits or charges. It is set at £30,940 in 2003/4.

Entitlement to S2P equals the total of the relevant elements of each year's earnings, re-valued and weighted by accrual rates and averaged over a full working life.

S2P in payment will also be up rated annually in line with prices. It is unfunded.

Contracting Out of S2P

The arrangements are similar to SERPS. However, those earning less than the LET can only contract out in respect of their actual earnings. If they do so, they still accrue an element of S2P in respect of the notional earnings attributed to them – that is the difference between their actual earnings and the LET.

Those earning more than the LET can contract out and receive rebates equivalent to their total S2P entitlement.

ANNEX B: BASIC PENSION PLUS

On 5th March 1997 the Prime Minister, John Major, and I announced a revolutionary plan to reform the state pension system called Basic Pension Plus.

The Plan involved three key elements:

> **A Personal Fund** - all young people entering the labour market would be given their own fund.
>
> **Rebates** - from their National Insurance Contributions would be invested in their fund sufficient to finance their basic state pension (a flat rebate of £9 per week rising with inflation) and a compulsory second pension (5% of earnings).
>
> **Guarantee** - the state would guarantee that fund holders would receive at least their Basic State Pension. If the fund's performance were inadequate for any reason, the state would top up their pension from that fund to equal the BSP level.

We said the plan would bring about the largest extension of personal ownership of wealth since the spread of home ownership – and in so doing resolve one of the major issues facing modern governments – providing decent, secure pensions for increasing numbers of elderly people.

Its aims were to guarantee the Basic State Pension; to enable future pensioners to share in economic growth; to give a massive boost to investment and ultimately to relieve taxpayers of their biggest burden.

If the extra investment boosted the average growth rate by just one twentieth of one per cent (e.g. from 2.25% to 2.30% pa) it would generate sufficient extra tax revenues to be self-financing. In any case the 'double funding' cost was to be mitigated by changing the timing of tax relief on saving for the generation covered by the scheme from an up front to a PEPs basis. Pensions for the generations covered by BPP would therefore be free of tax.

ANNEX C: AUSTRALIA'S EXPERIENCE OF COMPULSORY PERSONAL PENSIONS

Much has been written about funded pension systems in Chile and other Latin American countries, Singapore's centrally operated funded system and new systems being developed in former communist countries.

But these countries have totally different political, institutional and economic frameworks from the UK. So any lessons are unlikely to be directly applicable to us.

A far more relevant experience is that of Australia – a developed country that shares our Anglo-Saxon institutions. Moreover, it started from a heavily means tested universal system of state pensions rather similar to that which is being created in the UK by the present Labour government.

Australia recognised nearly two decades ago that the disincentives and resentment inherent in a means tested state system lead logically to compulsory savings.

Before 1983 Australia had a universal Age Pension funded from taxation and set at a low level by OECD standards. It was means tested against both income and assets. So it resembled Income Support or the MIG/Pension Credit system being developed in the UK.

It acted as a strong disincentive to save for retirement for those on modest earnings. There were generous tax incentives for occupational and personal pensions but they were generally sufficient to outweigh the disincentive effect of means testing the Age Pension only for those on or above average earnings. Even those who did save for a pension were often tempted to draw their savings as a lump sum and spend them in order to qualify for the means tested state Age Pension and related benefits such as health care cards and discounted transport.

Australia's current system was phased in over more than a decade under three successive Labour governments.

The first pillar remains the means tested Age Pension funded out of taxation. This is set at 25% of Male Total Average Weekly Earnings. Its value in 2002/03 was

A$11,164 per annum for a single person. (This was equivalent to £78 per week.)

A single person can have private income from other sources up to A$3,016 and still receive the full rate of Age Pension. Thereafter the Age Pension is reduced by 40 cents for every extra dollar of private income until it phases out at A$31,304.

The second pillar is a system of compulsory contributions paid by employers for all employees. Since July 2002 this contribution has been set at 9% of earnings. The self-employed are excluded as are most of those earning less than a Lower Earnings Limit of A$450 per month. There is also an Upper Earnings Limit of about A$90,000 per annum beyond which the contribution is not compulsory.

Some 88% of the workforce are within this system as against 40% with private pensions before it began.

The contributions are paid into each employee's personal account in a privately managed retirement fund. Not-for-profit trustee superannuation funds were established on an industry basis.

The intention is to build up a fund sufficient to buy an annuity worth, together with the means tested Age Pension, about two thirds of pre-retirement income. Table 4 shows projections for different contribution periods and income levels.

Table 4 Replacement income generated by Australian compulsory superannuation scheme plus means tested Age Pension

Total average salary	30 years of contributions % of gross pre- retirement	contributions % of net pre-retirement	40 years of % of gross pre-retirement	% of net pre-retirement
A$20,000	70	79	82	90
A$40,000	45	55	58	70
A$60,000	37	48	50	62

Source: Superannuation over two decades: The politics of pension reform in Australia. Senator The Hon Nick Sherry Jan 2003.

The third pillar is voluntary savings. It had been anticipated that voluntary savings would decline as people assumed that the compulsory level was the 'correct' amount. In fact, the level of additional voluntary contributions into the superannuation schemes has doubled from 20% to 40%. On the other hand employers who had contributed more than the compulsory 9% have tended to reduce to that level.

Costs

The cost of administering superannuation schemes in Australia averages 1.2% of the total amount invested and is declining as this increases.

This is comparatively low given that the system is still young, there is no cap on costs and there is no central clearing house like the UK National Insurance system that collects and distributes the NI rebates in Britain. Moreover, the Australian system has unexpectedly generated a multiplicity of small accounts as individuals change jobs and industries. On average there are 2.5 accounts for every member. It is proposed that accounts should automatically be consolidated. This should significantly reduce costs further.

There is no requirement that charges be proportionate to the amount invested so those on low incomes are not protected from bearing a disproportionate level of costs in some schemes.

Security

Industry-wide funds are run on a trustee basis with half the trustees appointed by the employer and half by the unions/employees. To make a decision requires a two thirds majority.

The 'Prudent Person' rules have been translated from Common Law to Statute. They require investment managers to invest at arms length, diversify and match risks with liabilities. Company schemes must reduce the amount invested in the firm to a maximum of 5% of the total.

There is a compensation fund providing 100% cover for theft or fraud. So far only one fund has been reported involving A$30m out of a total of A$530 billion.

Tax Issues

As compulsion removed the necessity for tax breaks to encourage saving, the tax regime for pension funds has become less generous. Indeed tax is now vying with declining administrative costs to become the major cost for pension funds.

A key and, to UK observers, unusual feature of the Australian system has been that savers have no obligation to convert their pension savings into an annuity on retirement. They can take 100% as a lump sum and put it to any use they choose. There is now a tax charge on exit, but savers can still take the whole lump sum and spend it on anything. The amounts accumulated under the new compulsory scheme by those reaching retirement are small so far.

About two thirds are taken as a lump sum – albeit often to repay mortgages or other debts. Australia may need to change these rules. The clear lesson for the UK, however, is that the primary call on retirement savings should be to ensure retired people are not dependent on means tested benefits.

Savings Ratio

After the introduction of compulsory savings in Australia there were at first signs that the long-term declining trend in household savings was beginning to come to an end or even reverse. But the downtrend resumed towards the end of the 1990s. Other Anglo-Saxon countries experienced a similar long-term decline, worsening in recent years. This may reflect a growing willingness to borrow as buoyant housing and stock markets increased the value of people's assets. In Australia the knowledge that funds accumulated in compulsory superannuation accounts can be used to repay debts may even encourage people to borrow during their working lives.

Public Sector Employee Pensions

Apparently public sector pension schemes moved from being defined benefit to defined contribution, similar to those in the private sector, with remarkably little fuss.

[39] Fuller details are available on my website – www.peterlilley.co.uk – under Speeches and Articles Feb 1999.

[40] The average exchange rate during 2002/3 was A$2.754/£.