PENSIONS POLICY INSTITUTE

PPI

Shaping a stable pensions solution: Should earnings-related pensions be compulsory or voluntary?

On 22 September 2005 the PPI and the Nuffield Foundation held the fourth seminar in the *Shaping a stable pensions solution* series at the Nuffield Foundation.

Around 30 people attended the seminar, which was chaired by Andrew Young (Government Actuary's Department, The Pensions Regulator and Pension Protection Fund).

Chris Curry (Research Director, PPI) presented key findings from the background paper *Should earnings-related pensions be compulsory or voluntary?* This showed that compulsory earnings-related pensions are becoming less important in the current pension system. Some people support compulsory earnings-related pensions, but it is expensive and the benefits are disputed. The paper also raised the question of whether voluntary earnings-related provision on top of a better state foundation pension could work as well as compulsory provision.

Three discussants gave contributions to the debate before questions and contributions were taken from the floor.

Please note that the PPI has not checked any facts referred to in the following, and we may not agree with the opinions expressed.

Christine Farnish (Chief Executive, NAPF) asserted that the primary role of the state is poverty prevention; otherwise, reliance on means-testing will increase. A rise in state spending on pensions is inevitable, even just to catch up with that spent in other countries. However, the state cannot afford to provide both poverty prevention and earnings-replacement.

The introduction of compulsory private earnings-related provision has many disadvantages:

- It is a 'one size fits all' policy; inflexible and restrictive of people's savings choices. For example, saving in a pension may not be the most appropriate savings vehicle for people on a low income.

- Innovation in the development of new savings vehicles would be stifled.
- It would be perceived as a tax – so contributions would be low.
- Voluntary saving would be likely to decrease.
- It is unlikely that the Government would continue to fund tax incentives.
- The state would be required to protect people from investment risk and this could be costly.
- It is unlikely that employers and private pension providers would be encouraged to provide additional savings options on top.

Voluntary saving has not been given a fair chance in this country, as the system sits on top of an extremely complex state system. Incentives to save are rendered less effective due to complexity and over-regulation of the pension system. Tax incentives are very regressive and could be better targeted at employers rather than individuals.

It is cheaper to concentrate state funds on a minimum level universal pension benefit. With complexity and means-testing reduced, the state could then focus on incentivising and enabling voluntary saving.

Chris Kenny (Director of Life and Pensions, ABI) declared that the partnership between the state and the individual is fundamental to securing adequate retirement income. The question is about finding the optimum balance between the state and private sector. It is economically ludicrous to suggest that the state can fund all the objectives from poverty alleviation to earnings-replacement. Enabling and incentivising voluntary saving play key roles.

The compulsory state earnings-related pension should act as a stepping stone to kick-start voluntary saving. The option of contracting-out encourages people to reduce reliance on state provision. However, to reinvigorate the incentive to contract-out, this mechanism requires reform. S2P should be set at a flat rate, assuming that all recipients earned £15,000. This would provide adequate income to keep the majority of people out of means-testing. Means-testing will always be a component of the system, but it needs to be radically reduced.

Compulsory private saving has many disadvantages, particularly as it would be seen as a tax. The public favour compulsion in theory, but support is qualified, and reduces significantly when perceived as a trade-off with wages.

Donald Duval (Head of Professional Practice, AON Consulting) used the case of Australia to draw out the lessons for the UK. A compulsory private element was introduced to the Australian pension system due to the belief that means-testing was increasing and private saving was reducing. The alternative of a higher flat-rate pension was dismissed as it was believed that it would get forced down to an inadequate level circumscribed by political definition. This would effectively down-grade the level of poverty. The private sector system was seen as protecting the state system.

Voluntary saving collapsed almost completely when compulsion was introduced. However, this effect proved to be temporary. Approximately 45% of the workforce now contribute to voluntary pensions. Also, there is no evidence of political moral hazard since people do not think that they are actually paying for their state pensions as there is no National Insurance system in Australia. The state does not guarantee pension income from the compulsory private schemes, as it has never been deemed necessary. While expenses are high as compared with state systems, service levels are also a lot higher, for example, the issuing of half yearly benefit statements, and a tracing service for private pensions from previous employments

However, applying the lessons from Australia to the UK requires country-specific context. For example, it is likely that extending compulsion in the UK would not be as successful due to the current regulatory attitude. Costly guarantees and excessive regulation would be likely to significantly damage voluntary saving.

Points raised in discussion included:

- In order to maintain political approval, the role of the state in pension provision must be socially and fiscally sustainable both within generations and across the generations. Raising state pension age should allow a sensible change in state resources to pensioners.
- If the state focuses entirely on poverty prevention then it is unlikely that everyone, throughout the entire earnings spectrum, will buy in to it. An earnings-related retirement benefit is more likely to address the concerns of middle to high income earners.
- The debate about compulsion must consider how long people work for.
- One argument in favour of compulsion is that it is very difficult for people in their 20's and 30's to know what their income requirements will be when they reach their 70's, and how they can

go about achieving that level of income. Even if they act entirely rationally, it is uncertain whether those actions will result in what they want.
- Confidence in the pension system is vital for the political sustainability of compulsion. However, investing in Defined Contribution schemes does not seem likely to be the most acceptable request.
- More research into consumer engagement is required. The lessons from Australia are not clear cut. Although pension saving regimes in Australia incur a low cost, the system retains an element of complexity. Consumer engagement in Australia was low until people's individual pension pots started to grow.
- Consumer engagement would be facilitated by an increase in financial literacy, which is currently very low in the UK.
- The number of people contracting-out is decreasing. In order for this function to act as a stepping stone, it needs to be reinvigorated. This could be done if the contracted-out rebate has a clear incentive, as was the case in the late 1980s.
- However, there is uncertainty over the evidence that contracting-out actually does act as an effective stepping stone to increase voluntary pension provision.
- Tax incentives are currently too complex, regressive and often poorly targeted. For instance, more incentives need to be targeted to employers and in more imaginative ways.
- There needs to be more research into how effective tax incentives are and more work on the practicalities of how to change the system to make it more progressive. But as improving tax incentives may have little impact on net saving there may not be political will to change.
- It is not always politically feasible for the state to enhance redistribution. For example, SERPS allowed for higher contributions through the introduction of earnings-related benefits.
- There is sometimes confusion about redistribution in the transition phase of a pension reform and the redistribution effect in the long-term. One way to avoid a regressive transition to a new pension system is through the 'offset' method, whereby people receive the higher benefit from either the new system or what they have accrued under the old system.

Conclusions (synthesised by the PPI after the event):

- The role of the state ought not to stop at the poverty prevention first-tier pension.
- Voluntary saving is preferred to private-sector compulsion, but there are differences of opinion as to whether the state's role in enabling and incentivising voluntary saving can go far enough.
- If compulsion for second-tier pensions is to be considered, then as compulsory private earnings-related pensions are problematic, greater compulsion in the state system seems to be preferred.
- The existence of contracting-out is a large issue for debate when considering a policy change to earnings-related pensions.