Pensions Policy Institute

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NPSS policy and design choices

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Published by the Pensions Policy Institute

ISBN 0-9548248-5-7
www.pensionspolicyinstitute.org.uk

Introduction

The Government is now consulting on whether to introduce something like the National Pension Savings Scheme (NPSS) proposed by the Pensions Commission in November 2005.

The Pensions Commission left some design details to be considered, but the proposal was a fairly detailed blueprint of a very low cost national auto-enrolment pension scheme to be run by a partnership of state and private industry.

Different alternatives to the NPSS have been put forward by industry groups. A variety of designs for similar savings products around the world are either proposed or in practice.

This paper considers other proposed or existing savings vehicles similar to the NPSS to ask whether the blueprint proposed by the Pensions Commission is the most appropriate for UK policy.

In particular it considers the KiwiSaver proposals in New Zealand in depth to learn the appropriate lessons for the UK context, as that is the only other example worldwide of a national auto-enrolment scheme. It does not consider the merits of KiwiSaver for the New Zealand context.

This paper is organised as follows:
- The first chapter describes the design of NPSS and other examples, including KiwiSaver.
- The second chapter compares the policy background and aims of the NPSS and KiwiSaver.
- The third chapter considers the implications of the policy choice made for the NPSS and asks whether an alternative policy, learning lessons from KiwiSaver, could be more successful.
- The final chapter considers some product design and implementation choices for NPSS.

NPSS policy and design choices: Summary of conclusions

Although some countries have introduced compulsory private pension savings, so far only one country – New Zealand – plans a national auto-enrolment scheme: KiwiSaver. Compared to KiwiSaver, the Pensions Commission's proposed NPSS auto-enrolment scheme for the UK has a more prescriptive design and requires greater operational change.

Despite being planned for the only two countries considering national auto-enrolment, the NPSS and KiwiSaver have very different policy aims:
- The Pensions Commission's objective is for the NPSS to make up for remaining inadequacies in the state pension (and continuing high levels of means-testing) and take retirement income above adequacy. The NPSS is a new design for a low cost pension product.
- The New Zealand Government has developed KiwiSaver to help people get into the habit of saving because saving is seen as good for improving security and choice. KiwiSaver is designed around existing products and infrastructure where possible.

The Pensions Commission believes *it is a reasonable aim of public policy to seek to ensure that the median earner achieves an income replacement rate of at least 45%*. This defines a target and asserts that the target should be reached by a specific combination of state pension and state-sponsored saving. It puts Government 'on the hook' for getting people to a standard of living in retirement that is higher than adequate.

This sets a very high standard for the success of the NPSS. If instead state pension reform guaranteed adequacy with less means-testing than now, the aim of the NPSS could be more like that of KiwiSaver: to encourage discretionary savings. This could stand more chance of success:
- A general savings product could be more appealing than a prescriptive pension and more effective at promoting personal responsibility.
- Implementation and liability risks for the Government and employers would be lower, while the investment risk to individuals would be less critical to their overall retirement income.

If this purpose for the NPSS is preferred (and it is in line with many pension experts' views) then the policy priority would be to push for as high a level of guaranteed adequacy in the UK's state pension as possible.

However state pensions are reformed, there are some product design and implementation lessons from KiwiSaver for a 'BritSaver':
- Ways to increase appeal as a discretionary savings product should be investigated, including flexible withdrawal options, the appropriate form of savings incentives and help in making financial decisions.
- Ways to minimise the risks of implementation should be considered, such as working with existing providers and processes, phasing in and aiming to lower cost without making very low cost the focus.

Chapter 1: The National Pensions Savings Scheme and alternatives

This chapter compares the Pensions Commission's proposal for a National Pensions Savings Scheme (NPSS) with some international examples of similar schemes.

Although some countries have introduced compulsory private pension savings, so far only one country – New Zealand – plans a national auto-enrolment scheme: KiwiSaver. Compared to KiwiSaver, the Pensions Commission's proposed NPSS auto-enrolment scheme for the UK has a more prescriptive design and requires greater operational change.

Possible role models

Schemes which can be compared to the NPSS (and have been used to learn lessons for the NPSS) include (Table 1):

- Existing national compulsory private pension schemes. The policies in Sweden, Australia and Chile are the most often quoted.
- Existing employer-based auto-enrolment schemes, usually tax-incentivised. The US Thrift Plan for federal employees in the US is the usual example. 401(k) plans in the US are voluntary, and the impact of different enrolment methods on these has been analysed[1].
- Plans for a national auto-enrolment scheme. KiwiSaver in New Zealand is the only example at present.

The KiwiSaver proposal is a useful model from which to learn new lessons for the NPSS as:

- It is the only proposal or existing scheme that is based on auto-enrolment (rather than compulsion) with national (rather than one employer) coverage.
- The policy thinking and practical planning for KiwiSaver is ahead of that in the UK, and useful lessons are emerging.
- KiwiSaver was cited by the Pensions Commission as a model for the NPSS, although not considered in detail or in context in their report[2].
- The compulsory schemes are older and have already been considered in some detail elsewhere[3].

This report therefore compares the New Zealand KiwiSaver with the NPSS in some detail. As well as working from KiwiSaver draft legislation, Cabinet papers and other official documents from the policy planning stage[4], the PPI interviewed in February 2006 officials, politicians, providers, employers and others in New Zealand currently engaged in practical preparation for the launch of KiwiSaver in April 2007.

[1] Pensions Commission (2004) pp. 208-209
[2] Pensions Commission (2005) p. 109
[3] For example, Pensions Commission (2004) Appendix D; PPI (2005 SEM4)
[4] www.securingyourfuture.govt.nz May 2005; www.treasury.govt.nz/kiwisaver February 2006

Main differences in design

Compared to KiwiSaver, the NPSS has a very prescriptive product design, and requires more radical operational changes (Table 2 and see Appendix for a more detailed comparison).

The NPSS proposal is for a pension of tightly controlled design and scope.

- **Benefits are more tightly controlled**. The benefit from NPSS has to be taken as a pension, as other UK pension products: it is not available before age 55 and must be annuitised or drawn down by age 75. KiwiSaver benefits can be taken as a lump sum after state pension age and early withdrawal is possible in certain circumstances.
- **The scope of NPSS is wider**. All employees are automatically enrolled into the NPSS and employers of those employees who do not opt out are compelled to contribute. KiwiSaver has automatic enrolment for employees but no requirement for any employer contribution.
- **Tax incentives are more valuable.** The Government contributes one-eighth of every contribution into the NPSS. With KiwiSaver, the Government gives a NZ$1,000 kickstart lump sum (around £365) when people enrol and up to NZ$5,000 on withdrawal for a first house purchase. Government will also contribute to members' administration fees, to what extent is not yet known.

The NPSS implementation will require radical operational changes.

- **The NPSS will change the industry's operation.** The NPSS is envisaged to operate with only a handful of funds serving a large portion of the working population on a 'no-advice' basis. Radical change is envisaged to drive down costs. Any provider can apply to be registered to offer a KiwiSaver, using current products if they can.
- **The NPSS will introduce significant new governance and regulation requirements.** The NPSS is envisaged as a new body directly accountable to Parliament with responsibility for controlling a small number of funds, including the main default fund. KiwiSaver uses existing product and provider regulation.
- **The NPSS will need multiple new systems with more implementation risk.** KiwiSaver can be ready more quickly than NPSS because it uses existing providers, systems and processes. In particular, New Zealand has a PAYE income tax system that can be adapted easily to track KiwiSaver contributions monthly. The UK needs new systems to be built for day 1 of the NPSS as proposed, most obviously a new monthly contributions collection system.

Table 1[5]: Basic description of the main examples of similar schemes to the NPSS

	US Thrift Savings Plan	US 401k	New Zealand KiwiSaver
Timing	1987	1981	Due to launch April 2007
Target population	All federal employees	All employees and self-employed	All employees and self-employed
Nature of compulsion	Voluntary	Voluntary. Automatic enrolment is permissible and subject to employer criteria.	Employees auto-enrolled. Right to opt out. Others can opt in. Employer contributions not required.
Number of members	Roughly 3.5m members in 2004, with 2.5m contributing	45m members in 2001	Roughly 680,000 expected after 7 years
Minimum contribution level	Decided by individual members (but capped)	Decided by individual members (but capped)	4% of gross salary or wages paid by employee
Benefit restrictions	For federal employees, a TSP loan programme and one off withdrawals are available. On retirement, option of annuity, partial withdrawal or transfer.	Funds can be withdrawn from age 59½ (maximum age 70½). Loan provisions from 401k accounts available.	Partial withdrawal available after 3 years membership for deposit on first home. Full amount available after age 65 as a lump sum.

[5] IMA (2005); Australian Bureau of Statistics www.abs.gov.au

	NPSS	Swedish Premium Pension	Australian Superannuation Guarantee	Chilean AFP
Timing	Proposed introduction 2010	1998	1992	1981
Target population	All employees from age 21 earning over a threshold	All employees and self-employed	All employees (earning above 15% NAE) and self-employed	All employees and self-employed
Nature of compulsion	Employees auto-enrolled. Right to opt out. Others can opt in. Employer contributions compulsory.	Employee and employer contributions compulsory	Employer contributions compulsory	Employee contributions compulsory
Number of members	Expected 7m members (in NPSS or alternative)	Roughly 5.3m accounts	Roughly 9m in 2005	Roughly 7.1m members in 2004
Minimum contribution level	As % of gross earnings between £4,888 and £32,760: 5% by employees (including 1% from tax relief), 3% by employers	2.5% of gross earnings split between employer and employee	9% of gross earnings, paid by employer	10% of the first $22,000 of gross wages paid by employee
Benefit restrictions	Annuity or drawdown equivalent between ages 55 and 75	Between age 61 and 67. Annuitisation is mandatory.	From age 60. As a lump sum, annuity or mixture.	From 60 for women, 65 for men. Annuity or drawdown.

Table 2[6]: Significant operational differences between the Pensions Commission's NPSS proposal for the UK and the KiwiSaver proposal in New Zealand

	NPSS	KiwiSaver
Number of workers eligible	~23 million day 1	~700,000 a year
Expected number of members	~7 million day 1 new to pension saving in NPSS or alternative	~680,000 after 7 years
Contribution collection system	Need new system as current PAYE system is annual	Can use existing monthly PAYE system
Approach to industry	Change cost base and nature of operation	Work with existing products and providers
Clearing house	New body acts as clearing house for individual accounts and communicates with members	Inland Revenue allocates individual contributions to providers who communicate directly with members
Investment choice	Core of 6-10 funds; one default fund controlled by NPSS	Providers apply to be approved for KiwiSaver. A limited number of default providers selected by competitive tender.
Management of processes	Under the new non-departmental body directly responsible to Parliament	Inland Revenue will collect member contributions and send to providers
Product/Provider regulation	Not covered in Pensions Commission report	Existing regulation, overseen by Government Actuary
Guidance on opt-out and investment choices	Not covered in Pensions Commission report	Existing *Sorted* website gives generic financial information. Government to run education campaign explaining KiwiSaver. Providers able to give 'advice'.
Overall approach	**'Big bang' to new world**	**Works with existing processes**

[6] See Appendix for full details

Chapter 2: Policy contexts for national auto-enrolment schemes

This chapter compares the policy backgrounds in the UK and New Zealand and the stated aims for the NPSS and KiwiSaver.

The retirement income policy environment is very different in the two countries. Different choices have been made for the aims for NPSS and KiwiSaver:

- The Pensions Commission's objective is for the NPSS to make up for remaining inadequacies in the state pension (and continuing high levels of means-testing) and take retirement income above adequacy. The NPSS is a new design for a low cost pension product.
- The New Zealand Government has developed KiwiSaver to help people get into the habit of saving because saving is seen as good for improving security and choice. KiwiSaver is designed around existing products and infrastructure where possible.

Different policy environments
As with all international case examples, the KiwiSaver model cannot be taken 'off the shelf' and slotted in to the UK situation. The policy, economic and social environment in New Zealand is very different from that in the UK. This report is based on understanding KiwiSaver in the New Zealand context and then taking the appropriate lessons for the UK.

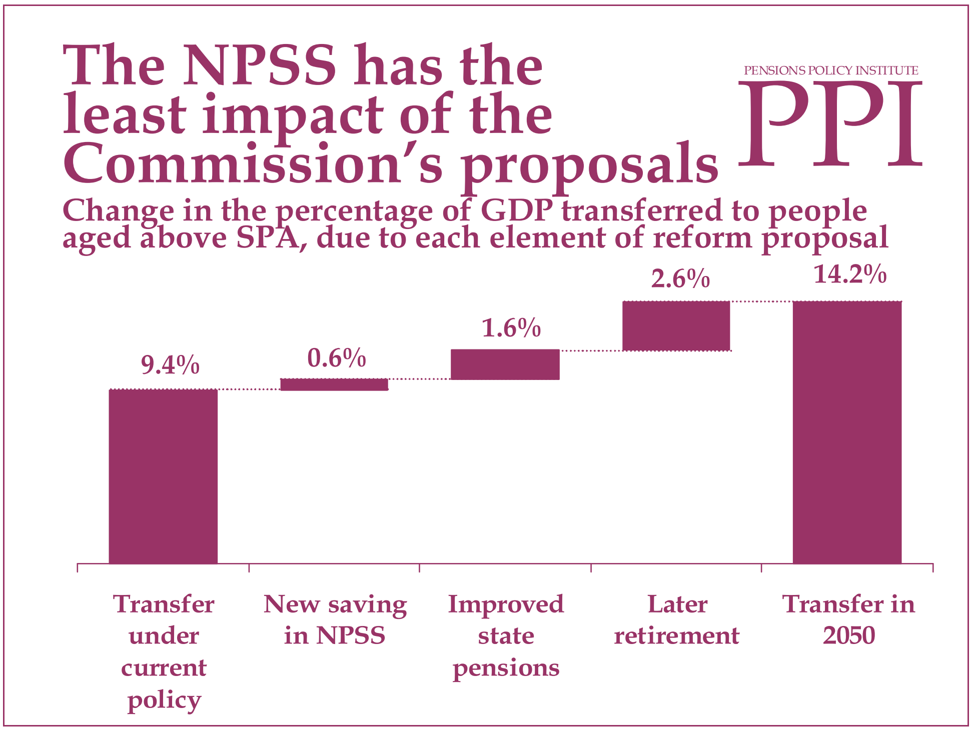
The UK and New Zealand retirement income policy environments are very different:

1. UK policy is in a state of flux with a major White Paper expected in spring 2006 to include reform of the state pension, whereas in New Zealand there is a stable consensus about the future of the state pension.
2. In the UK, there will still be concerns about the adequacy of the state pension, even after the reforms suggested by the Pensions Commission, whereas in New Zealand the state pension guarantees an adequate income.
3. There are concerns about a 'savings gap' in the UK, but much less so in New Zealand.
4. In both, the advantages of and barriers to individual ownership of savings are recognised, but there is more emphasis in the UK on lowering the cost of provision.

1. Reform expected in UK, stable in New Zealand

The Pensions Commission's proposals recognise that new saving in the NPSS is only part of retirement income policy reform. In fact, it has the least impact compared to their proposals for extending working lives and reforming state pensions which are larger contributors to improving the income of people over state pension age in future (Chart 1).

Chart 1[7]



Reform to state pensions has been a contentious issue in the UK for some years, and the Commission's proposals are still being considered by Government. Alternatives have been proposed, which have generated some public debate on preferred designs for a reformed state pension[8].

However, there is no agreement (or even strong public debate) on how large a share of GDP state pensions should take, and how that should change over time with an ageing population[9]. Until Government decides this fundamental point, designing a reformed state pension will remain contentious.

[7] Simplified from Pensions Commission (2005) p. 289 and p. 299
[8] PPI Briefing Note 18
[9] PPI Briefing Note 27; Pensions Commission (2005) pp. 12-17

This is illustrated by the unresolved issue of how much of the total income of people over state pension age should come from the state and how much from private sources.

- For many years, the ratio has been 60:40 with the majority coming from the state. Following the trend in the 1990s to privatise welfare, because of the supposed too high cost to the state of the ageing population, the prevailing philosophy has been to increase the level of funded private provision while reducing the level of pay-as-you-go state provision. In 1998 the UK Government set a target to reverse the ratio to 40:60 over the next 50 years.
- The reversal is now proven as unlikely and unnecessary[10]. The state seems most likely to remain as the majority provider, consistent with the policy of welfare privatisation being reconsidered in other countries[11].

By contrast, the state pension in New Zealand (New Zealand Superannuation or NZS) has had remarkable durability and there is a clear political consensus to keep it[12]. Both the two main political parties have signed up to the political commitment provisions of the Act that defines the form and parameters of New Zealand Superannuation[13].

The rising cost of NZS as the population ages (from 3.3% of GDP now to 6% by 2030 and 7.5% of GDP in 2050) does not seem contentious. It has been tackled explicitly by Government setting up a Reserve Fund which smoothes the required net tax revenue over time[14], again agreed to by both the largest political parties. There is no target set for the proportions of retirement income from state or private provision; it does not seem to arise as an issue.

2. State pension adequacy concerns in UK

In New Zealand, the state pension, NZS, provides adequate retirement income for most older people. Around 93% of people over state pension age receive full NZS, which is set roughly at a level to pay for living costs for people owning their own home[15]. This means that any income from saving or earnings on top might be desirable, but it is not necessary in order to pay for a minimum standard of living.

The features of NZS that make this possible are:

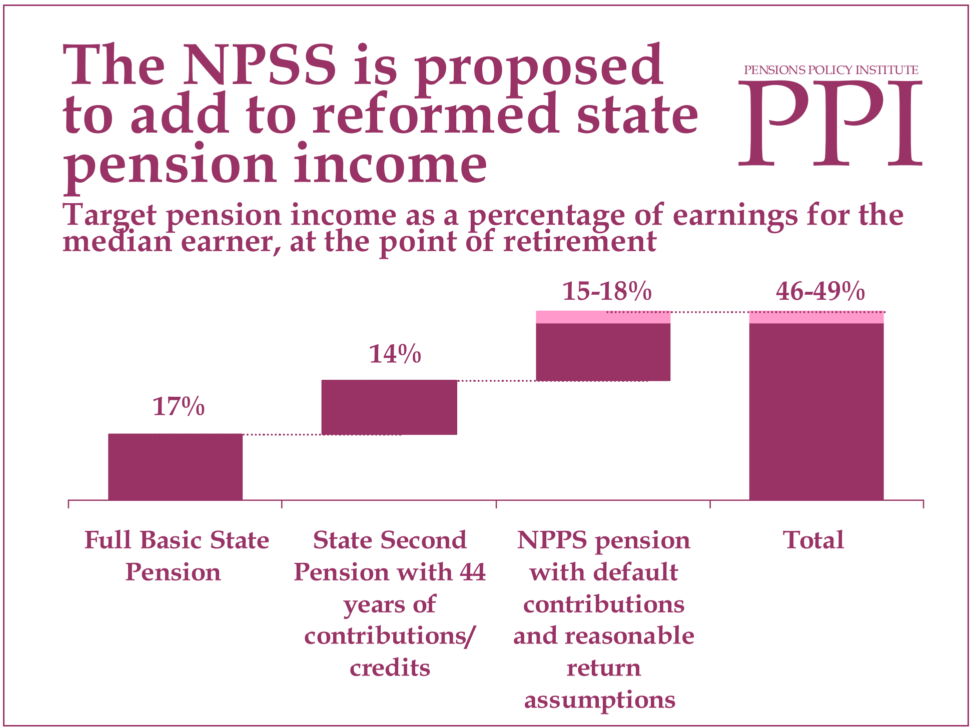
- It is set at 33% of National Average Earnings (NAE) for a person in a couple or 42% of NAE for a single person living alone.
- It is indexed to earnings, so the 'gap' being chased by savings remains constant in earnings growth terms over a lifetime.

[10] PPI (2005 SEM1)
[11] *Financial Times* (13 January 2006), *Politicians begin to confront the unsustainable; International Herald Tribune* (10 January 2006) *Chile rethinks its privatized pension system*
[12] See O'Connell (2004 CPNZ) and ASFONZ survey of political parties (2005). This consensus was also clear from a large number of interviews in New Zealand in February 2006.
[13] New Zealand Superannuation [and Retirement Income] Act 2001 Amended 2005, see Schedule 4
[14] www.nzsuperfund.co.nz
[15] See O'Connell (2004 CPNZ) p. 4. Means-tested income support is available on the same basis as for younger people and means-tested benefits are available for disability and to help with high housing costs.

By contrast, under the Pensions Commission's proposals for reform of the UK's state pension, adequacy (in the sense of poverty prevention) is not assured[16]. The outcome will be lower relative to NAE than the minimum 33% of NAE in New Zealand, but will vary over time and for different people:

- Someone with a lifetime of median earnings would receive a Basic State Pension and State Second Pension of 31% of median earnings, by 2053, after the full impact of the Commission's proposals (Chart 2). This is equivalent to 27% of NAE, less than the state pension in New Zealand.

Chart 2[17]



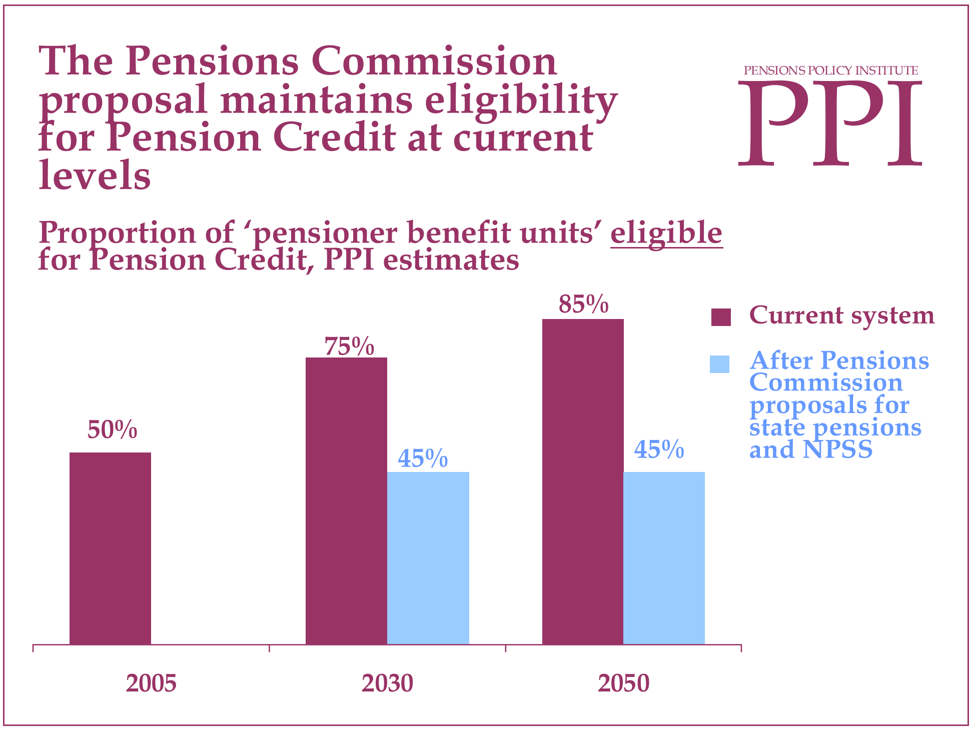
- But for many people, the state pension will be less than this, because of gaps in eligibility for State Second Pension (S2P), and/or because lower earnings mean a lower accrual to S2P, and/or because of the delay until the proposed improvements have worked through fully.

- Also, as S2P is indexed to prices rather than earnings, pensioners will receive less relative to NAE as they grow older.

[16] Note that in this paper 'adequate' is taken to mean the minimum amount someone should have to live on. Exactly what that would be is subject to different opinions, but Guarantee Credit at 21% of NAE is a guide. The Pensions Commission used the word 'adequate' in a different sense: a good replacement rate that did more than provide 'adequate' income, but also maintained living standards into retirement.
[17] Pensions Commission (2005) p. 19

- A floor should be provided by Pension Credit, of around 21% of NAE for a single person or 32% of NAE for a couple. But this is compromised by low take-up: currently around 30% of those eligible for the basic level of Pension Credit do not claim it[18]. Half of pensioner households are currently eligible for Pension Credit. The Pensions Commission proposals would keep this proportion broadly level in future, instead of the rapid increase expected under current policy (Chart 3).

Chart 3[19]



For these reasons adequacy (poverty prevention) is not assured even after the full effect of the Pensions Commission proposals. In particular, the extent of means-testing through Pension Credit has been a major pre-occupation of the pension community in the UK, because it makes the value from saving uncertain[20]. The Commission's proposals will still leave a historically high level of means-testing for basic income. The highest the eligibility level for Pension Credit predecessor benefits ever reached was 35% in 1994/5 and for most of the 1990s it was less than 30%[21].

So the NPSS is proposed to be built on a foundation where adequacy is not guaranteed, and first has to compensate for that before it can take retirement income to higher levels (more on this in Chapter 3).

[18] PPI estimate for those eligible for Guarantee Credit, with or without Savings Credit. Take-up rates are not available precisely, for example the take-up rate for Pension Credit as a whole is in the range 58%-66%. DWP (2006).
[19] PPI estimates using the Aggregate and Distributional Models
[20] PPI (2005 SEM5)
[21] PPI analysis of entitlement to predecessor benefits (Income Support, Minimum Income Guarantee) from DWP administrative data

3. 'Savings gap' concern in UK

There are frequent media references to the UK's 'pension crisis' or 'savings gap'. The UK 'retirement savings problem' is typified by statements such as:

- A '£27bn savings gap'[22], or
- 'Between 9.6 million and 12.1 million people are undersaving'[23], or,
- 'An additional 4.8% of GDP needs to be transferred to people over state pension age by 2050 in order to maintain average income levels for that group relative to the rest of society'[24].

All these statements are based on similar methodologies: assume a target retirement income, project forward what representative individuals will have from the state, calculate how much saving will make up the difference to the target, and then compare that 'required' amount of saving with the actual level of saving observed.

All such calculations necessarily require a large number of data points and assumptions to be made. There are many imperfections in the available data and inadequacies in such analyses:

- Over-reliance on cross-sectional saving rate data at a point in time rather than over individuals' lifecycles, for different cohorts.
- Insufficient distributional data to make the analysis representative enough for the diversity of the population.
- Inaccurate data on existing wealth, such as accumulated savings or housing equity, and questions over the extent to which these assets can be turned into retirement income[25].
- Uncertainties in critical assumptions about the future, for example labour force participation at higher ages, or the impact of the changes in occupational pension provision.
- Lack of a reality check for the answer, especially against the affordability of saving at the rate suggested as needed to fill the 'gap'.

Further, even if the 'gap' could be measured exactly, there is also great subjectivity in arriving at the conclusion that the 'gap' is a <u>savings</u> problem, and specifically a <u>pension</u> savings problem:

- A target level of retirement income has to be assumed in such calculations: the higher the target, the larger the gap. Different policy makers might take different views on an appropriate target, and especially the target at which Government should aim policy. Individual people will have different personal targets, either explicitly or implicitly.
- More personal saving is only one way the 'gap' can be filled. Higher state pensions (paid for by higher taxes) or working longer are the principal others[26]. The common reference to a 'savings gap' presupposes the solution.

[22] Oliver Wyman & Co (2000)
[23] Pensions Commission (2004). DWP (2002) made an earlier estimate on similar lines.
[24] See Chart 1
[25] Banks et al (2005)
[26] Pensions Commission (2004) p. 17; PPI (2005 SEM2)

- Non-pension saving and housing equity, which are not counted in some savings gap analyses, may also help to fill the gap. This leads several commentators to be sceptical that the UK's pensions savings gap need be such a concern[27]. The percentage of people in the UK aged 50-65 thought to be 'undersaving' is estimated to reduce by over half if all of non-pension assets and half of housing equity can be assumed to turn into income[28]. However, what is an appropriate assumption is unclear, and good data is not available to do a full analysis of the potential contribution of these assets over the age and income distribution.
- Even accepting that people may not be 'adequately' planning for retirement by choice, conscious or not, it is impossible to say whether it is because they lack the ability or the desire to prepare for retirement[29].

So the results of any so-called 'savings gap' analyses should only be read as indicative of the size of what some would see as a problem to be resolved by saving more in pensions. All the academic literature in the countries where such analyses have been undertaken (mainly US, UK and New Zealand) carries warnings over the interpretations of 'savings gap' analyses[30].

However, despite the imperfections of these analyses, it is obvious that there should be some concern in the UK over the level of saving for retirement. It follows logically from – assuming all other things are equal - the facts of[31]:

- The increasing cost of a given level of retirement income as people live longer, and,
- The declining value of state pensions, and,
- The observation that pension saving, at best, is not growing and at worst is predicted to fall significantly[32].

So while concerns in the UK over the pensions savings gap should be questioned rigorously, they exist and are widespread enough to be part of the rationale for a new policy approach to retirement income.

In contrast, in New Zealand, 'savings gap' analysis does not suggest the need for such a high level of concern[33]:

Typically…actual savings rates do in fact exceed the rates needed for maintaining living standards in retirement. This reinforces our tentative conclusion that there is no apparent gross under-saving for retirement especially in the older age cohorts.

[27] For example, Congden (2005); HM Treasury quoted in IMF (2006)
[28] Pensions Commission (2005) p. 79
[29] Hurst (2004)
[30] Scobie et al (2006) and Gibson & Scobie (2005) give a good summary of these issues based on reviewing the literature of international studies; see also Engen et al (2004) for more on the US. See PPI (2005 PCR) for a more detailed assessment of the Pensions Commission 'undersaving' analysis and Pensions Commission (2004) pp.158-159 for the Commission's discussion of the difficulties in their calculations.
[31] PPI (2003 TPL)
[32] Pensions Commission (2005) p. 57 predict 1.3% of GDP less in private pension saving in the long term compared to now, which will be an overestimate if some of the special contributions now being made by employers to deal with past deficits stick for future funding rates
[33] Scobie et al (2004) p. i

The role of the state pension, New Zealand Superannuation (NZS), plays a major role in this conclusion, because:
NZS places a floor under the incomes of retirees, such that even where some fall below what is arguably a poverty line, the gap is negligible...the presence of NZS significantly reduces the inequality of retirement wealth accumulation…for almost half of those in the bottom 40% of the income distribution, their preferred strategy …is to make no additional saving for retirement. The case for arguing that this group is saving 'adequately' for retirement may better be viewed as a statement about the absolute level of their pre-retirement incomes, rather than their saving behaviour[34].

4. Similar individual ownership aim, but more concerns on cost in the UK
There have been debates in both the UK and New Zealand about the 'ownership society' or the 'asset state'[35]. The theme is that saving brings not only economic benefits to individuals, but also has important social and community benefits, in particular because asset ownership opens up opportunity and narrows inequalities. In the UK, these debates have been separate from the pensions debate, instead concerned with general savings vehicles such as the Child Trust Fund or the Savings Gateway.

But there are good reasons for Government pursuing policies to encourage retirement savings, even if not convinced of a 'pension savings gap' problem:
- A pension is one of the biggest assets an individual accumulates in his or her life. There is no reason that pensions should be exempt from the 'ownership society' philosophy.
- It is hard to argue that helping people to have higher savings is a bad thing, provided that such help does not distort the market (which it could be argued some forms of tax incentives do).

The policy rationales for both KiwiSaver and the NPSS aim to remove similar barriers to saving - inertia, difficult access to savings products and high costs of available products - but with different emphasis:
- Both policy proposals cite **individual disinclination** as a barrier to saving. People tend to put off making decisions on whether to save at all and what type of saving to make, even when seemingly obvious choices are presented to them. Complexity and issues of trust also reduce people's comfort with savings decisions. Both NPSS and KiwiSaver proposals build on the same body of research which suggests the use of auto-enrolment increases participation in employer-based savings plans in the US[36].

[34] Scobie et al (2006) pp. 111-112
[35] For example: speech by Secretary of State for Work and Pensions *The Asset State: The Future of Welfare* 5 July 2005, Paxton et al (2006), the New Zealand Institute's research program on *Creating an Ownership Society* (2005)
[36] New Zealand Treasury (2006) p. 2, Pensions Commission (2005) pp. 68-69

- The NPSS aims to **extend coverage because of a perceived lack of access to good pension provision** so employees not covered by good workplace pensions have the same opportunity as those that are[37]. The NPSS sets up a minimum expectation, so alternative arrangements have to prove they are at least as good. The NPSS will therefore set a minimum national standard; although it is targeted at fewer than half of those in work (53% being pension savers already)[38]. Further, more new pension savers could join existing schemes than join the NPSS. The Pensions Commission suggests roughly 7 million people will be new pension savers as a result of NPSS. But there are 4.6 million people not saving in a pension employed in organisations with an existing pension scheme. Some may join that scheme instead of NPSS[39]. In New Zealand, there is much less existing coverage of workplace pensions. Around 15% of employees are in schemes[40]. KiwiSaver was explicitly developed as a workplace-based scheme in order to achieve a high coverage and benefit from economies of scale[41].

- Central to the NPSS proposal is the argument that **the level of fees in current retail pension products are too high.** Some segments of the market cannot be served profitably, except at such high fees that the return on saving would be severely reduced[42]. The NPSS design therefore aims to minimise costs, setting a target fee of 0.3% of assets under management (AUM), a huge reduction from the c. 1.3% AUM fees on current retail stakeholder products (although not from the costs of running large pension funds). In the KiwiSaver policy rationale there is no such similar argument, or specific target for fees, although the actual fees for current products seem about the same as the equivalent in the UK. KiwiSaver aims to be low cost in the best interests of the member. Government will provide an explicit contribution to members' fees and KiwiSaver default providers will have to demonstrate 'competitive' fees[43].

[37] Pensions Commission (2005) p. 362
[38] Pensions Commission (2006) p. 13
[39] Pensions Commission (2005) p. 287, DWP (2004). Note there is no estimate for what the outcomes would be for the 4.6m current non-savers, i.e. how many would join NPSS, join the existing scheme or opt-out.
[40] New Zealand Government Actuary (2005)
[41] Statement by Finance Minister Hon Dr Michael Cullen 13 May 2004
[42] Pensions Commission (2005) p. 70-73
[43] Ministry of Economic Development (2006)

Different stated policy aims
In such different policy environments, the aims of the two national auto-enrolments schemes are very different.

The Pensions Commission takes a stronger view of what should be the concern of public policy, and the extent of state intervention in private saving, compared to the aim for KiwiSaver in New Zealand (Table 3):

Table 3[44]: Stated policy aims of the Pensions Commission in the UK for the NPSS and the New Zealand Government for KiwiSaver

NPSS	**KiwiSaver**
It is a reasonable aim of public policy to seek to ensure that the median earner achieves an income replacement rate [in retirement] *of at least 45%.*	*…help New Zealanders to save, giving them greater security and choice and strengthening the economy.*
The NPSS is designed to ensure that: *…people achieve a baseload of* [earnings-replacement] *pension income in retirement, thus limiting the danger of any means-tested reliance on the state...* *… people not presently covered by adequate pension arrangements are enabled and strongly encouraged to save for a pension, while their employers are required to make a modest matching contribution….not intended to replace existing good pension provision* *The potential to make pension saving possible at substantially lower Annual Management Charges is one of the key rationales for creating this national system….The target we propose is 0.3%.*	*A voluntary work based savings scheme … KiwiSaver includes a first home deposit subsidy.* *…to encourage a long-term savings habit and asset accumulation… with the aim of increasing individuals' well-being and financial independence …designed to complement* [state pension] *for those who wish to have more than a basic standard of living in retirement…* *The Government's role in this scheme is to facilitate, rather than coerce, saving….it has been designed to minimise compliance costs for employers and to work off existing processes where possible.*

[44] Pensions Commission (2005) pages 20, 274, 380, 362, 394, 396; Press Release Finance Minister Hon Dr Michael Cullen 19 May 2005; www.securingyourfuture.govt.nz homepage; Memo 6 April 2005 from Minister of Finance to Cabinet Policy Committee; Explanatory Note to KiwiSaver Bill, New Zealand Treasury (2006)

Chapter 3: Policy choices for NPSS in the UK

This chapter considers the implications of the policy choice made for the NPSS and asks whether an alternative policy, learning lessons from KiwiSaver, could be more successful.

As the last chapter showed, the Pensions Commission believes *it is a reasonable aim of public policy to seek to ensure that the median earner achieves an income replacement rate of at least 45%*. This defines a target and asserts that the target should be reached by a specific combination of state pension and state-sponsored saving. It puts Government 'on the hook' for getting people to a standard of living in retirement that is higher than adequate.

This sets a very high standard for the success of the NPSS. If instead state pension reform guaranteed adequacy with less means-testing than now, the aim of the NPSS could be more like that of KiwiSaver: to encourage discretionary savings. This could stand more chance of success:

- A general savings product could be more appealing than a prescriptive pension and more effective at promoting personal responsibility.
- Implementation and liability risks for the Government and employers would be lower, while the investment risk to individuals would be less critical to their overall retirement income.

If this purpose for the NPSS is preferred (and it is in line with many pension experts' views) then the policy priority would be to push for as high a level of guaranteed adequacy in the UK's state pension as possible.

High policy target

The introduction of the NPSS in the UK is inherently linked to not only compensating for an inadequate state pension, but also to a view that policy should target a higher level of retirement income:

- After the Commission's proposals for state pension reform, someone with a lifetime of median earnings would receive a Basic State Pension and State Second Pension of 27% of NAE. As explained in Chapter 2 though, many people, especially during the transition to the full reforms, would have less state pension than this.
- But the Pensions Commission believes that policy should ensure a certain level of retirement income, in proportion to previous earnings. For a median earner a replacement rate of at least 45% is suggested[45]. This defines a 'gap', by reference to earnings, and asserts that public policy should fill the gap by Government-sponsored savings.

[45] Adjusting for median and average earnings, a 45% replacement rate for a median earner is around 40% of NAE

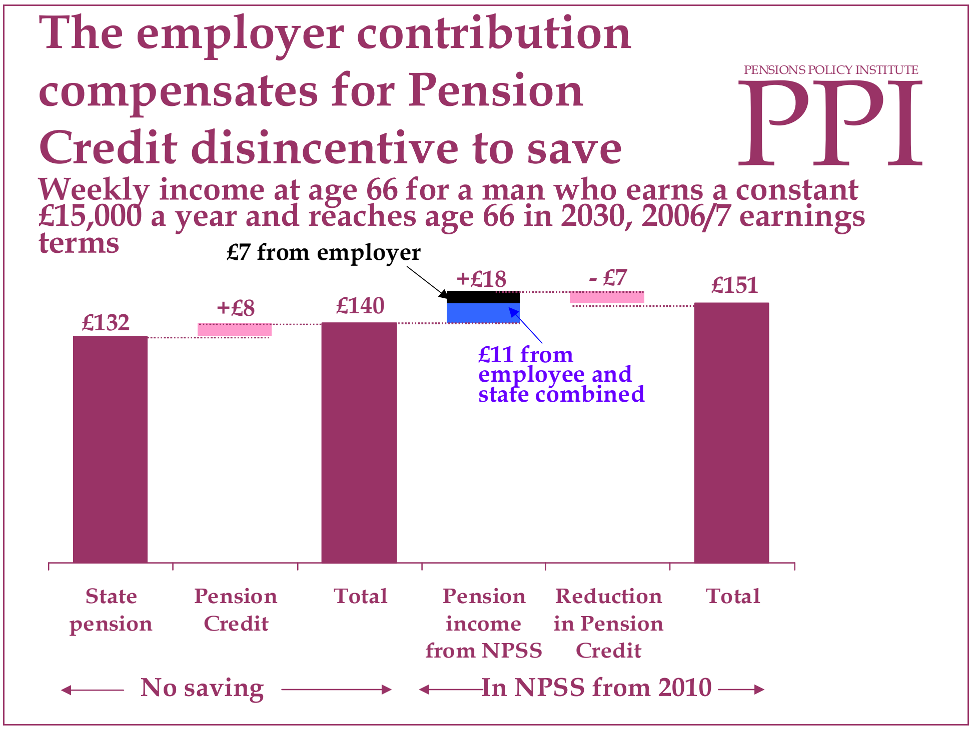
- The NPSS (or approved alternative saving) is expected to make a contribution to retirement income for everyone except those earning under around £8,000 (around 40% of the working age population)[46]. But people can still opt out, so there would still be people without any private pension coverage.
- Pension Credit would provide adequacy for those that claim it, but not for those that do not, or necessarily the target replacement rate for all.

The element of compensating for what is seen to be an inadequate state pension is reinforced by the stated policy aim for the NPSS of:
…limiting the danger of any means-tested reliance on the state…[47].

But even under the reform of the state pension suggested by the Commission, there will still be enough means-testing for the return on joining the NPSS to be doubtful for some members:
..a modest compulsory matching employer contribution within the NPSS is essential to ensure that all members can be certain of achieving attractive returns on their own contributions[48]*…*

The level of the compulsory employer contribution (at 3% of the total 8%, so 37.5% of the total contribution) more or less compensates for the 40% withdrawal rate on savings for those eligible for Pension Credit (Chart 4).

Chart 4[49]



[46] Pensions Commission (2005) p. 282 and 285; PPI estimate using Family Resources Survey 2003/4
[47] Pensions Commission (2005) p. 380
[48] Pensions Commission (2005) p. 134
[49] PPI analysis using the Individual Model

Most people would accept that Government should get people to an adequate level of retirement income: enough to live on at a basic level. And Governments will certainly be interested in how the distribution of retirement income for people above state pension age compares to adequate and desirable levels.

But there are policy choices around how much Government policy should intervene to take people to a target level above adequacy:

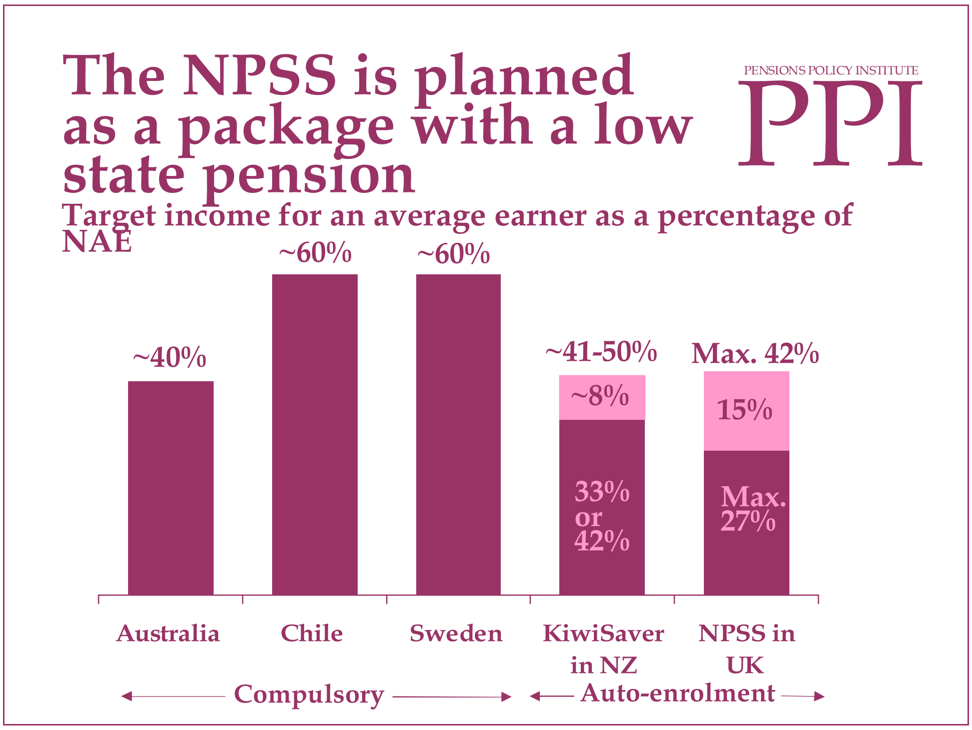
- Where Governments have decided to make private saving compulsory, policy explicitly mandates a certain pattern of paying tax or contributions during working life in order that people have a certain retirement income or wealth that is more than adequate. This is the model taken in Sweden, Australia or Chile, for example. In theory at least, through compulsion, everyone should be taken above and beyond adequacy. For example, Sweden mandates a mixed system that targets a retirement income of around 60% of NAE.
- An alternative policy is to guarantee adequacy through the state pension. New Zealand is a fairly generous example of this approach. With an adequate state pension ensured, any saving on top is desirable, but not mandatory. People can save money during working life in order to have more than adequacy in retirement, if they choose to do so, and that can be given a push in the 'right' direction by Government intervention. A policy of auto-enrolment, with some financial incentives, makes the push quite directional, but still allows the choice of opting-out. If an individual does opt-out of the KiwiSaver, or the investments perform badly, adequacy is not risked, because of the state pension. The KiwiSaver policy does not set up a specific retirement income target.
- The Pensions Commission proposal for the NPSS is different from both the approaches above. The reformed state pension cannot guarantee adequacy (because of the incomplete and low state pensions, take-up issues with Pension Credit and the slow pace of reform), and the NPSS cannot because of the opt-out. But still policy aims for a higher than adequate target income. This means that there are risks of the target retirement income level not being met, and of some people not even having an adequate level of pension.

So compared to the policy in other countries, a lot is being asked of the NPSS (Chart 5).

Further, the Pensions Commission hopes that additional voluntary contributions into the NPSS take retirement income still higher. A doubling of NPSS contributions is calculated as taking the median earner to a 60% replacement rate[50]. In modelling the expected outcomes from the NPSS, the Pensions Commission assume that, in aggregate, contributions total 1.25 times the default level, at 10% of band earnings[51].

[50] Pensions Commission (2005) p. 19
[51] Pensions Commission (2005) p. 287

Chart 5[52]



High standard for NPSS

By setting the bar so high for the NPSS policy, a number of interlocking features have to work effectively and significant risks accumulate:

- **State pensions**: The UK state pension system has to be reformed to deliver at least as well as expected. But even then, the remaining extent of Pension Credit means-testing threatens to compromise the returns from NPSS saving.

- **Employer compulsion**: NPSS introduces a compulsory employer contribution contingent on the employee not opting-out. It is suggested to help improve returns on the employee contribution (critical to help get out of the means-testing trap) and to level the playing field between employers currently contributing and those currently not[53]. Contingent compulsion on employers is controversial and not as straightforward as it often seems at first sight[54]. It means that additional policing of employer contribution payments and behaviour is required (for example, whether undue pressure is being put on employees to accept a higher level of salary if they opt-out). This is not a trivial exercise[55]. In addition, measures would have to be taken to absolve employers of liability from participation or investment choices made by them on behalf of, or by, their employees.

[52] OECD (2005); Palacios (2004); see end of Appendix for more detail on NPSS and KiwiSaver figures
[53] Pensions Commission (2005) p. 133
[54] CBI (2006); PPI (2005 PCR); Pensions Commission (2004) pp. 252-254
[55] PPI Briefing Note Number 28

- **Liability risk to Government**: Because the NPSS is presented as an inherent element of achieving a Government-endorsed level of saving, expectations are raised. 'Political moral hazard' (the risk of increased lobbying for pension increases when expectations are not met) is increased. In theory the risk to Government is limited because it is an auto-enrolment scheme, not compulsory, so individuals retain the choice of opt-out, and individuals can choose their investment profile. But this may not prove an effective get-out clause; after all, the basis for the NPSS is that people are not making such decisions sensibly. As the majority of members are expected to be in the default fund, the governance of that fund through the NPSS will be questioned if there is any issue over its investment performance. Investment performance will be very important, because if the fund performs badly, basic income is affected through the means-testing trap. The NPSS looks very like a state body, so all liability risks are likely to reflect on Government. There is already a precedent for Government having to step in if something goes wrong with non-state voluntary pensions: the Pension Protection Fund.

- **Risk to existing provision**: The NPSS is unusually being proposed into an environment with an already high level of existing private pension provision compared to other countries introducing compulsory or auto-enrolment schemes. So there are few clues as to the impact NPSS might have on existing personal or occupational pensions. Existing pension arrangements will become more regulated. They would have to prove they are at least as good as NPSS or convert to an NPSS scheme. Employers may react by 'levelling down' contribution rates to the default 8% of NPSS band earnings. This means NPSS has to work even harder for new saving to make a net increase in the aggregate saved, or, there has to be acceptance that the policy might lead to some people having new saving, but others having less.

- **Low costs**: The low cost of the NPSS is emphasised so will be a high-profile measure of its success. This drives radical design features such as centralised collection and one default fund, which are untested, and give rise to risks of implementation failure.

- **Promoting personal responsibility**: Although personal funding may increase, personal responsibility (in the sense of individuals making informed, active decisions on whether to save, with which provider and in what investments) is rather heavily directed with the NPSS. If 90% of people stay in the default fund, would confidence in saving have improved, or saving responsibly increased? Provision of advice on how individuals can make decisions such as whether to join NPSS or what investments to choose has not yet been considered for the NPSS model.

An alternative policy model
The Pensions Commission takes a particular view: that *it is a reasonable aim for public policy to seek to ensure that the median earner achieves an income replacement rate* [in retirement] *of at least 45%.* This suggests a belief that people 'should' have retirement incomes at levels higher than adequacy and depending on their previous earnings profile. The corollary is an expectation that the state should intervene fairly heavily to achieve this, and the NPSS is the state-sponsored savings part of the package to do so.

This is a more interventionist role for the state than many pension experts would advocate. The majority view of the experts contributing to a PPI/Nuffield Foundation project throughout 2005 was that[56] *the role of the state in UK pensions should be clearly delineated into two:*
- *Deliver better on the one role that only the state can do - poverty prevention* [referred to as adequacy in this paper], *and,*
- *Enable and incentivise the private sector to do what it does best – provide earnings-related pensions on a voluntary basis.*

In this model, Government is still very interested in outcomes over and above adequacy, but does not set up expectations that Government policy should be responsible for achieving higher incomes, or intervene quite so much to achieve it.

The reasons for this alternative view include:
- There is a widespread concern that means-testing makes it uncertain what people will receive from the state in future. Experts believe that central to promoting personal responsibility to save for a higher-than-adequate retirement income is that Government should communicate with certainty what the state pension will give[57]. This implies a clearly delineated state pension with certain outcomes, and less reliance on Pension Credit.

- It is well accepted that the state has a duty to redistribute tax revenues to provide a state pension to take people to an adequate level of retirement income, so that poverty is prevented in old age. But in an ageing society, the cost to the state of doing a lot more than that will probably mean too high a tax rate. The appropriate level of adequacy for the state pension would always be debated. For the UK, provided it has wide individual coverage, the state pension would need to be at least 21%-25% of NAE (because Pension Credit is of this order), but higher would of course be welcomed[58]. Having settled on an affordable level of state pension the question becomes how best to organise it simply so that adequacy is guaranteed without the uncertainties, inequalities, gaps in coverage and unintended consequences inherent in the current system.

[56] PPI (2006 SSPS)
[57] There will always be political risk of change with any system, but the certainty important here is that with no policy change, an individual can be sure what his or her state pension will be
[58] The history of SERPS plans and subsequent cutbacks has meant that the long-run history of UK state pensions has generally provided in this range. If left to evolve without reform, the current system will flatten out at providing around 20% of NAE. See PPI (2005 SEM4).

- Government intervention in the private sector necessarily means regulation (so cost to consumers), and can mean confusion where state and private pensions overlap. Preferences from industry participants have generally been to aim for simplification, to minimise regulation and to lobby for Government to increase incentives to influence savings behaviour.

KiwiSaver is being introduced in New Zealand under a policy similar to the alternative model proposed for the UK. This allows a more flexible product design compared to the Pensions Commission's NPSS proposal, with lower policy and implementation risks for Government and other participants:

- **State pensions**: The New Zealand state pension guarantees adequacy. Any saving on top is discretionary and has no impact on the amount of state pension received. Success in greater saving would be welcomed, but is not critical to achieving a specific Government-endorsed retirement income target. There is no danger of a means-testing trap and KiwiSaver does not have to provide a pension income. Annuitisation is not necessary. The flexibility to withdraw savings before state pension age can be included, which appears to add to the appeal of the product as well as allowing Government to address wider savings aims.

- **Employer compulsion**: There need be no compulsory employer contribution into KiwiSaver because there is no means-testing trap, or policy imperative to achieve a certain level of pension. Additional policing of employer administration is required, for example, that they are sending employees information packs and forwarding employee KiwiSaver contributions to the Inland Revenue. But the latter is made easier by the ability to use the existing PAYE system for monthly contributions. The employer liability is therefore less than in the NPSS, and legislation will explicitly state that employers only acting as a conduit for employees, even if they choose a default scheme, will not be liable under New Zealand investment advisers and securities legislation[59].

- **Liability risk to Government**: Consistent with KiwiSaver being for discretionary savings, individual choice in provider and fund is encouraged. Auto-enrolment and default providers still mean that 'no choice' is an option. But there will be more than one default provider, randomly allocated to an individual not making a choice. Such providers will be chosen by competitive tender, by a process sub-contracted from Government. Market commentary can be expected on the comparative performance of the different defaults: if one underperforms, it can be removed from the panel. The liability risk therefore seems more removed from Government than in the NPSS.

[59] New Zealand Treasury (2006) p. 14

- **Risk to existing provision**: Existing private pension provision is lower in New Zealand than in the UK. The risk of levelling down is therefore much less than in the UK context, although still a concern. As KiwiSaver is a discretionary saving product it is more of a complement rather than an alternative to current workplace schemes.

- **Low costs**: Under the KiwiSaver model, low cost would be desirable but is not the focus. There appears to be no felt need to change the industry to aim for the lowest costs possible. KiwiSaver has been designed to work off the existing industry model, with providers likely to be investment management companies, banks, insurance companies and pension funds. Set-up can therefore be quicker and more flexible, reducing the implementation risks and set-up cost compared to developing a new vehicle like the NPSS. The administration cost of proliferating accounts is minimised by restricting individuals to having one KiwiSaver provider at any one time.

- **Promoting personal responsibility**: KiwiSaver is based around KiwiSaver scheme providers rather than funds, so individuals engage with providers about their fund choices and, potentially, other product needs. This should mean more personal responsibility is encouraged. KiwiSaver also encompasses an ongoing education programme aimed at raising public awareness and skills regarding savings and investment. The Retirement Commission has been helping people make financial decisions in New Zealand since 1996, with the *Sorted* website available since 2001. Government is now giving additional funding to the Retirement Commission to put financial education 'champions' in the workplace to run seminars for employees and help employers think through the options for employee provision[60]. The philosophy is: *What we need to achieve is both an increased volume of retirement savings and an increased understanding throughout the community of how to approach investment*[61].

[60] O'Connell (2006)
[61] Speech by Finance Minister Hon Dr Michael 23 March 2006

Policy priority: clarify state pensions
Before moving ahead with the NPSS or alternative, it is obviously critical for the UK Government to clarify its policy on the role of the state in retirement income policy. As described above, the policy choice is:

- **Option 1**: Something like the Pensions Commission's package: a better state pension than currently but still not adequate for all or certain; plus a prescriptive NPSS to make up for remaining inadequacies and take pension income to a higher replacement rate.
- **Option 2**: A state pension more in line with the expert consensus view that better guarantees adequacy with less means-testing, so that an NPSS-style product, if introduced on top, can be for discretionary savings.

Taking the second choice forward, a higher level of the adequacy guarantee in the state pension, would entail:

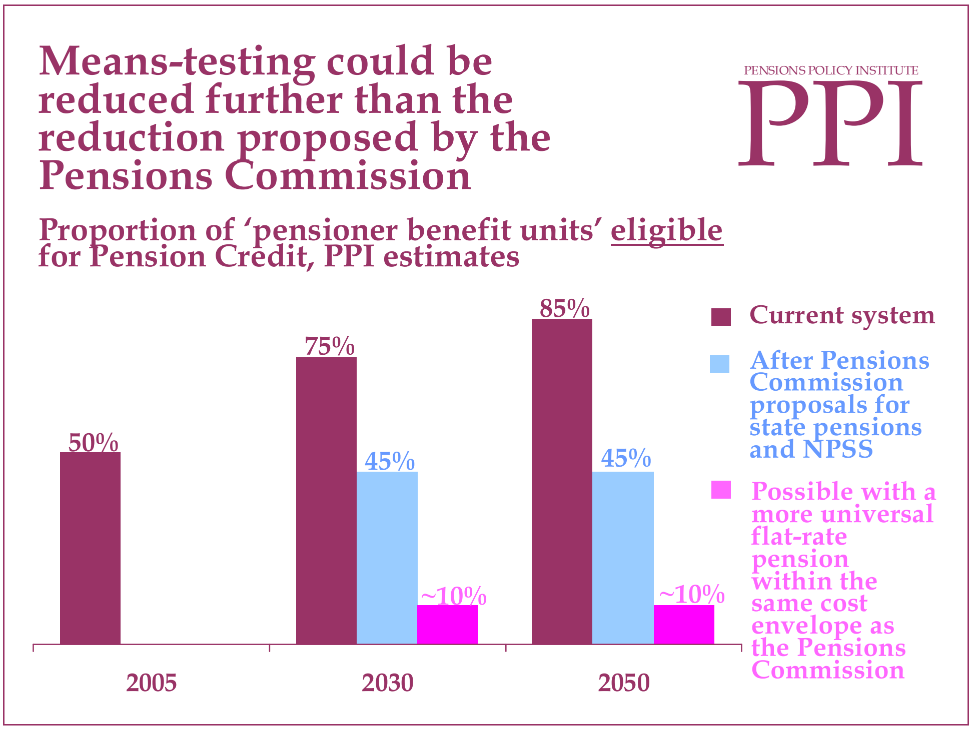
- Reforming state pensions similarly to the Pensions Commission's proposals, but fine-tuning so the transition occurs more quickly and the outcome for all is more certain. This would probably mean a flat-rate, single tier pension, with wide enough coverage and at a high enough level to reduce means-testing for basic income.
- The critical test would be to reduce the number of people that are at risk of being eligible for Pension Credit, so that uncertainty, and complications with any Government-sponsored saving falling into the means-testing trap, are minimised.
- The cost of improving state pensions could still be mitigated somewhat by raising the state pension age, as suggested by the Commission. Additional cost may still need to be found from other sources, or paid for by increasing National Insurance contributions, whether for the Pensions Commission's proposals or other reform models.

Is Option 2 possible? Further analysis of the options for state pension reform, and the implications, is in a separate PPI paper[62]. But feasible options exist that would reduce the proportion of pensioners eligible for Pension Credit from current levels, rather than just reduce the expected future spread of Pension Credit. For example, a flat-rate state pension with improved coverage set at an individual entitlement of around 21% of NAE (or 16% for each member in a couple) is just one model that would take the proportion of pensioners eligible to Pension Credit down to around 10% (Chart 6) and yet would be within the cost envelope of the Pensions Commission proposals.

This is possible because a quicker transition to a flat-rate pension than envisaged by the Pensions Commission releases money to target towards lower-income people, rather than continuing the opportunity for higher income people to get more out of the system for longer.

[62] PPI (2006 TT), forthcoming

Chart 6[63]



Other more generous models to achieve Option 2 may need higher National Insurance (NI) contributions to help pay for it. Only a small increase in NI contributions (in the region of 1% for employer and employee, similar to the recent increase to pay for reforms to the National Health Service) should be necessary[64].

If so, then this could be instead of at least part of the envisaged auto-enrolment employee contribution of the NPSS, the contingent compulsory contribution of the employer, and the proposed NPSS tax incentive.

A small additional NI contribution – even if compulsory – may be preferred by employers and employees to assure a good foundation state pension. Under this approach, commensurately less contribution could then be expected into the NPSS – only 6% in total, say, rather than 8%. Full value from the NPSS saving would then be achieved with no means-testing trap. Total pension – state and NPSS – would be at least as good as otherwise expected, with less exposure for the individual to investment and annuitisation risk.

[63] PPI analysis from Pensions Commission (2005), information from Pensions Commission, Steventon (2005)
[64] Steventon (2005) Table 9 p. 26

There are some obvious trade-offs in putting even slightly more than the Pensions Commission envisaged into state pensions and less in the NPSS:

- Two of the main drivers for the NPSS are to increase coverage (especially for lower earners) and to reduce running cost of pension provision. State pensions have the highest coverage and lowest running cost[65].

- State pensions carry no investment longevity risk for the individual, as the NPSS would. State pensions carry the risk of change from future political decisions, but so would a state-sponsored NPSS or similar vehicle.

- A higher amount in the NPSS means less in pay-as-you-go pension and more in funded savings. Another way to increase the level of funding in the system, under any structure of state pensions, is to use a 'Buffer' or 'Reserve Fund'. This invests part of the pay-as-you-go revenues to help smooth cash flow for later payouts. In other countries, including Ireland, New Zealand and Norway such a fund can be controversial but it can also help to support long-term stability of the state pension system[66].

However achieved, with Option 2, the purpose of an NPSS-type vehicle would be to encourage individual ownership of discretionary savings. This could be a simpler, more flexible version of the NPSS as proposed, similar to KiwiSaver. It could be easier to implement sooner.

Although this model of state pension reform removes some constraints on product design and implementation for the NPSS, lessons from KiwiSaver are relevant whatever the state pension reform chosen. The most relevant lessons are discussed further in Chapter 4.

[65] Pensions Commission (2005) p. 71
[66] Pensions Commission (2005) p. 167; (PPI 2006 SSPS) p. 18

Chapter 4: Design and implementation choices for the NPSS

This chapter considers some product design and implementation choices for an NPSS-type solution in the UK, whatever state pension reform has been agreed. It considers the most striking product design and implementation lessons from KiwiSaver for a similar 'BritSaver' product:

- Ways to increase appeal as a discretionary savings product should be investigated, including flexible withdrawal options, the appropriate form of savings incentives and help in making financial decisions.
- Ways to minimise the risks of implementation should be considered, such as working with existing providers and processes, phasing in and aiming to lower cost without making very low cost the focus.

Discretionary savings product design
Comparison between the NPSS and KiwiSaver suggests some design features for a discretionary 'BritSaver' that could increase the appeal of the product and widen Government policy aims:

1. **Use more encouraging language about helping would-be savers**: The rationale for the NPSS is in the context of the pensions debate in the UK which is spoken and written about in terms of *people needing to save more.* This is in marked contrast to the language of the debate in New Zealand. KiwiSaver is not promoted as a new product because people must save; rather, it is assumed people want to save, and KiwiSaver helps them to do so: *giving people increased financial independence and flexibility, particularly in retirement*[67]. This is consistent with the Retirement Commission's finding that people engaged more with personal financial planning if the conversation did not start with the R word (retirement)[68]. In the UK, taking the emphasis off the P word (pensions) may also have that effect.

2. **Reconsider incentives**: The financial incentives for the NPSS and KiwiSaver are structured very differently. There is no evidence to suggest a lump sum kick-start from Government such as that in KiwiSaver is a more or less effective incentive to join than the continuing 1% contribution for Government proposed for the NPSS. If the available tax incentives on existing UK provision are different from the incentive in the NPSS, then comparisons will be made to see which is best for individuals, especially higher-paid employees. It may prove too difficult a comparison so employers may close schemes in favour of the NPSS for simplicity. Or, it may encourage a split between higher income employees staying in existing provision and lower income employees being moved to the NPSS. Given the widespread agreement that the current pension tax incentives are regressive[69], it would be preferable to review them before introducing any new incentives in the NPSS.

[67] Memo 6 April 2005 from Minister of Finance to Cabinet Policy Committee
[68] Retirement Commission (2004)
[69] Pensions Commission p. 312

3. **Consider flexible savings features:** Making the product a general savings vehicle means that it does not need to be as highly restricted as a pension. This means that annuitisation rules could be relaxed. The ability to take all the savings as a lump sum after a certain age may be more appealing, and more relevant to the target group of low earners. Also, the facility to take early withdrawals at times which are difficult financially, such as the purchase of a first home, may make saving more relevant to younger people. The link to Child Trust Funds and other Government initiatives could also be explored. Early withdrawal options and removal of the annuitisation requirement should be considered alongside the possibilities for reshaping tax incentives. These options are constrained if the product is planned to sit above a state pension system with high levels of means-testing, so these features also have to be considered alongside state pension reform.

4. **Guide would-be savers with financial information**: In New Zealand, the Retirement Commission and *Sorted* website are well-established sources of information and guidance on making financial decisions. This is now to be enhanced with financial education 'champions' in the workplace widening the reach of such guidance where it is needed because of the workplace-based context of KiwiSaver.

   The UK has no such unique source of unbiased help. Introducing a similar body offering information, education and tools to help make decisions on financial matters – not just connected with the NPSS, but also covering issues such as debt management and all forms of saving - seems not only essential if an NPSS-style product is introduced, but if done well is also likely to be popular.

Operational change
The KiwiSaver plans also suggest some lessons that the UK could consider in order to minimise implementation risk:

1. **Work with existing providers and regulation processes:** The UK could follow a similar model to selecting providers, funds, governance and regulation as in KiwiSaver rather than the 'one size fits all' approach of the NPSS proposal. By making the decision to design KiwiSaver around existing providers (not funds), liability and implementation risks are reduced compared to the NPSS model.

   For example, the NPSS is responsible for a new default investment fund (and a small number of other funds) which is expected to be the home for most NPSS saving. A KiwiSaver provider is responsible for its own investment funds (and may use its current funds, which have the advantage of an investment performance history). Organising around providers could work just as well in the UK environment.

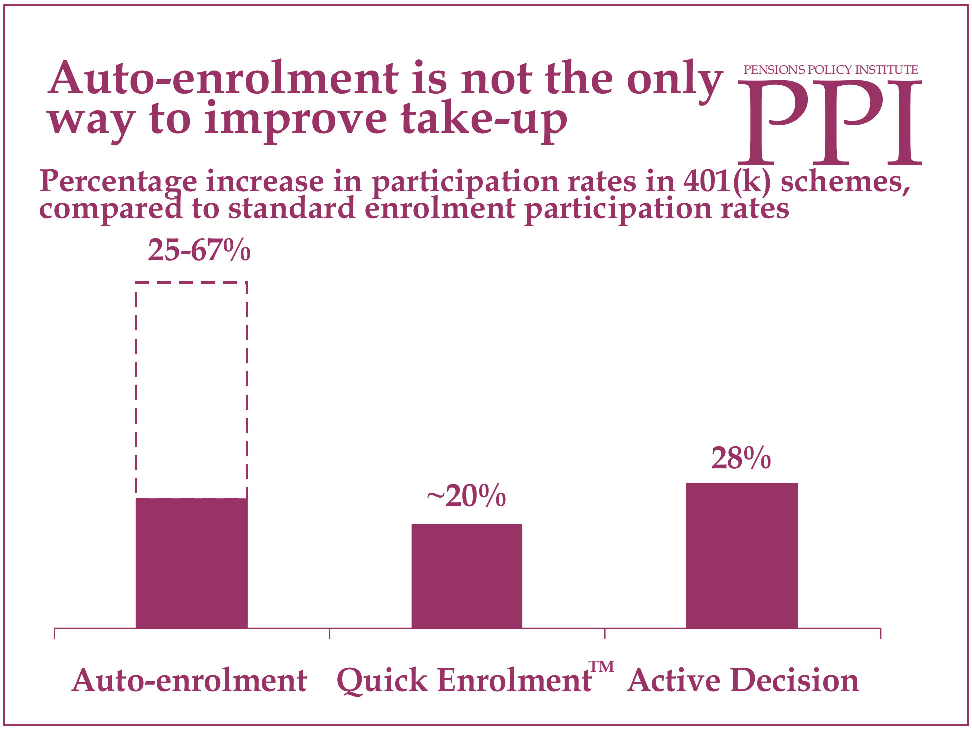
Instead, the NPSS proposal is heavily dependent on the successful development of new regulation, governance and organisation for the NPSS:

- A KiwiSaver provider can be any type of institution which satisfies existing registration for superannuation arrangements and specific new KiwiSaver requirements. Government does not then have to make a choice on a certain type of provider or style of fund management.
- The starting point for regulation and governance in the UK could be existing approved pension plan regulation, suitably amended for NPSS objectives. The NPSS proposal instead requires a concentration of governance in the NPSS organisation.
- The use of a competitive tender (sub-contracted from Government) for default providers as in KiwiSaver can be used to spread the risk of investment under-performance into a number of default funds. This is a different model to that of the NPSS which anticipates most people will end up in one default fund.

2. **Phase in to minimise operational risk:** The NPSS requires multiple systems to be in place at the start of what will be a radical switch affecting millions of people on one day, say, 6 April 2010. There is therefore an accumulation of operational risks. Confidence is not high for the delivery of Government-sponsored IT projects on time and on budget, so it is appropriate to look for ways to make smaller changes, which could perhaps start earlier. A phased approach could also help to test product design features and fine-tune the NPSS design:
   - NPSS depends on having a way of sending monthly contributions from employee to investment fund. Currently in the UK, the PAYE system cannot do monthly individually-attributed transfers, which is possible with the PAYE system in New Zealand. Until there is some confidence that a new PAYE system or equivalent will be working in the UK within a reasonable timeframe, the NPSS as proposed seems very high risk.
   - Employees are auto-enrolled into KiwiSaver as they change jobs. Other employees and self-employed people can join should they choose. This seems a practical way to avoid an overload on the NPSS administration systems on day 1.
   - Auto-enrolment is proposed in both the NPSS and KiwiSaver, assuming that take-up rates will be higher than under a voluntary scheme, because of the inertia of people making savings decisions. Auto-enrolment is the new feature expected to lead to an increase in the coverage of savings.

While auto-enrolment seems to have improved the participation of employees in employer-based schemes in the US and UK, it is untested on a national scale. It may be that there is something about an employer environment helping auto-enrolment to be effective that will be hard to replicate in a national scheme, for example, the power of peer pressure, or appeal to employees in certain industries. Other methods of enrolment have also been found to increase participation, which may or may not be more effective nationally (Chart 7).

Chart 7[70]



For example an 'Active Decision' regime (where employees have to make an explicit choice to opt-out or opt-in to a specific fund, with no default to fall back on) is suggested as being more appropriate in situations where potential members are heterogeneous and the sponsoring organisation is concerned about liability for participation and investment decisions[71]. Both conditions apply to a national savings scheme.

[70] Choi et al (2001, 2004a, 2004b, 2006); Madrian and Shea (2001); Mitchell and Utkus (2006). See also Pensions Commission (2005) pp.68-69
[71] Choi et al (2004b)

The phasing in of NPSS could allow different enrolment techniques to be tested and the outcome measured. For example, it could start with something like Active Decision, and move up to auto-enrolment if outcomes are not as good as expected. Similarly, as contingent compulsion on employers is untested and controversial, and requires new administration by employers, it could be introduced at a later stage if outcomes suggest it is necessary.

3. **Aim to lower cost, but loosen the focus on achieving lowest possible cost**: By taking a phased approach, the NPSS may not get to the lowest possible cost structure and certainly not to the target of 0.3% AUM. But an NPSS, designed as suggested more like KiwiSaver, could still be run at lower cost than most current UK pension provision. The competitive tender for defaults is one way that cost standards can be influenced. Not mandating annuitisation removes the cost of providing income in the decumulation stage. The Government could also choose, as in New Zealand, to give an explicit fee subsidy if it felt that consumers are very concerned with lowering charges still further.

   But there is no evidence to suggest that people are not saving because of concern over charges. Investment performance can have a much bigger effect on final fund size than fees[72], and the feasibility of the 0.3% target in the NPSS is challenged. This all suggests that ways to lower the cost to the consumer should be important, but not the most important factor in the design of the NPSS.

[72] IMA (2006)

Next steps

This paper has outlined some policy choices and design issues for NPSS and suggested that Government needs to make policy choices on state pensions before making a decision on whether to introduce something like NPSS.

The specific design of KiwiSaver was decided following the recommendations of the Savings Product Working Group. This group was tasked to advise the New Zealand Government on *the design and implementation of work-based savings products for retirement*, within a specified framework[73].

The group was not asked to consider what the policy issue might be or what an appropriate policy response should be – that had already largely been decided by Government. The group was asked to work within some boundaries such as the scheme should be for work-based savings, and not to address issues such as tax incentives which Government would address separately. Very specific practical questions were asked of the group (such as *What design features will be necessary to allow for on-going contributions to such a product, or, maintenance without contributions during periods of non-employment?*).

The group responded within 4 months, and draft KiwiSaver legislation was ready within another 18 months for a planned implementation date within another 14 months. Once the policy issues are decided and a broad outline of a product suggested by Government, practical details on what is possible for design and implementation can follow quite quickly.

[73] See Statement by Finance Minister Hon Dr Michael Cullen 13 May 2004

Appendix: Detailed comparison of NPSS and KiwiSaver

	National Pension Saving Scheme (NPSS)	KiwiSaver
Policy context[74]	*It is a reasonable aim of public policy to seek to ensure that the median earner achieves an income replacement rate* [in retirement] *of at least 45%.*	*…help New Zealanders to save, giving them greater security and choice and strengthening the economy.*
Aim[75]	*The NPSS is designed to ensure that:* *…people achieve a baseload of* [earnings-replacement] *pension income in retirement, thus limiting the danger of any means-tested reliance on the state...* *… people not presently covered by adequate pension arrangements are enabled and strongly encouraged to save for a pension, while their employers are required to make a modest matching contribution….not intended to replace existing good pension provision* *The potential to make pension saving possible at substantially lower Annual Management Charges is one of the key rationales for creating this national system….The target we propose is 0.3%.*	*A voluntary work based savings scheme … KiwiSaver includes a first home deposit subsidy.* *…to encourage a long-term savings habit and asset accumulation… with the aim of increasing individuals' well-being and financial independence …designed to complement* [state pension] *for those who wish to have more than a basic standard of living in retirement…* *The Government's role in this scheme is to facilitate, rather than coerce, saving….it has been designed to minimise compliance costs for employers and to work off existing processes where possible.*

[74] Pensions Commission (2005) page 274; Press Release Finance Minister Hon Dr Michael Cullen 19 May 2005
[75] Pensions Commission (2005) pages 20, 380, 362, 394, 396; www.securingyourfuture.govt.nz homepage; Memo 6 April 2005 from Minister of Finance to Cabinet Policy Committee, Explanatory Note to KiwiSaver Bill, New Zealand Treasury (2006)

	NPSS	KiwiSaver
Timing	Proposed November 2005; Government White Paper proposals expected Spring 2006; launch by 2010.	Announced May 2005; Bill introduced to Parliament 2 March 2006; Royal Assent expected around October 2006; launch anticipated 1 April 2007.
Nature of compulsion: • **Individual**	Auto-enrol, right to opt out.	Auto-enrol, right to opt out.
• **Employer**	Compulsory contributions if member stays enrolled, unless alternative employer scheme is at least as good.	No compulsion to contribute. Must give KiwiSaver information to employee from Inland Revenue and channel contributions from employee to Inland Revenue.
Opt-out: • **Initial**	Employees inform NPSS of opt-out within 4 weeks of joining.	Employees inform Inland Revenue of opt-out within 2-6 weeks of starting new job, by completing a written opt-out form.
• **Subsequent**	Opts in or out allowed at 1 month's notice, status must be maintained for minimum 6 months period.	Contribution holidays allowed after an initial 12 months for up to 5 years. Can be repeated. Contributions holiday allowable during initial 12 months on grounds of serious financial hardship.
Membership: • **Employees**	All employees earning over Primary Threshold. Triggered again for new job starters and every 3 to 5 years.	New job starters. Existing employees can choose to opt-in.

	NPSS	KiwiSaver
• **Self-employed & economically inactive**	Can choose to join with same tax relief as employees (will need new contribution collection process for self-employed).	Can choose to join. Contributions will be collected either by the Inland Revenue or directly by the KiwiSaver provider.
Age eligible	From age 21.	From age 18; those under 18 can choose to join. People already receiving state pension (age 65 and over) are not eligible, but those who joined before reaching state pension age can continue contributing.
Expected membership levels (from Pensions Commission or New Zealand Government)	Modelling assumed 65%-80% take up of employees currently not contributing to a pension (depending on earnings), and 25% take-up by self-employed. Roughly 7m in total in either NPSS or approved alternative, new to pension saving. Note 4.6m people have been estimated as not being members of the existing occupational scheme at their employer (DWP, 2004). If their existing scheme became an approved alternative, many such people could be expected to be new savers in their employer's existing scheme rather than the NPSS. Voluntary contributions in aggregate equivalent to an additional 2% of band earnings.	25% of eligible population after 7 years: roughly 680,000 in either KiwiSaver or approved alternative.

	NPSS	KiwiSaver
Minimum contributions:	As a % of pre-tax earnings between Primary Threshold and Upper Earnings Limit (£4,888 to £32,760; 18% to 122% NAE; to be indexed to earnings)	As % of total pre-tax salary or wages, including bonus, commission, overtime etc.
• **Member**	4%	4%
• **Employer**	3%	None
• **Government**	Tax relief worth 1% of earnings band plus a tax-free lump sum available at pension age, or (alternative proposal) 1.5% with no lump sum.	NZ$1,000 "KickStart" contribution at first joining. Government contribution to members' fees (flat annual NZ$ amount per member) to be paid into each member's KiwiSaver account; amount to be determined. Additional subsidy for first home purchase: see later.
Voluntary additional contributions	Yes – both member and employer up to maximum total annual cash limit of around £3,000 (set at 16% of band earnings for a median earner).	Member can choose alternative of 8%. Additional contribution can be made via Inland Revenue or direct to provider. Employer can choose to contribute (via Inland Revenue) on own terms and conditions. Those not employed can choose their own contribution level.

	NPSS	KiwiSaver
Alternative arrangements	Employers can provide an alternative workplace scheme if levels of employer, and total, contributions exceed what they would be in the default NPSS taking into account the effect of charges; and auto-enrolment is as strong as the NPSS.	Employers with an existing work-based Registered Superannuation Scheme (RSS) will be able to apply to the Government Actuary for an exemption from the automatic enrolment provisions if the RSS: is open to all permanent employees, has total (employer and employee) contributions of at least 4%, employer contributions vest within 5 years and balances can be transferred to other schemes. Exempt RSS do not qualify for KickStart or fee subsidy, but do qualify for first home deposit subsidy. Existing RSS will be able to continue operating independently of KiwiSaver, convert to a KiwiSaver scheme or establish a KiwiSaver scheme within the existing Trust Deed. Members of RSS can opt in to KiwiSaver.
Help for employers	No exemptions, but financial help from Government towards contributions from small employers should be considered. No National Insurance payable on employer contributions.	No exemptions, but Government subsidy to payroll agents to meet PAYE-related compliance costs for the first 5 employees of a small company (this is separate from KiwiSaver).

	NPSS	**KiwiSaver**
Contribution collection	Payroll deduction to NPSS. Likely to need new contribution collection system, as PAYE identifies individual contributions only annually.	Payroll deduction via employers to Inland Revenue, using existing PAYE system.
Investment of monies	Individual accounts held at NPSS; NPSS allocates money to chosen fund on behalf of individual.	Inland Revenue forwards contributions to the individual's registered KiwiSaver provider for investment on behalf of individual.
Investment choice	Funds chosen by individual from available list of core c. 6 to 10 funds arranged by NPSS. NPSS 'bulk-buys' core funds, negotiating for low fees. Should include indexed funds and a Government bond fund. Investment in other funds could be allowed. Outstanding issues include: length of mandates; whether one or more mandates for any one asset category.	Individuals can choose a registered KiwiSaver provider and investment fund(s) from those offered by the KiwiSaver provider. Providers will be able to offer KiwiSaver schemes if they meet the requirements of the Superannuation Schemes Act 1989 and additional KiwiSaver criteria such as lock-in of funds, transferability, and 'not unreasonable' fees.

	NPSS	KiwiSaver
Default investment (if member does not make an active choice on where money is to be invested)	A lifestyle 'smoothing' fund. Definition of the default fund a role for the NPSS, but legislation could define it 'fairly clearly'.	Members not specifying a KiwiSaver provider will be randomly allocated a default provider, and to the default conservative investment product within that provider's KiwiSaver scheme, by the Inland Revenue. A 'limited number' of default KiwiSaver providers will be selected via an open competitive tender process. Brief details only on the selection criteria are currently available. Selection will be made shortly after the KiwiSaver Bill gains Royal Assent (expected October 2006). Employer can choose any one provider as a default for employees.
Splitting investments	Allowable subject to minimum percentage.	Members can only be invested with one KiwiSaver provider at a time, but can invest in a number of different products offered by that provider.
Changing fund choice	Annual or semi-annual.	Any time.
Portability of account	Portable on changing employer, and transfers between NPSS and other pension schemes should be allowed.	Fully portable as independent of employer.

	NPSS	**KiwiSaver**
Government guarantee of return	None	None
Benefit withdrawal	Available as rules of other pension saving: any age from 55 to 75. No early withdrawal.	Full amount any time after state pension age (65) or after 5 years, whichever is later. Funds can be withdrawn if in serious financial hardship (not Government KickStart incentive) or permanent emigration. After 3 years membership, a one-time withdrawal of member's funds (not Government KickStart incentive) is allowed subject to eligibility for a first home purchase. This attracts an additional subsidy of NZ$1,000 for each year of membership up to NZ$5,000.
Form of 'pension' benefit	Have to buy an annuity on open market (or use drawdown equivalent before age 75). Can choose single or joint life annuity; strong guidance to price-linked rather than flat. NPSS should consider bulk-buying annuities.	After age 65, members have the option of withdrawing funds as a lump sum. Providers may choose to offer other options such as an annuity (currently a very small market for annuities in New Zealand).
Inheritance rights before taking benefit	To member's estate.	To member's estate.

	NPSS	KiwiSaver
Financial advice e.g., on opt-out decision	Generic advice envisaged to be available from Government (no details given by Pensions Commission).	Employers required to give new employees an information pack provided by Inland Revenue, containing information to help select a KiwiSaver provider and on how to opt-out. Government to run an education campaign explaining KiwiSaver. *Sorted* website provides information and education on general financial concepts and terms, run by the Retirement Commission, an independent Crown entity. KiwiSaver provider can provide advice and on-sell other products.
Communication within product account	'Strongly branded and nationally recognised' annual statements of combined value of NPSS account and state pension: amounts accrued and likely future amounts, showing range of different pension ages. Communication function could be outsourced from NPSS.	If a default KiwiSaver provider is allocated, Inland Revenue sends scheme provider's investment statement to employee. Inland Revenue notifies employee of contributions sent to default KiwiSaver provider. Account information sent from KiwiSaver provider to member.
Branding	Benefits of link to National Savings & Investments (for branding and organisation) 'should be explored'.	Branding of KiwiSaver vis-à-vis provider branding under consideration.

	NPSS	KiwiSaver
Governance and regulation	NPSS is set up as a non-departmental body, established under statute with own legal identity, and its own Board, directly responsible to Parliament to a defined remit with a Minister accountable for its continued existence and expenditure. Legislation may set out guidelines, but leave 'significant latitude' for detailed decisions and expert consideration of issues relating to the range of appropriate funds within the NPSS. Product and provider regulation not considered by Pensions Commission, but envisaged to be in legislation.	Processes to be centrally administered by Inland Revenue: information provision from employers to employees; allocating default providers; receiving and forwarding contributions; managing contribution holidays etc. Provider, disclosure and investor protection regulation similar to that for existing registered superannuation schemes. All regulation overseen by Government Actuary (within Ministry of Economic Development) who will additionally: register KiwiSaver schemes; approve employer exemptions; monitor Government contribution to members' fees etc.

	NPSS	KiwiSaver
Costs: • **Set-up**	Not assessed (but could be substantial as new contribution collection process required).	Government costs of NZ$53m (£21m) in 2007 for entire KiwiSaver package (operational from 1 April).
• **Ongoing**	Core funds will have to operate so that total costs are 'substantially below' 0.5% of assets under management p.a. with target of 0.3% (although whether this can be achieved has been questioned). Gross cost of tax incentives: c. £1bn – £2bn pa (PPI estimate)	No restriction on level of provider charges. No information available on planned level of Government contribution to members' fees. Estimated total cost to Government over next 5 years around NZ$700m (£272m).
Pre-tax state benefit for a median earner, as % National Average Earnings	**27% of NAE** Assumes full transition of Pensions Commission reform proposals (by 2053). Because of earnings-related accruals of State Second Pension, state pension benefit will be less for lower earners and more for higher earners during transition e.g., by 2030: 23% of NAE for an earner in the 1st decile, 30% NAE in the 9th decile of male full-time earnings (PPI estimate).	**33% or 42% of NAE** Lower end of range is for a person in a couple; higher end is for a single person living alone (regardless of work or earnings history).
Expected level of benefit from new scheme <u>for a lifetime member at default level</u>	**15% of NAE**	**8% to 10% of NAE** depending on whether withdrew funds for a first home deposit.
Total	**42% NAE**	**41%-52% of NAE** Note: Government gives no illustrations of KiwiSaver income, only the possible lump sum. Income above calculated by the PPI using Pensions Commission assumptions of rate of return and annuitisation for comparison.

Acknowledgements and Contact Details

Thanks to all the many people in Wellington and Auckland who generously gave their time to discuss aspects of KiwiSaver. The help with requests for information from Kim Everett, David Feslier, Professor John Gibson and Grant Scobie is especially appreciated.

The Pensions Policy Institute is grateful to the reviewers of this paper:

Chris Kenny	Sarah Meagher
Jonathan Lipkin	Graham Vidler
Michael Littlewood	David Yeandle

Alison O'Connell takes responsibility for errors, omissions and interpretations.

The Pensions Policy Institute is an educational charity promoting the study of retirement provision through research, analysis, discussion and publication. The PPI takes an independent view across the entire pensions system.

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The Family Resources Survey 2003/4 was supplied by the UK Data Archive, University of Essex, and is funded by the Department for Work and Pensions. The UK Data Archive and the Department for Work and Pensions bear no responsibility for further analysis and interpretation.

Published by
PENSIONS POLICY INSTITUTE

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www.pensionspolicyinstitute.org.uk
ISBN 0-9548248-5-7