REPORT BY THE PENSION PROVISION GROUP

We all need pensions - *the prospects for pension provision*

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REPORT BY THE PENSION PROVISION GROUP

We all need pensions - *the prospects for pension provision*

LONDON: THE STATIONERY OFFICE

The Pension Provision Group

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Foreword

from the Secretary of State for Social Security

Our manifesto said 'we believe that all pensioners should share fairly in the increasing prosperity of the nation'. Average living standards for pensioners have increased markedly over recent years. The average incomes of newly retired pensioners with occupational pensions are higher than ever before. However, behind that average, the income gap between the better off and the poorest is greater than at any point in the last thirty years. Women, part-time workers and the self-employed are less likely to have occupational or personal pensions, and where they do, their incomes from those pensions are likely to be lower than those of men who have worked full time for an employer.

Much of today's pension system was founded on the model of a male breadwinner who supported himself and his family, who suffered, at most, temporary interruptions to a life of full-time work, often for a single employer, and who had a relatively short retirement. Since then economic and social change has been dramatic. Fewer people now work for a single employer for their entire working lives, and self-employment is much more widespread. Many pensioners now live much longer and spend more time in retirement than was previously the case. More women work, but often not on the same terms as men. Their caring and domestic responsibilities mean that they are more likely to take breaks in their careers, work part-time, and be low paid. Finally, the old assumption – that women, as workless members of families headed by working men, could and should rely largely on their husbands' pension provision – is no longer valid.

Pension provision has also changed. The growth of occupational pension schemes in the 1950s and 1960s was followed by the introduction of SERPS in 1978 and compulsory second-tier pensions for employees. More recently, personal pensions have grown as an alternative source of second-tier provision, whilst SERPS was reduced in value. These changes have widened the gaps in provision between those with and without good second-tier provision.

Last July, I launched our Pensions Review. The Review is being driven forward in the Department of Social Security by John Denham, working closely with Ministers in other Departments. At the start of the Review process, we set out the ten challenges which must be met if we are to succeed in narrowing the gaps in retirement incomes, between the richest and poorest pensioners, between women and men, and between full- and part-time workers. The Review is developing proposals which will contribute to a Green Paper later this year, which will aim to meet those challenges. They will also ensure proper regulation of pension investments and strike a balance between public and private funding.

Security in retirement comes from a combination of the basic state pension and a good second pension in a partnership between public and private provision. The Government is pledged to retaining the basic state pension as the foundation of pension provision and to reforms which will extend good second-tier provision.

The Government has taken early action to provide more help for today's pensioners. We have honoured our commitment to uprate the basic state pension in line with prices; we have made available a total of £400 million to help pensioners with winter fuel bills; we have cut VAT on domestic fuel bills to five per cent; and we have established pilot projects in nine areas to look at the best ways of ensuring that all pensioners receive Income Support to which they are entitled.

In considering what action we need to take to ensure that all pensioners – today's and tomorrow's – can enjoy a decent standard of living in retirement, it is important to understand and debate the trends in pension provision, and to establish their impact on future pensioner incomes. It is this need which led us to set up the Pension Provision Group, and to commission this report.

The Group's report makes an important contribution to the debate on future pensions policy. For the first time it provides everyone with an interest in pension provision with a clear, comprehensive and authoritative statement of the current state of provision in the UK, and the future trends which we can expect.

I am grateful to the Pension Provision Group for the energy and commitment which they have put in to produce this report. They have given their time, experience and expertise, and their report is sure to prove most valuable in the major work on pensions reform which we have ahead of us.
I particularly want to thank Tom Ross for his chairmanship of the Group.

The most significant conclusion which the Group has reached is that, without action to address the gaps in pension provision which they have identified, the gaps between those with and without a good income in retirement will continue to widen. The Government is committed to taking that action and ensuring a decent income in retirement for all of our people.

Harriet Harman

June 1998

Preface

by Tom Ross, Chairman of the Pension Provision Group

The Pension Provision Group was established by the Secretary of State for Social Security in summer 1997 to contribute to the Government's Pensions Review. Our role has been essentially diagnostic, as reflected in our terms of reference: 'To determine the current levels of pension provision in the UK, and likely future trends; and to report by February 1998.'

The pensions system is very complicated and the scope for research is considerable. In the time available to us we have been guided, in deciding on the particular issues to address, by the challenges set out by the Secretary of State when she launched the Pensions Review. These are reproduced in the first chapter of our report. We hope that our report will encourage an informed debate on these (and other) pensions challenges and on the policy proposals which are brought forward by the Government in due course.

The provision of secure and adequate retirement incomes is a very long-term undertaking, and there are many hazards along the way. Whilst the UK system has many positive features and has served some pensioners well, there are many others who have not been so well provided for. We envisage this gap widening if no action is taken.

More funded second pensions may be expected to play an important part in filling this gap. But it seems to us to be unrealistic to expect those on low incomes to be able to provide adequately for themselves without help. We therefore also envisage a continuing role for the state as a provider of pensions, not just as a facilitator and regulator.

We think that it is very important that everyone takes a keen interest in their pensions and that all providers, including the state, give regular, clear, unambiguous information to people about the pensions they can expect from their various arrangements. We hope that our report will play a part in this vital process.

We are indebted to the many individuals and organisations who helped us with advice, research and comments. They are too numerous to mention here, but they are listed in Annex B. Without their help we could not have completed our work to the extent, or to the timescale, that we have.

I would like to thank all members of the Group for the very considerable effort they have devoted to our work. Our backgrounds are varied, but we blended into an enthusiastic and committed team.

Finally, my colleagues on the Group join me in thanking the Group's Secretariat, led by Guy Fiegehen and including Iain Gordon and Joyce Carvalho. Without their single-minded commitment we would not have completed our task.

Tom Ross

April 1998

1 Introduction

In this chapter we introduce the issues and questions we believe need to be addressed.

We:

- set out our terms of reference and our independent, diagnostic role;
- describe our role within the wider Pensions Review and refer to the Secretary of State's challenges; and
- highlight the key issues and questions identified by the Group which we discuss in later chapters.

The basics

To start with some fundamental points:

- pensions affect everyone. We all need pensions for our old age. Pensions replace our incomes when we retire;
- nearly all of us contribute to the cost of pensions – our own and others' – while we are in paid work. It is from the product of work that all pensions are paid; and
- because paid work is the basis for most pension provision, people who spend time not in paid work, or who earn little when they are, are most at risk of poverty in old age and are most likely to depend on the provision that others make. Women are particularly vulnerable in this respect because of their traditional family roles and because more are on low incomes.

Pensions involve planning for the long term:

- decisions we take now – whether personally as individuals or collectively through government or our employers – affect our own living standards and those of others for many decades ahead;
- because the implications can be difficult to predict and may not be felt for a long time there is always a temptation – for governments as well as individuals – to postpone decisions about pension provision. The cumulative effect of delay can be very serious, both for individuals and for society as a whole; and

- the system of pension provision needs the flexibility to respond to the demands of often unpredictable changes. But changes should, where possible, be introduced sympathetically with due consideration being given to their impact on long-term planning.

A fifth of the population is retired. About ten million people in the UK receive state retirement pensions now. By 2030 it will be around 14 million despite the planned rise in women's state pension age from 60 to 65. Although they have been getting better off on average relative to the rest of the population, many pensioners are poor today. On present policies and trends, many will also be poor in the future. The critical question for policy makers is: what can governments and individuals do about this?

Our task in the Pension Provision Group is to assess the structure of pension provision in the UK, the influences on it and their effects as well as the direction – based on current policies – in which they are leading. Pension provision is the result of many economic and social processes which are themselves constantly changing and evolving. We shall look at these. We shall also look at the framework for pension provision to see whether it provides the right balance of stability and flexibility that people and their employers need, so that they can adapt to change and plan for the future with the maximum degree of certainty.

Role of the Pension Provision Group in the Pensions Review

We were appointed in the summer of 1997 as part of the Government's Pensions Review. The Review is led by Ministers and has a number of strands of activity. Within the Review we have an essentially diagnostic role.

We are an independent group, drawn from a number of different pension backgrounds. Our participation has been entirely in our personal capacities. Our membership is shown at the front of this report.

Our terms of reference are:

> *'To determine the current levels of pension provision in the UK, and likely future trends; and to report by February 1998.'*

The Secretary of State for Social Security has set ten challenges for the Pensions Review. They are set out in the following box. They form a starting point for our analysis and a reference point to assess the value of our report.

Clearly, given our terms of reference and the nature of our role, those people who are not well provided for under the current system are a major focus of our report.

THE SECRETARY OF STATE'S CHALLENGES FOR THE PENSIONS REVIEW

1. *To achieve a sustainable consensus on pensions policy: so people can properly plan for the future.*
2. *To agree where the responsibility for funding pensions should lie: and to establish the right balance between the public and private sectors.*
3. *To respond to demographic change.*
4. *To respond to social and labour market change: to ensure our pension system provides for* ***everyone*** *– men and women, full- and part-time workers, the self-employed, those in permanent jobs and people on short-term contracts.*
5. *To ensure resources devoted to pensions are used to maximum effect: so that every penny available for pensions is used as effectively and efficiently as possible.*
6. *To strike the right balance between the generations: we must look at the position of today's pensioners, as well as facing the challenge of providing for the future.*
7. *To narrow the pensions gap between men and women: to give greater security in retirement.*
8. *To get the regulation of pensions right: so people are confident their pensions are secure.*
9. *To raise awareness of pensions and improve the level of financial education: so that people understand the importance of saving for their retirement and make the right choice about what sort of pension is best for them.*
10. *To tackle the growth in pensioner inequality.*

Our report provides analysis and background for the Pensions Review and in this way will inform the decisions the Government will reach. We aim to establish the consequences of continuing with present pensions policy. But our remit is not to propose policy solutions, rather to identify the areas that policy needs to address and to suggest ways in which the effectiveness of alternative solutions can be judged.

Our focus is on pensions, as they are the main way in which people provide for their retirement. But in some parts of our report we have given the phrase 'pension provision' a wider interpretation. People may choose to make part, or indeed most, of their provision through other forms of saving and investment. So when we look at pensioners' incomes, for example, it is right in that context to take account of all sources of income including income from pensioners' assets.

More people are spending parts of their lives working in the rest of the European Union and elsewhere abroad. Working in other countries can affect people's pension rights. However, given our remit, we decided we would not look further at the implications of this.

Sources of information

We have been helped in our work by the many reports on pension matters that others have published in recent years. They have come from a range of sources and contain a wealth of information. A key part of our job has been to bring this information together and to give an independent view of what it tells us about both the present position and the direction in which pension provision is heading.

As well as published papers and reports, we have drawn on the latest research in a number of areas and have been able to obtain further analysis of some of the main official information sources. We have also had the benefit of discussions with a small number of other pension specialists. Details of our sources and contacts are shown in Annex B. We are grateful to everyone who has helped us in this way.

Although extensive information is available from various sources, it is collected and presented in different ways. This makes it impossible to provide as comprehensive and reliable a picture as the issues at stake merit and as would be possible with better co-ordination. We therefore believe that it would be helpful, going forward, if an independent body had lead responsibility for accumulating, analysing and publishing information on current and future pension provision and its implications for pensions policy.

Key issues

As we shall see, pensions are complex and require long-term planning. They therefore raise issues which give rise to widely differing opinions. We think it important to identify what we see as the main issues facing the UK, both today and in the future, to ensure that our report will inform the debate constructively.

The major issues facing pensions policy and planning are in our view:

- **demography and the cost of pensions**
  with the rising number of retired people, can society afford the pensions the state has promised to pay in the future? How confident can we be that non-state pensions will meet the expectations of future pensioners?
- **inequality**
  what are the implications of current policies for the gap between rich and poor pensioners and for the respective positions of men and women and of pensioners and non-pensioners?

- **pensions for those who do little or no paid work**
  do current arrangements meet the needs of those who – for whatever reason – can do little or no paid work, many of whom contribute to society in other ways?
- **extent of means-testing**
  will the need for means-testing reduce in the future as society generally gets better off?
- **the future role of second-tier pensions**
  what benefits will they deliver and to whom?
- **compulsion**
  does the state need to increase the existing requirements for people to save for their own retirement?
- **funding vs pay-as-you-go**
  should more pensions be provided through pre-funded schemes to reduce the extent of pay-as-you-go?
- **planning with confidence**
  does the present level of pensions information, education and awareness enable people to understand and plan their own pension position?

Structure of the report

Chapters Two to Nine present our analysis of the available information that we have examined:

- in Chapter Two we give a general introduction to the main features of pension provision in the UK today;
- in Chapter Three we look at the incomes of today's pensioners and the various trends and influences on them in recent years;
- in Chapter Four we examine changes to the labour market in the context of their impact on pension provision;
- in Chapter Five we turn to state financial provision for people in retirement, both now and in the future;
- Chapter Six is devoted to occupational and personal pensions;
- Chapter Seven deals with the risks and levels of efficiency involved in the main forms of pension provision;
- in Chapter Eight we examine a number of issues on the financing of pensions; and
- in Chapter Nine we look at the prospects for pensioners' incomes in the future, drawing on the evidence we have accumulated and on a statistical model that has been developed to make such projections.

Finally, in Chapter Ten we give our conclusions.

2 Overview of pension provision in the UK

In this chapter we aim to give a general introduction to the main features of pension provision in the UK today. We introduce the key concepts and terms that readers need to follow the discussion in subsequent chapters.

We cover:

- pensions being paid today that are the result of arrangements made in the past; and
- the pattern of provision being made today for tomorrow's pensions.

We have divided the chapter into two main parts:

- pensions that are being paid today that are the result of arrangements made in the past; and
- provision that is being made today to ensure pensions are paid in the future.

Like any specialism, pensions has its own jargon which non-specialists can find difficult to assimilate. We have tried as far as possible to avoid this in our report. (A glossary of pension terms is at Annex A.)

Pensions being paid today

More than ten and a half million people are over the state pension ages – currently 60 for women and 65 for men – and most have retired from paid work. We estimate that about a further one and a half million people below these ages have also retired from work, in some cases voluntarily, but in others because they are unlikely to work again due to a long-term sickness or disability. People over state pension age or retired below it together comprise about one in five of the total UK population, or about one in four of all adults.

In influencing the total share of resources channelled to this group and the respective levels of the different forms of provision for them, the state performs three central roles:

➢ providing pensions and benefits;

➢ enabling people to make their own provision for retirement by setting the legal, financial and regulatory framework; and

➢ setting the framework for the provision of certain services such as health and social care, which are particularly important to older people.

In our report we focus on the first two of these.

We estimate that the total income received by people over state pension age is currently in the region of £100 billion a year. This represents around 15 per cent of gross domestic product.

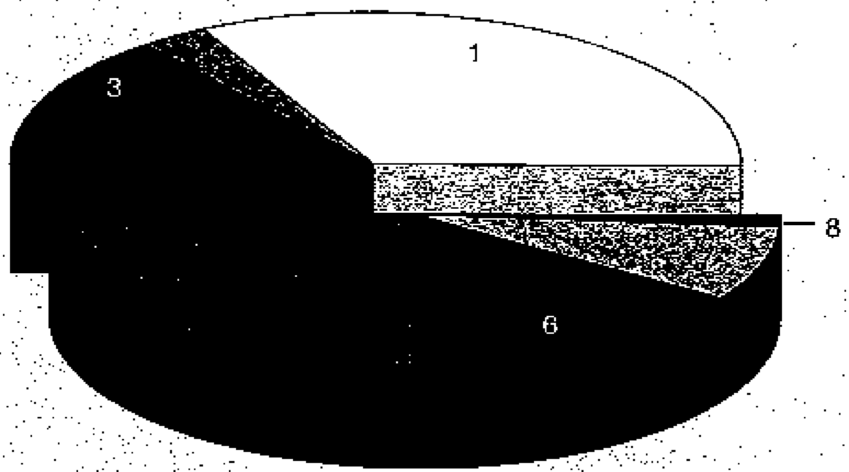
Retired people today get most of their income from two main sources:

➢ state pensions and benefits; and

➢ occupational pension schemes provided by their former employers.

Figure 2.1 shows how the various sources contribute to the total amount of income received by people over state pension age. It shows the position for pensioners as a whole. As we shall see in Chapter Three, the relative importance of each source of income can vary significantly between individuals.

Figure 2.1: Sources of pensioner incomes in 1995/6



State sources	%	*Private sources*	%
1 Basic pension	33	5 Occupational pensions	24
2 Earnings-related pension	3	6 Investment income*	16
3 Means-tested benefits	10	7 Earnings	8
4 Disability benefits	5	8 Other	less than 1
Total state sources	51	Total private sources	49

Source: Calculated from Table 1a of the *Pensioners Incomes Series 1995/6*

Notes: (1) State benefits allocated according to the amounts of expenditure shown in Figure 5.1.

(2) *Investment income includes income from personal pensions and their predecessor schemes.

State provision

The state provides three main kinds of pension income for older people.

- The largest single share of the income today's pensioners receive comes from the basic state pension. The main elements of the current scheme have been in place since 1948 and its origins lie in the National Insurance Act of 1908. The full rate for a single person is £64.70 a week from April 1998. It is calculated on a flat-rate basis according to each individual's contribution record. A system of National Insurance credits – which date back to the start of the scheme – and of home responsibilities protection – which has been available since 1978 – ensures that most people are in effect covered for the basic state pension even when they are not in work or are earning below the National Insurance contribution lower limit.

- The state also provides a second contributory pension to some of today's pensioners. This is the state earnings related pension scheme (SERPS). It pays benefits according to the earnings people had during their working lives. Those with higher earnings get more. It began in 1978

and is still in the process of maturing; people reaching state pension age in 1998/9 will be the first to receive the full rate of SERPS pension. Many of today's pensioners retired either before or soon after SERPS had started and so have little or no pension from the scheme. Although the maximum amount of SERPS people reaching state pension age now can receive is about £125 a week, the average new SERPS pension for a man who has been a continuous full member since 1978 is about £44 a week, for a woman about £22 a week. Most of today's pensioners, if they have any SERPS, receive less than these amounts.

➢ The third main category is means-tested benefits which ensure a minimum level of income for those who claim them. People with the least resources of their own get the most benefit. Benefits are lower for those with higher income or savings.

Pensioners may also receive other benefits. The most important are connected with disability.

The basic state pension is also known as the first tier of pension provision. It is redistributive. Everyone gets the same level of pension subject to having a sufficient contribution record but – because contributions are related to earnings – higher earners pay more than lower earners. The redistributive effect applies all the more in the case of means-tested benefits which go only to poorer people and are paid for from taxes which are broadly related to income.

SERPS is only available to employees. Amounts of SERPS pension are related to the earnings on which individuals pay National Insurance contributions as employees. So periods of self-employment are not covered, nor are earnings below or above the National Insurance contribution limits, which from April 1998 are £64 and £485 a week.

All state pensions and benefits are pay-as-you-go, i.e. they are paid for by current National Insurance contributors and taxpayers.

Private provision

All forms of private provision depend upon the earnings people have in work. They seek to postpone part of an individual's income from working life into retirement. They do not normally seek to redistribute income from better paid to less well paid people, though some types of scheme can be more advantageous to some groups of members than to others.

Among people retired today most who have income from private pensions were in occupational schemes run by – or on behalf of – their former employers. Often these were schemes where benefits are related to the individual's own earnings and length of service, known as defined benefit schemes. A key feature is that the employer undertakes to pay enough

contributions – after allowing for any contributions paid by the members – to ensure that the promised benefits are paid. The detailed calculation of benefits can vary widely from scheme to scheme. Many of today's pensioners were – and most occupational scheme members today still are – in a form of defined benefit scheme known as final salary. In these schemes benefits are normally based on an individual's pay close to retirement and on their length of scheme membership.

The benefits from other forms of private pension are not directly related to people's earnings. In these schemes the benefits paid out depend on the return obtained from investing contributions each year and on annuity rates at retirement. These schemes are known as defined contribution or money purchase schemes.

This type of scheme can be provided by employers with contributions related to the individual's earnings. But at the time when today's pensioners were in work, such defined contribution schemes were mainly used by self-employed people and by those whose employer did not run an occupational pension scheme. Before 1988, they could take out what were known as retirement annuity contracts. In 1988 these were replaced by personal pensions, although people who had a retirement annuity contract before 1988 can continue to contribute to it. Relatively few of today's pensioners have income from the personal pension arrangements introduced in 1988 as, at their launch, they were aimed mostly at younger people who today are still well below pension age.

Other points

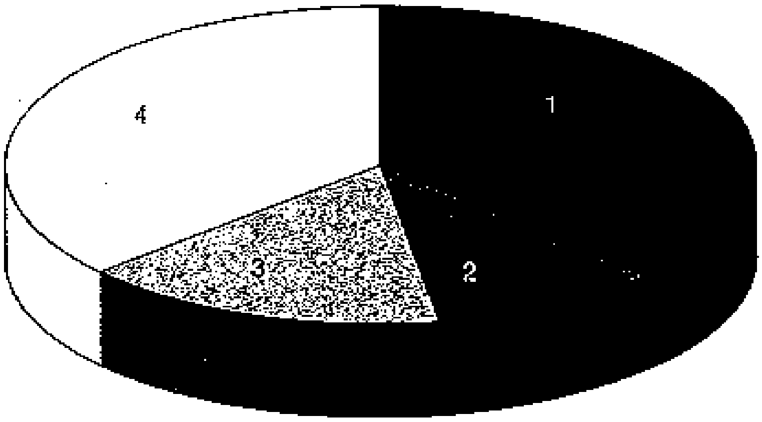
SERPS, occupational and personal pensions are often referred to as second-tier pensions because they are provided in addition to – or on top of – the basic state pension.

A key feature of second-tier pensions in the UK is the option for employers and individuals to contract out of SERPS on the basis of a suitable occupational or personal pension scheme. People in such schemes pay a lower rate of National Insurance contribution – as do their employers – and in return receive a lower SERPS pension. For those of today's pensioners who could have been in SERPS or in a contracted-out scheme, there was – from 1978 to 1988 – a guarantee that they could not lose if they chose to contract out, i.e. they would not have a lower retirement income than if they had remained in SERPS. This guarantee has been eroded since 1988 when it started to be possible to use defined contribution schemes for contracting out. These schemes offer no commitment to a particular level of benefit.

The majority of occupational and all personal pensions are paid from the funds accumulated from the proceeds of investing contributions. These are known as funded or pre-funded pensions.

Figure 2.2: Second-tier provision made by people in work

Employees



1 In occupational pension scheme and have never had a personal pension: **38%**

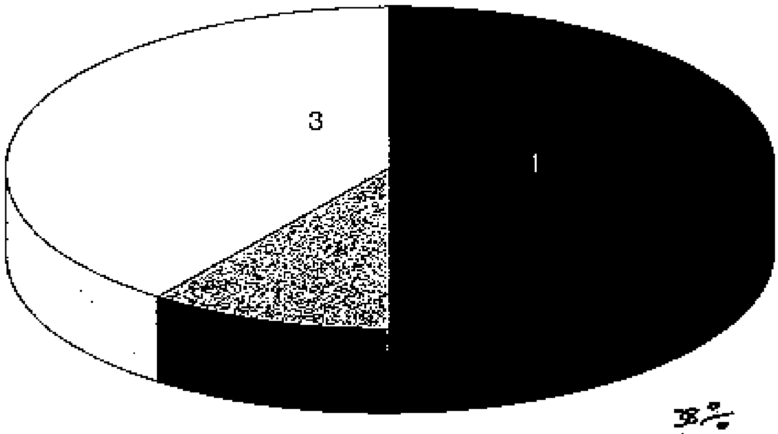
2 In occupational pension scheme and have at some time had a personal pension: **10%**

3 Have at some time had a personal pension and not in an occupational pension scheme: **16%**

4 Have never had a personal pension and not in an occupational pension scheme: **37%**

Self-employed

1996 figures



1 Currently making a contribution to a personal pension: **50%**

2 Has a personal pension to which contributions were made in the past but are not being made now: ~~**10%**~~ 11%

3 Never had a personal pension: 38% ~~**39%**~~

Source: 1995 General Household Survey

Notes: (1) The Government Actuary's provisional estimate for the proportion of employees in occupational pension schemes in 1995 – 46 per cent – is a little lower than the total suggested by the first two categories of employees shown above.

(2) In the figures for employees, people with a personal pension may not be contributing at present.

(3) Percentages may not sum to 100 per cent due to rounding.

Provision being made today for the future

There are about 32 million people between the age of 20 and state pension age. Of these:

- about 25 million are in paid work, of whom about three and a quarter million are self-employed;
- about two million are looking for paid work (including those not receiving state benefits); and
- about five million are not currently in the labour market.

As noted earlier, nearly everyone of working age is in effect covered for the basic state pension. But only those in paid work can contribute to second-tier pensions.

Figure 2.2 illustrates the types of second-tier provision employees and self-employed people are making.

- The largest single group are employees in occupational schemes, 10.5 million according to the Government Actuary's provisional estimate for 1995. About 85 per cent of these employees were contracted out of SERPS.
- About one in four employees has a personal pension. This includes people who are currently contributing to a personal pension as well as those who used to contribute but are not doing so now. It also includes a large number who are currently in an occupational scheme. Most employees with this form of pension are also contracted out of SERPS.
- Looking at employees and self-employed people together it appears that more than a third of people in paid work are making no private pension provision, i.e. unless they have previously built up rights to an occupational or personal pension, they are currently relying on the prospect of only receiving state benefits in retirement.

In the past, up to 1980, although it could not be said that there was an absolute commitment to it, the value of the basic state pension in practice stayed broadly in line with earnings. Now, there is a much more explicit commitment to increases in the basic state pension, but these are in line with prices. The result is that many people's expectations are that the basic state pension will fall behind the rise in average earnings.

Other major differences between the nature of provision being made now and that made when most of today's pensioners were in work are:

- the improving rights of women to the basic state pension through, for example, home responsibilities protection;
- the improving rights of women to occupational pensions resulting from women doing more paid work and their improved access to occupational pensions, especially for those in part-time employment;
- the introduction of SERPS in 1978;
- subsequent large reductions in the promised value of SERPS benefits;
- better protection of the value of pension rights for people who leave their occupational scheme before retirement age, although early leavers from defined benefit schemes still suffer a loss of pension rights compared to long stayers;
- better inflation protection in retirement for occupational pensions partly as a result of the introduction of compulsory limited price indexation; and
- greater reliance now on defined contribution schemes, particularly personal pensions. One million people are now also in occupational schemes of this type, compared with only one hundred thousand in the mid 1970s.

3 Incomes in old age

In this chapter we look at the position of retired people today – in particular those over state pension age – and at the factors that determine their incomes.

We examine:

- the spread of pensioner incomes;
- changes over recent decades;
- the reasons behind low incomes in retirement; and
- income adequacy, including comparisons of pensioner incomes to current workers' incomes and other benchmarks.

Later, in Chapter Nine, we will look ahead to prospects for pensioner incomes in the future.

We begin by explaining an important feature of the information about incomes that we use in this chapter.

Information on individuals and on 'units'

The information we have found on pensioners' circumstances comes from a number of sources. They use a number of approaches when calculating the amounts of income that pensioners receive. Annex C describes this in more detail.

A key feature of each information source is the extent to which people living together are assumed to benefit from the incomes of other household members. The main approaches are to measure:

(a) the income each individual person receives without regard to other incomes in the household;

(b) the incomes of 'income units', or in this case 'pensioner units'. This involves looking at the incomes of married couples jointly, but single people – including widowed, separated and divorced – are treated separately even if they share a household with other people; and

(c) the incomes of all the members of a household together.

Much of the information we show here comes from the *Pensioners' Incomes (PI) Series* published by the DSS. For the most part it uses approach (b) above. But we also refer to information that uses approaches (a) and (c).

There are advantages and disadvantages to each approach. Many people do live in 'income units'. While they may not pool their incomes explicitly, or equally, they usually share in each other's income to some extent and, as a separate point, are able to make do with less than if they were living separately as two individuals. On the other hand, access to an adequate, independent retirement income can be valued for the sense of personal control it brings and may be increasingly important in a world where lifelong partnerships are becoming less common.

The income information we show from the *PI Series* refers to people living in private households in the UK. At the time of the 1991 Census, five per cent of people aged 65 and over – and nearly a quarter of those aged 85 and over – were living in other settings such as residential care or nursing homes. Evans (1995) estimates that the proportion of the non-household population who have incomes below half the average is higher than for the household population, but we have found no figures relating specifically to the incomes of older people living in residential settings.

The spread of pensioner incomes

In Figure 3.1 we show *PI Series* information on the median income for each fifth of the distribution of income for, respectively:

- single pensioners (4.4 million people, 62 per cent of all pensioner units in 1995/6, more than three-quarters being women);
- married pensioners (5.4 million people, 2.7 million couples or 'units'); and
- all pensioner income units (9.8 million people living in 7.1 million pensioner units). (Note: The *PI Series* covers only those pensioners living in private households.)

We show estimates for pensioners' net incomes after income tax in 1979 and in 1995/6 – the latest available year – measured in terms of constant 1995/6 prices. Figure 3.1 gives amounts on two bases – before housing costs (BHC) and after housing costs (AHC). Average income for all pensioner units grew by about two-thirds in that period; average earnings rose by only 38 per cent over the same period.

Growing inequality since the late 1970s

Income growth was greatest for the highest income categories and smallest for the lowest. For the bottom 60 per cent income growth was below the average for pensioners as a whole, with the lowest categories in each group recording rates of growth less than half the average.

Figure 3.1: Real growth since 1979 in net income of pensioner units

Amounts are £ per week in July 1995 prices

	Fifths of the income distribution					
	Lowest	**2**	**3**	**4**	**Highest**	**Mean**
All pensioner units						
Net income BHC						
1979	54.70	68.60	82.70	109.70	176.60	103.70
1995/6	75.40	103.70	131.30	176.80	302.40	170.20
Real growth %	*38*	*51*	*59*	*61*	*71*	*64*
Net income AHC						
1979	46.10	53.90	68.90	93.10	155.00	88.50
1995/6	59.30	75.80	108.90	157.80	289.60	150.30
Real growth %	*29*	*41*	*58*	*69*	*87*	*70*
Married pensioners						
Net income BHC						
1979	91.50	106.50	123.70	157.60	237.00	150.90
1995/6	118.60	152.30	191.20	255.70	396.10	238.90
Real growth %	*30*	*43*	*55*	*62*	*67*	*58*
Net income AHC						
1979	76.60	89.00	106.90	140.10	214.70	132.00
1995/6	99.20	132.90	174.20	242.50	381.50	220.60
Real growth %	*30*	*49*	*63*	*73*	*78*	*67*
Single pensioners						
Net income BHC						
1979	52.40	61.90	70.20	78.90	113.60	78.80
1995/6	68.40	91.40	105.90	127.90	196.20	128.10
Real growth %	*31*	*48*	*51*	*62*	*73*	*63*
Net income AHC						
1979	43.30	50.50	55.30	64.80	100.30	65.60
1995/6	55.30	65.30	80.90	111.40	181.80	107.10
Real growth %	*28*	*29*	*46*	*72*	*81*	*63*

Source: DSS *Pensioners' Incomes Series 1995/6* which is based on the Family Expenditure Survey

Notes: (1) The distribution of income has been calculated separately for the before housing costs (BHC) and after housing costs (AHC) measures of income. The distribution of income is also calculated separately for each group, for example estimates for married pensioners show the income for each fifth of the married pensioner income distribution.

(2) Figures for each fifth of the distribution show the growth in the median income of that fifth.

(3) Married pensioners are defined as a couple where the man is aged 65 or over.

The inequality in pensioner incomes appears to have grown since the late 1970s or early 1980s. A separate analysis of income data for the period 1981/2 to 1991/2 by Johnson and Stears (1995) confirms the trend shown in the *PI Series*, but also found that in the two decades before 1981/2 pensioners' incomes had, in contrast, become more equal – see Figure 3.2. Long-term trends in pensioner incomes are not immutable.

Figure 3.2: Growth in pensioner incomes 1961/2 to 1991/2

	Poorest tenth percentile	Median	Richest ninetieth percentile
1961/2 to 1971/2	41%	30%	11%
1971/2 to 1981/2	38%	30%	22%
1981/2 to 1991/2	10%	26%	57%

Source: Johnson and Stears (1995)

Notes: (1) This table shows the rates at which net incomes of pensioners at different points in the pensioner income distribution grew faster than the rise in prices. Incomes have been calculated on an 'equivalent' basis – see Annex C for a further explanation.

(2) The 'poorest tenth percentile' is the income received by the person one tenth from the *bottom* of the income distribution. The 'richest ninetieth percentile' is the income received by the person one tenth from the *top* of the income distribution.

A number of factors were involved in causing such a sharp change of direction in income trends to occur:

- the distribution of earnings for people in work also started to become more unequal at about that time;
- in 1979 the basic state pension – which is of most importance to the less well off – began to rise in line with prices. Before then, basic state pension had over the longer term more or less kept broadly in line with earnings;
- as we shall see in Chapter Four, in the 1960s and 1970s there was a large fall in the proportion of men continuing to work after state pension age;
- those retiring at the beginning of the 1980s were probably among the first to have spent large parts of their working lives as members of occupational schemes; and
- increases in pensions during retirement were also becoming more widespread in occupational schemes. Many who had retired before the 1980s had seen their incomes fall behind the rise in prices during periods of high inflation.

Comparison with the rest of the population

We have also looked at comparisons between the distribution of pensioner incomes and those for the population as a whole. The method for doing this – which allows for differences in the number of adults and children living in each household and in housing costs – is explained further in Annex C.

If pensioners had the same distribution of income as the overall population, 20 per cent of pensioners would be found in each fifth of the overall distribution. But, perhaps not surprisingly, pensioners tend to be concentrated in the lower part of the overall distribution – see Figure 3.3. Over half of all pensioners are in the lowest two-fifths of the income distribution for the total population. In 1979 the figure had been two-thirds, reflecting the general improvement in the position of pensioners as a group relative to the rest of the population. The proportion of pensioners in the lowest fifth for all age groups fell by about a half; the representation of pensioners in other parts of the distribution rose but this was mostly concentrated in the second and third fifths. In 1995/6 around ten per cent of pensioners were in the top fifth of the income distribution for all age groups.

Figure 3.3: Pensioner incomes in relation to the total population income distribution

	Fifths of the overall population income distribution					
	Lowest	***2***	***3***	***4***	***Highest***	***Total***
1979			***Percentages***			
All pensioners						
Before housing costs	47	24	13	9	8	100
After housing costs	46	22	13	9	10	100
Married pensioners						
Before housing costs	44	24	14	9	9	100
After housing costs	45	21	14	10	10	100
Single pensioners						
Before housing costs	49	24	11	8	7	100
After housing costs	47	23	11	9	9	100
1995/6			***Percentages***			
All pensioners						
Before housing costs	25	33	19	12	10	100
After housing costs	20	33	20	14	13	100
Married pensioners						
Before housing costs	25	30	20	14	12	100
After housing costs	20	29	21	15	15	100
Single pensioners						
Before housing costs	26	38	17	11	8	100
After housing costs	21	37	18	13	11	100

Source: DSS *Pensioners' Incomes Series 1995/6*

Notes: (1) The table shows the proportion of pensioners within each fifth of the overall population income distribution. Further details about the methods used are in Annex C.
(2) Percentages may not add up to 100 per cent due to rounding.
(3) See also notes to Figure 3.1.

Continuing concentration of many pensioner incomes at lower levels

Figure 3.4 reveals the continuing concentration of many pensioners' incomes within a narrow band of relatively low income. Again, this may be as expected because of the equalising effect of most state pensions and benefits which are the single most important source of income for most of today's pensioners. The basic pension is flat rate and means-tested benefits provide a floor below which those who claim need not fall.

Gender

There are important differences in the amounts of income men and women receive individually, that is income paid directly to them rather than received by a partner even if on their behalf. As Figure 3.5 shows, women over state pension age typically have lower individual incomes than men.

In the case of married pensioners, women's individual incomes in 1995/6 were on average less than half those of men. State pensions are paid to individuals, but currently many married women are not entitled to a full basic state pension. Other income from the state paid to couples – such as means-tested benefits – is more likely to be paid to the husband than to the wife.

Amongst single pensioners, the gap between men's and women's individual incomes is much smaller – on average single women's incomes are about 15 per cent lower than men's. The smaller gap may be partly because many single women pensioners are widows, for many of whom the amounts of pension income they receive individually often increase after their husband's death. (It is more usual for wives to survive their husbands than *vice versa.*) Also, never-married women are likely to have earned more than married women and are more likely to have built up pension entitlements in their own right.

The Equal Opportunities Commission has also published an analysis of the incomes received individually by men and women pensioners in the years 1975 and 1994/5. This suggests that since 1975 the improvement in pensioner incomes has tended to benefit men more than women so that women's position relative to men's has fallen behind. Ginn and Arber have found a similar result for the period 1985/6 to 1993/4. There are, however, problems in interpreting differences between the individual incomes of men and women. As we said before, some types of income are paid on behalf of couples, rather than individuals, and by convention are often paid to the man. Income Support is an example. Any increase in the reliance on Income Support therefore has a tendency to widen the apparent gap between men's and women's individual incomes.

Figure 3.4: The concentration of pensioner incomes

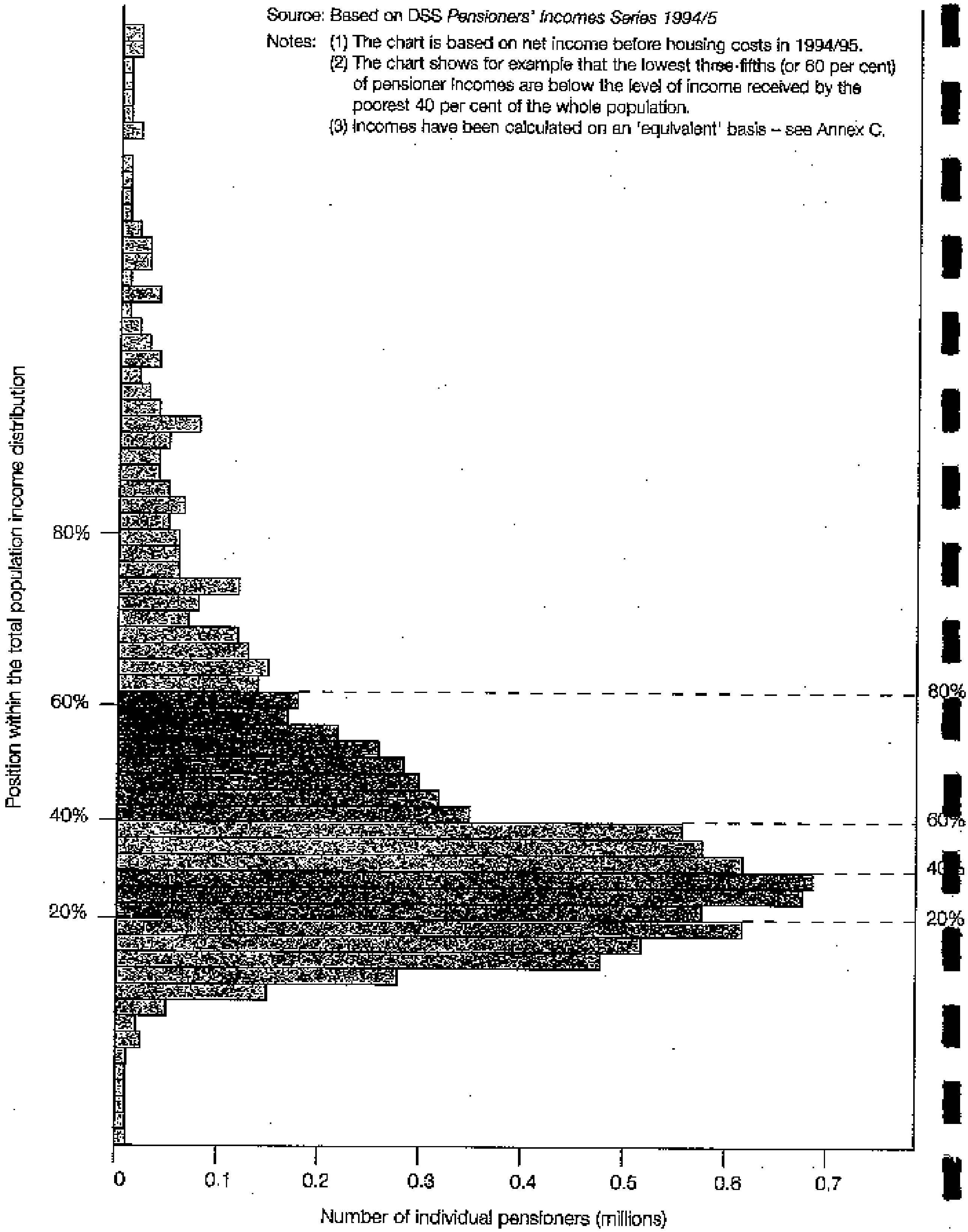


Figure 3.5: The individual incomes of men and women over state pension age, 1995/6

Fifths	**State**	**Private**	**Total**
		£ per week	
Single men			
Lowest	68	7	75
2	87	14	101
3	94	24	118
4	96	53	149
Highest	95	216	311
Mean	88	63	151
Single women			
Lowest	64	4	68
2	78	13	91
3	96	14	110
4	100	34	135
Highest	107	131	238
Mean	89	39	128
Married men			
Lowest	69	9	78
2	84	22	106
3	94	11	135
4	93	96	189
Highest	84	328	412
Mean	85	99	184
Married women			
Lowest	20	2	22
2	35	1	36
3	37	10	48
4	50	23	73
Highest	50	132	181
Mean	38	34	72

Source: Special analysis of the 1995/6 Family Resources Survey by the Institute for Fiscal Studies for the PPG.

Notes: (1) Incomes are amounts reported in the Family Resources Survey. This survey covers Great Britain. Figures used elsewhere in this report drawn from the *Pensioners' Incomes Series* may differ.
(2) Fifths of the income distribution have been calculated separately for each gender and marital status category.
(3) Incomes are before tax and housing costs.
(4) Amounts may not sum to totals due to rounding.

A different trend emerges where this problem does not apply, in the case of single pensioners (including widowed, separated and divorced). The *PI Series* shows that the incomes of single women pensioners are lower than those of single men pensioners but, if anything, rose at a slightly faster rate than men's between 1979 and 1995/6 (see DSS *Pensioners' Incomes Series 1995/6, Table 1b*).

Figure 3.6: Income distribution for pensioners by their ages, 1992/3

All figures are percentages

	Fifths of the income distribution					
Pensioner age	***Lowest***	***2***	***3***	***4***	***Highest***	***Total***
60–69 years	13	19	19	23	26	100
70–74 years	21	20	19	20	20	100
75–79 years	26	23	19	18	15	100
80+ years	26	20	24	17	13	100

Source: Johnson *et al* (1996)

Notes: (1) The table shows the proportion for each age group who have income within each fifth of the total pensioner income distribution. For example, twice as many new pensioners fall within the highest income fifth as in the lowest, whilst the reverse is true of pensioners aged 80 or over.
(2) The table is calculated in terms of net 'equivalent income' – see Annex C – and based on the Family Expenditure Survey in 1992 and 1993.
(3) Rows may not sum to totals due to rounding.

Age

Older pensioners are more likely to have lower incomes than younger pensioners. Figure 3.6 shows that in 1992/3 twice as many pensioners in their 60s were in the top fifth of the pensioner income distribution as those in their 80s (26 per cent and 13 per cent respectively). The converse was true for the proportions in the bottom fifth (13 per cent and 26 per cent respectively). Looking just at the incomes received by men, for example, Johnson and Stears (undated) found that in 1992/3 men's average income at age 65 was nearly £200 a week compared with an average of rather over £120 a week at age 85 (both at 1995 prices).

There are a number of reasons why today's older pensioners tend to have lower incomes than younger pensioners:

- older pensioners retired with lower occupational pension rights than people retiring today. This effect could lessen in the future;
- if pensions in payment are not fully inflation-proofed, those who retired longer ago will tend to have lower real incomes than people who have retired more recently. Again, this effect may be smaller in the future as private pensions are increasingly required to provide better inflation proofing;
- since second-tier pensions are earnings-related, so long as there is economic growth, newly retired people will always tend to retire with higher pensions than their predecessors;
- incomes may change during retirement for other reasons, death of a partner probably being the most important; and
- because women tend to live longer than men, a high proportion

of older pensioners are women. Two-thirds of people aged 80 and over, for example, are women.

We show further information in Annex C on the incomes of single pensioners according to their age and to whether they have never married, are widowed, or are separated or divorced.

Housing tenure

The proportion of pensioners who own their homes has risen substantially, from around 40 per cent in 1979 to about 56 per cent in 1995/6. The proportions who rent and who live in other people's households have fallen.

Owner-occupier pensioners have significantly higher incomes than other pensioners. In 1995/6 the incomes of married pensioners who were owner-occupiers, for example, were more than half as large again as those for married pensioners who rented their homes – see Figure 3.7.

Figure 3.7: Pensioner incomes by housing tenure

	£ per week	Proportion of pensioners in each category %
Married pensioners		
Owner-occupiers	310	72
Tenants	194	26
Others	178	2
Single pensioners		
Owner-occupiers	165	46
Tenants	137	43
Others	114	11

Source: Special analysis of the Family Expenditure Survey by DSS

Notes: (1) Incomes are before tax and housing costs.
(2) Married pensioners are defined as a couple where the man is aged 65 or over.

Information we have not found

We have found no reliable information on differences in pensioner incomes between regions or between ethnic groups. And whilst we know that many pensioners have assets – and indeed the income from pensioners' savings and investments is included in the income information we have shown – we have not been able to find much useful information on the value of those assets themselves. (We show some figures about personal wealth for the whole population in Chapter Eight.) Information on the incomes of individuals rather than of units or households and on the incomes of older people living in residential settings is also scarce.

The reasons for low income

State benefits and pensions provide a floor, or first tier, of income to which nearly everyone over pension age is entitled. Those with the very lowest incomes in retirement are people who have not been able to build up rights to state pensions, have few other resources and do not receive Income Support. We have found no estimates for the size of this group but it is probably very small.

Other pensioners on low incomes include people receiving a state pension with little or no SERPS entitlement and little or no income from other sources – such as occupational pensions or savings – who have not claimed an entitlement to means-tested benefits. The DSS estimate that in total about one million pensioners did not claim an entitlement to Income Support in 1995/6. The average unclaimed amount was £16.10 a week. About three hundred thousand pensioners did not claim their entitlement to Housing Benefit (average amount unclaimed £22.80 a week). And about one and a quarter million did not claim their entitlement to Council Tax Benefit (average amount unclaimed £5.70 a week).

Looking further up the income scale we see that the main difference between poorer and better off pensioners lies in the extent to which they receive income from sources other than state benefits and pensions. The 1988 Retirement Survey found only half the men in the lowest fifth received any private income and these were mainly very small amounts, averaging about £1 a week at 1995 prices. In the middle and highest fifths all men reported private income, averaging respectively £33 and £194 a week. In that survey, too, no women in the lowest fifth reported any private income. All women at the middle fifth reported private income but the average amount was only £7 a week. Women in the highest fifth had on average £90 a week in private income, less than half the amount recorded for men at that level. Details are in Figure 3.8.

Figure 3.8: Amounts of private income

	Men		Women	
	Average amount £pw	Proportion receiving %	Average amount £pw	Proportion receiving %
Lowest fifth	1	52	0	0
Middle fifth	33	100	7	100
Highest fifth	194	100	90	100

Source: Johnson *et al* (1996)

Note: Calculated from 1988 Retirement Survey and revalued to 1995 prices.

Having income other than from the state does not, however, guarantee a high income in retirement. In May 1997, for example, 230,000 people on Income Support had income from an occupational pension.

Pensioners can also add to their income through paid work. Fifteen per cent of pensioner units had earnings from employment in 1992/3 and four per cent from self-employment (Johnson *et al* [1996]). But it is not clear the extent to which such income went to pensioners who would otherwise be in the lower income groups but for their earnings, or to those with good occupational pensions and savings as well.

Income adequacy

There is no generally agreed definition of income adequacy and all attempts to fix one have been controversial and subject to legitimate challenges. But a number of dimensions of adequacy underpin everyday discussions, at least implicitly, and these have guided us in coming to our conclusions:

- at any one time there is an absolute dimension, a minimum level below which no one need fall and perhaps a higher standard which ideally most people can achieve. The Income Support levels are the closest we have to an official definition of the minimum level;
- adequacy is also relative, so it is important to monitor the incomes of pensioners against those of the rest of the population, particularly those in work; and
- for individual pensioners, the extent to which income in retirement replaces the income they had in working life (sometimes known as the 'replacement ratio') is significant.

Each dimension is important. However, it would be quite possible for somebody to appear poor on one standard, but not on another. The most relevant concept(s) of adequacy may also change as needs change, for example as the pensioner concerned gets older. In Annex D we provide further discussion of attempts to establish measures of income adequacy which have guided us. If nothing else, these show how difficult it is to reach agreement. Like many others before us, we have chosen not to endorse any single adequacy threshold. But apart from the information gaps we have mentioned, we believe that the range of analyses brought together above capture most of the key dimensions of adequacy.

Summary

Our main findings are that:

- pensioners with low incomes tend to be women rather than men, to have been retired the longest and to be single, especially widows, but also including separated and divorced people;
- pensioners with the lowest incomes are those who have not claimed state benefits, for example around one million appear not to have claimed their entitlement to Income Support. A more general cause of low income among pensioners is the lack of income from sources other than the state, such as occupational pensions or savings;
- once retired, under stable financial conditions – and especially with low inflation – pensioners' total incomes mostly retain their value against retail prices until there is a change in family circumstances such as the death of a partner who provided the main source of income;
- there is no generally agreed definition of adequacy and needs can change during retirement, for example if declining health brings additional care costs;
- some pensioners who have low earnings in their working lives can retire with a relatively high income in relation to their previous earnings but still have low income compared with the rest of the pensioner population;
- as living standards generally rise, what may have appeared adequate at the start may seem less so later in retirement; and
- the position of today's pensioners reflects their experiences during their working lives and the opportunities open to them. Past changes in pension provision will take many years to have their full impact.

4 The labour market context

In this chapter we look at certain aspects of the labour market which set the context for pension provision and for the accumulation of pension rights which we examine in more detail in later chapters.

We:

- note that the labour market is in continuous evolution and that the framework for pension provision needs to accommodate and support that process; and
- review the trend towards earlier retirement, especially among men.

We emphasized at the start of our report the fundamental link between pensions and paid work. Not only do pensions replace earnings in retirement but rights to future pension income are earned as part of employment. So, in this chapter we look at three aspects of the labour market which are likely to have most impact on pension provision:

- structural changes affecting the pattern of employment;
- earnings patterns; and
- the age at which people retire from paid work.

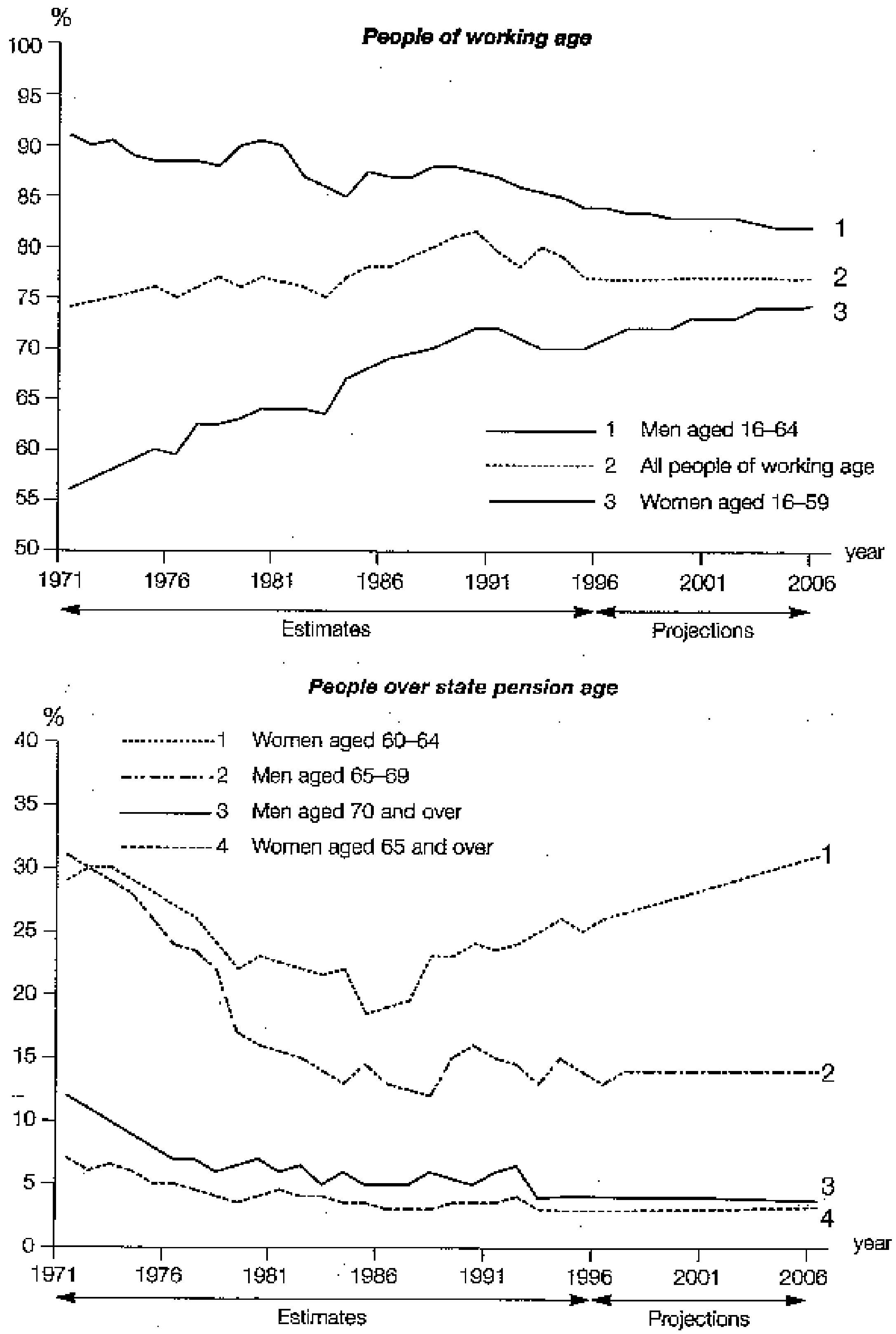
We also look at projections for the future. We have not considered the impact of regional differences as we have found little information directly relevant to pension provision.

Structural changes in employment

A range of reports has commented on changes in the UK labour market in recent years. About some changes there is clear agreement:

- at most ages, there are now more women in jobs than before but fewer men. Figure 4.1 shows the trends in terms of activity rates;
- there are now nearly as many women in paid employment as men;
- the total number of jobs has increased but much of the recent growth has been in part-time and temporary posts;

Figure 4.1: Estimates and projections of activity rates



Source: Office for National Statistics *Labour Market Trends* February 1997

- more employees are now on temporary contracts, full- and part-time. In total these now cover about one and a half million people or seven per cent of all employees, up from five per cent a decade ago;
- the service sector has expanded while manufacturing has declined;
- self-employment grew rapidly in the 1980s. About three and a quarter million people are now self-employed, twice the number in 1979;
- the size of the public sector has fallen;
- organisations have got smaller, with the main growth being in jobs in small and medium size enterprises; and
- in most sectors of the economy there has been a growth in managerial, professional and skilled technical occupations but a reduction in semi-skilled and unskilled jobs.

With the exception of the last of these changes, the general picture is one of growth in sectors of employment where the main form of second-tier provision – occupational schemes – has been less common. For many people working in new areas of employment, personal pensions or SERPS are the only forms of second-tier pension provision open to them. The shift to greater self-employment has also removed many from the scope of compulsory second-tier coverage.

Self-employment

Not only has self-employment grown but the nature of self-employment has also changed, both in terms of the types of people becoming self-employed and the types of activity they undertake.

Meager *et al* (1994) found the key features of the expansion of self-employment in the 1980s were:

- an increasing proportion of women among the new self-employed compared with the existing self-employed;
- relatively more young people among the new entrants to self-employment;
- a high rate of entry to self-employment from unemployment;
- a growth in dependent self-employment and sub-contracting resulting in the transfer of work that used to be done by employees to self-employed people; and
- a tendency for a disproportionately high share of the new self-employed to enter certain service sector activities, including at one end relatively low value-added personal service activities and, at the other, higher earning business and financial services.

They also found that low income self-employed people in the early 1990s were disproportionately in the same categories where self-employment grew rapidly in the 1980s.

Job security and tenure

There appears to be less consensus about:

- ➢ whether people now have less job security than in the past; and
- ➢ whether people nowadays move more often between jobs, between employment and self-employment, or in and out of work.

Clearly the structural changes we outlined above could have such effects.

But it appears also to be true that many people still spend long periods of their lives in stable employment conditions. According to Burgess and Rees in their analysis of the General Household Survey from 1975 to 1993, 'there is no strong tendency for shorter job tenures'. This confirmed their earlier findings that elapsed job tenure from 1975 to 1991 had 'barely changed over that period'.

The changes which we have outlined above and the inevitable continuing evolution of the labour market raise challenges for pension provision. In our view, pensions policy in isolation can only go so far in meeting these challenges. Employment policy and labour law have roles to play, too.

Earnings patterns

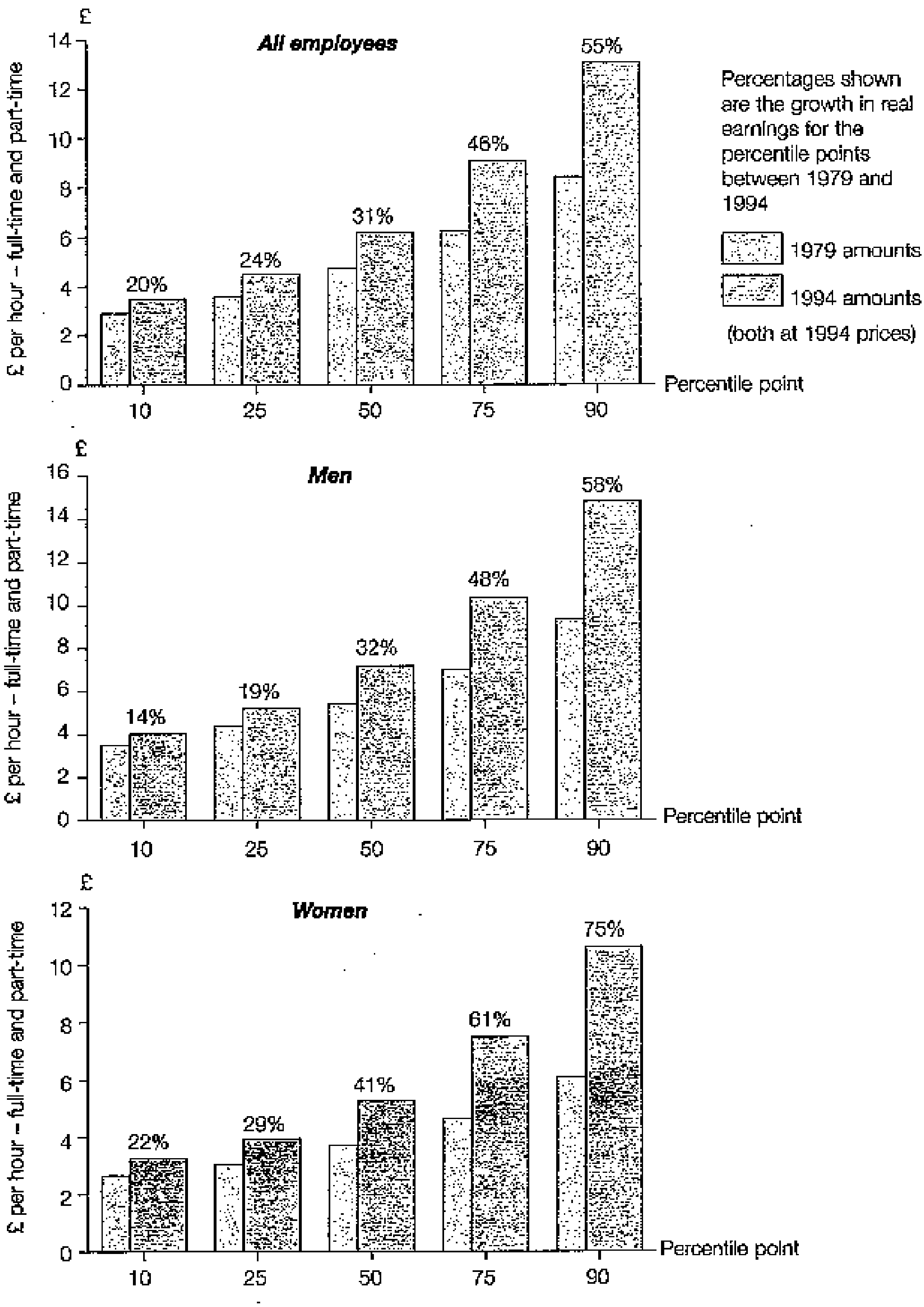
The distribution of earnings has widened substantially in the last two decades. Figure 4.2 shows, for example, that between 1979 and 1994 growth in hourly earnings rates was greatest at the higher levels and smallest among low earners:

- ➢ for the top ten per cent of men hourly rates were up by over a half in real terms, for women by over three-quarters; and
- ➢ for the bottom ten per cent of men hourly rates were up by less than 14 per cent, for women by less than 22 per cent.

The 1997 New Earnings Survey shows that amongst full-time employees earnings for the highest decile of men were 3.3 times the lowest decile, compared with 2.9 times in 1986. For women the ratio was 3.0 in 1996, 2.0 in 1986.

Given the earnings-related nature of much pension provision, greater inequality in earnings may well lead to a wider dispersion of incomes in retirement. Changes in earnings patterns also have an impact through changes in the numbers of people above or below the National Insurance earnings limits.

Figure 4.2: Distribution of earnings



Source: Special analysis of the New Earnings Survey by DSS

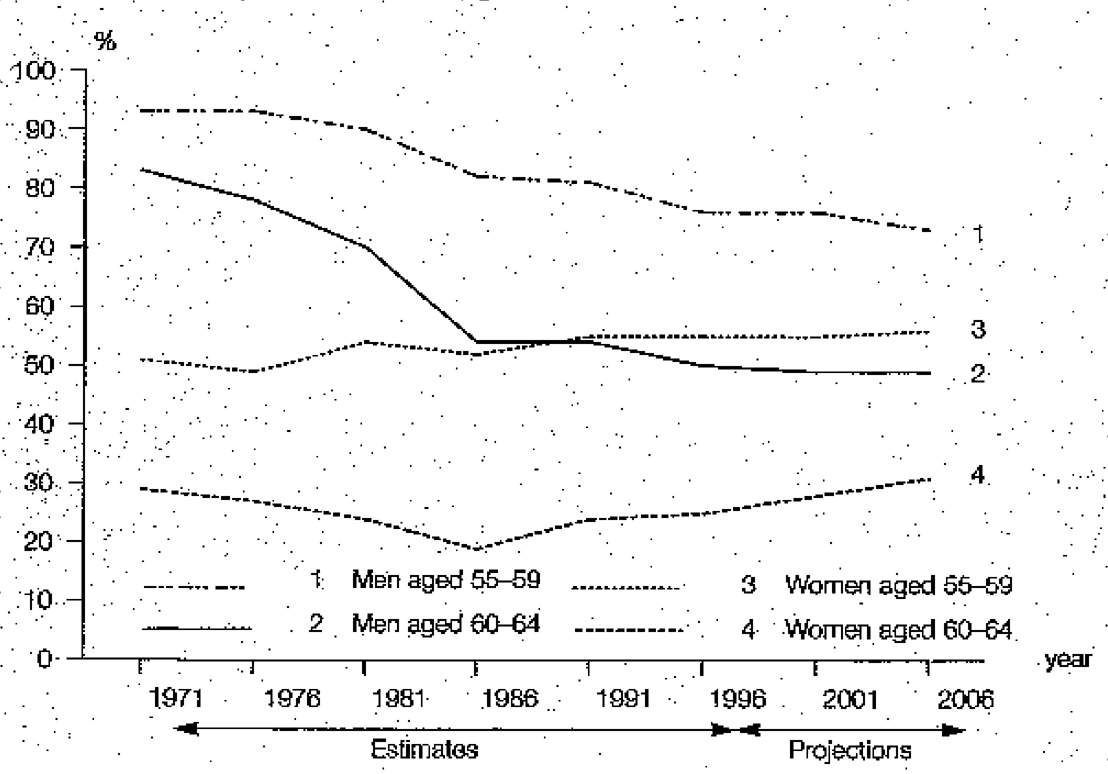
Age at retirement

Different trends for men and women

The Office for National Statistics makes estimates and projections for the number of people active in the labour market. 'Active' in this context means having or looking for a job. 'Inactive' is everyone else, including for example the retired and full-time carers. Figure 4.3 shows the position for people aged 55–64 since 1971 as well as projections up to 2006. At these ages:

- for *men* there has been a substantial fall in activity since the 1970s. In 1976 only seven per cent of 55–59 year-olds were inactive, now it is about a quarter. Half of those aged 60–64 are now inactive; and
- for *women* in these age ranges activity rates have been rising but are still below men's. About half of 55–59 year-old women were inactive in 1996, three-quarters of those aged 60–64. The rise in women's state pension age from 2010 may also increase the activity rates of women in these age groups.

Figure 4.3: Activity rates between ages 55 and 64, 1971–2006



Source: Office for National Statistics *Labour Market Trends* February 1997

Two patterns of early retirement

There are two sets of reasons for the move to earlier retirement amongst men, and they are associated with two groups of the early retired. One group has benefited from growing coverage of occupational pension schemes, and their early retirement can generally be thought of as 'voluntary'. They have adequate pension incomes to live on and often have no great need to work beyond their late 50s. The structure of final salary schemes and their use to encourage older workers out of employment to suit their employers' needs have played an important role in this.

The other large group of the early retired are those who are more likely to have left their final job involuntarily, have been unable to find other suitable work and are largely dependent on state benefits for their incomes. As many as a quarter of all men aged 60 to 64 receive state Incapacity Benefit.

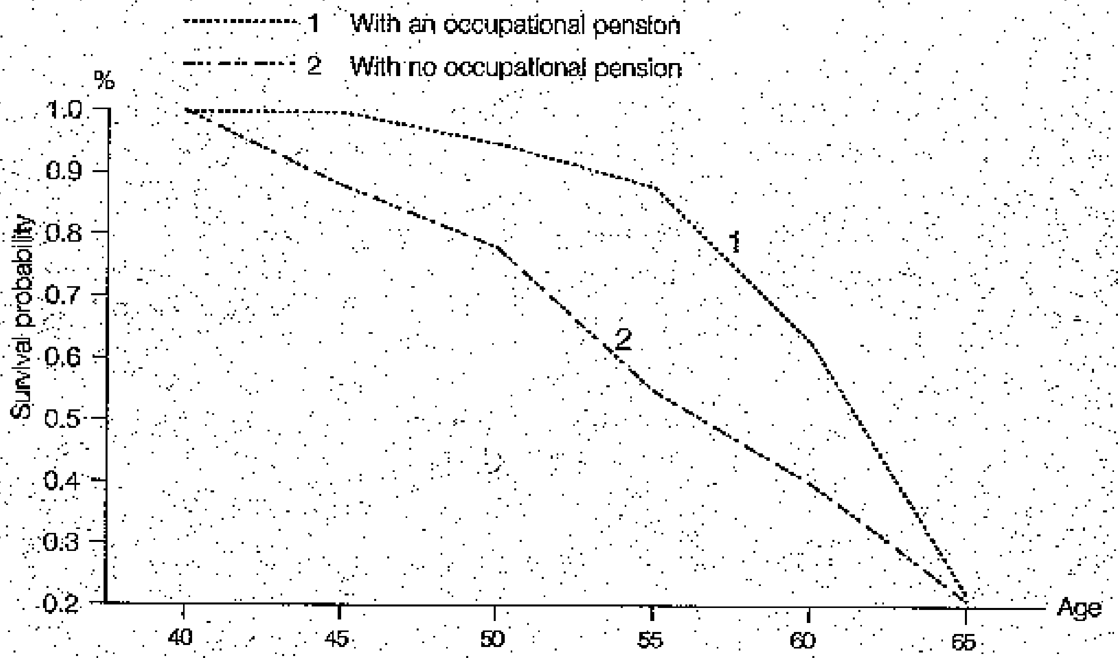
The profoundly different experiences of men with and without occupational pensions is illustrated in Figure 4.4. This shows that the probability of men continuing to be active in the labour market depends on, amongst other things, their pension status. Those without occupational pensions appear to leave the labour market at a remarkably constant rate from the age of 40 onwards. Those with an occupational pension tend to continue in work until the age of 55 and then start to leave in large numbers as pension rights become payable.

The reasons people give for not being in the labour market

The Labour Force Survey gives detailed information from spring 1992 to winter 1996. Figure 4.5 shows changes in the reason for inactivity amongst people within ten years of state pension age:

- more men and women now describe themselves as sick: at ages 55–59 men up from 14.9 per cent to 17.1 per cent, women from 14.6 per cent to 18.6 per cent;
- a small rise in the proportions saying they are retired: men 55–59 up from 3.6 per cent to 4.2 per cent, women from 6.5 per cent to 7.8 per cent; and
- amongst women 55–59, fewer are now giving family as their reason: dropping from 17.7 per cent to 13.8 per cent. Only one per cent of men do so.

Figure 4.4: Labour market survival probability by pension status



Source: Institute for Fiscal Studies.

Notes: The chart shows the probability of people aged 40 with and without an occupational pension still being active in the labour market at each future age.

Projections for the future

The impact of labour market changes on the pattern of pension provision will be felt for many years to come. Men who are now retiring earlier than their predecessors have to finance their retirement for a longer period. They are also living longer. But these changes mean there is more time for their incomes to fall behind those of people in work than was the case for previous generations.

Few projections are made about future changes in the labour market itself. The Office for National Statistics estimate activity rates only as far as 2006 and assume in the main that recent trends will broadly continue. We have found no evidence on prospects beyond then. While we do know that women's state pension age will rise from 60 to 65, there is no guarantee that they will work longer.

Figure 4.5: Reasons people give for not being active in the labour market

	Spring 1992	**Spring 1993**	**Winter 1996**
Men aged 55–59	%	%	%
Working	68.6	65.8	68.8
ILO unemployed	8.7	9.4	5.9
Inactive	22.8	24.8	25.3
Breakdown of inactive			
Sick	14.9	16.3	17.1
Retired	3.6	3.7	4.2
Family	1.0	1.1	1.0
Other reasons (discouraged, studying, do not need/want work)	2.7	3.1	2.5
Reason unknown	0.6	0.5	0.4
All	*100*	*100*	*100*
Men aged 60–64	%	%	%
Working	47.3	44.6	46.0
ILO unemployed	5.3	7.0	4.5
Inactive	47.3	48.3	49.5
Breakdown of inactive			
Sick		21.9	24.8
Retired		17.3	17.8
Family		1.3	1.4
Other reasons (discouraged, studying, do not need/want work)		5.0	4.5
Reason unknown	47.3*	2.8	0.9
All	*100*	*100*	*100*

Source: Special analysis of the Labour Force Survey by DSS

Notes: (1) Percentages may not add to 100 per cent because of rounding.
(2) ILO = International Labour Organisation.
(3) * No breakdown of reasons for being inactive is available for men aged 60–64 in spring 1992.

(continued overleaf)

Figure 4.5 (continued): Reasons people give for not being active in the labour market

	Spring 1992	Spring 1993	Winter 1996
Women aged 50–54	%	%	%
Working	64.6	65.1	67.3
ILO unemployed	3.7	3.7	2.8
Inactive	31.7	31.2	29.9
Breakdown of inactive			
Sick	9.7	10.2	12.1
Retired	1.3	1.4	1.3
Family	15.1	14.4	11.0
Other reasons (discouraged, studying, do not need/want work)	4.2	4.0	4.4
Reason unknown	1.4	1.2	1.1
All	*100*	*100*	*100*
Women aged 55–59	%	%	%
Working	50.9	50.2	50.8
ILO unemployed	2.5	3.2	2.2
Inactive	46.6	46.6	47.0
Breakdown of inactive			
Sick	14.6	15.1	18.6
Retired	6.5	7.1	7.8
Family	17.7	17.1	13.8
Other reasons (discouraged, studying, do not need/want work)	6.1	5.9	5.5
Reason unknown	1.7	1.4	1.3
All	*100*	*100*	*100*

Source: Special analysis of the Labour Force Survey by DSS

Notes: (1) Percentages may not add to 100 per cent because of rounding.
(2) ILO = International Labour Organisation.

Summary

The labour market will continue to evolve and, whilst many of the new jobs being created in the economy are low paid, part-time or temporary in nature, a large part of employment will continue to be permanent and long term. It is dangerous on the basis of the available information to prognosticate total upheaval in the shape of future employment. Our view is that patterns change slowly, but we accept that over time this can constitute significant structural change.

The change in the mix of jobs and in employment patterns will not alter the challenges that have faced pension provision for many years:

- the need to bring the benefits of occupational provision to people who are not in such schemes;
- the need to find better ways for self-employed people to make their own provision; and
- the need to minimise the adverse effects of job changes on future pension rights.

SHP plug.

Pension provision has always had to cater for a range of employment types and to a significant extent has responded to social and labour market developments. While it is relatively easy to make provision in areas of more stable employment, it is perhaps more challenging – and possibly more important – to do so in sectors where there is greater volatility.

There is a need for occupational and personal pensions, as well as any new schemes that might emerge, to be flexible and adaptable so that they can accommodate changes in social and labour market conditions.

5 State provision

In this chapter we discuss the role of state provision.

We look at the amount currently spent on state pensions and on other benefits for older people and – based on current policies – at how much state pensions will cost in the future.

We consider:

- ➢ the main forms of state financial provision for today's pensioners;
- ➢ the effect of means-tested benefits such as Income Support; and
- ➢ the impact of current policies on the future level and cost of state pensions.

The state has three key roles in relation to retirement and older people:

- ➢ providing pensions and benefits (the subject of this chapter);
- ➢ enabling people to make their own provision for retirement by setting the legal, financial and regulatory framework (the subject of later chapters); and
- ➢ setting the framework for the provision of certain services, such as health and social care, which are particularly important to older people.

Our report is not concerned directly with the last of these. (A Royal Commission has been set up to look specifically at the question of long-term care.) But the way in which such services are financed does have a bearing on pension provision. The extent to which they are provided free at the point of delivery – or attract charges – affects the adequacy of any given level of retirement income. And if people have to make contributions to public or private insurance for such services, this could affect their willingness and ability to contribute to pension schemes. Pension policy cannot therefore be entirely independent of policy in that area.

State financial provision

Expenditure on social security pensions and benefits paid to the elderly – either because they are over state pension age or because they have a low income – was expected to be about £42 billion in 1997/8. That represents:

- 44.3 per cent of total benefit expenditure;
- 13.5 per cent of all government spending; and
- the equivalent of 5.3 per cent of gross domestic product.

It is estimated that another £5 billion was paid to the elderly in 1997/8 in the form of disability and industrial injury benefits and war pensions. Figure 5.1 gives more details of how much is being spent.

Figure 5.1: State spending on pensions and benefits for older people, 1997/8

	£ billion
Basic state pension	30.1
Earnings-related pensions (SERPS and Graduated Scheme)	3.2
Means-tested benefits	
Income Support	3.9
Housing Benefit	3.9
Council Tax Benefit	1.1
Total, means-tested benefits	*8.9*
Disability benefits	5.0*
Total of all above pensions and benefits	*47.2*

Source: Estimates provided by DSS

Notes: (1) *Approximate figure.

(2) The table does not include other benefits that pensioners may receive, such as Child Benefit if they are parents of children still at school.

State pensions

State pensions are paid to over ten and a half million people, about three-quarters of a million of whom live outside the UK. Nearly everyone in the UK over pension age gets some state pension.

The amounts of pension people receive depend on:

- their own National Insurance contribution records during their working lives or those of their spouses; and
- certain aspects of their status after they reach pension age such as whether they have a dependant or have reached 80 years of age.

The pension comprises two main elements:

➢ *basic pension,* which is paid at a 'flat rate' according to the extent to which contributions have been paid or credited and according to current status. For example, in 1998/9 the rate of basic pension for a person with a full contribution record, aged under 80 and without a dependant, is £64.70 a week. The basic state pension is the key element of first-tier provision in the UK; and

➢ *earnings-related pension,* which depends on the amount of earnings as an employee in each year since 1978 in the case of SERPS – or between 1961 and 1975 in the case of the former Graduated Scheme – and which is reduced in respect of periods spent contracted out of these schemes. SERPS is one part of second-tier provision in the UK.

For both the basic and earnings-related pensions it is only earnings within a certain band – or the contributions paid on those earnings – which attract pension entitlement. The band for employees is currently between £64 and £485 a week. These limits are increased each year in line with the basic pension which in turn is linked to the rise in retail prices. Annex E gives more information about how state pensions are calculated. Contributing towards the basic state pension is compulsory for all adult employees currently earning above £64 a week. (Rates for people in self-employment are different.)

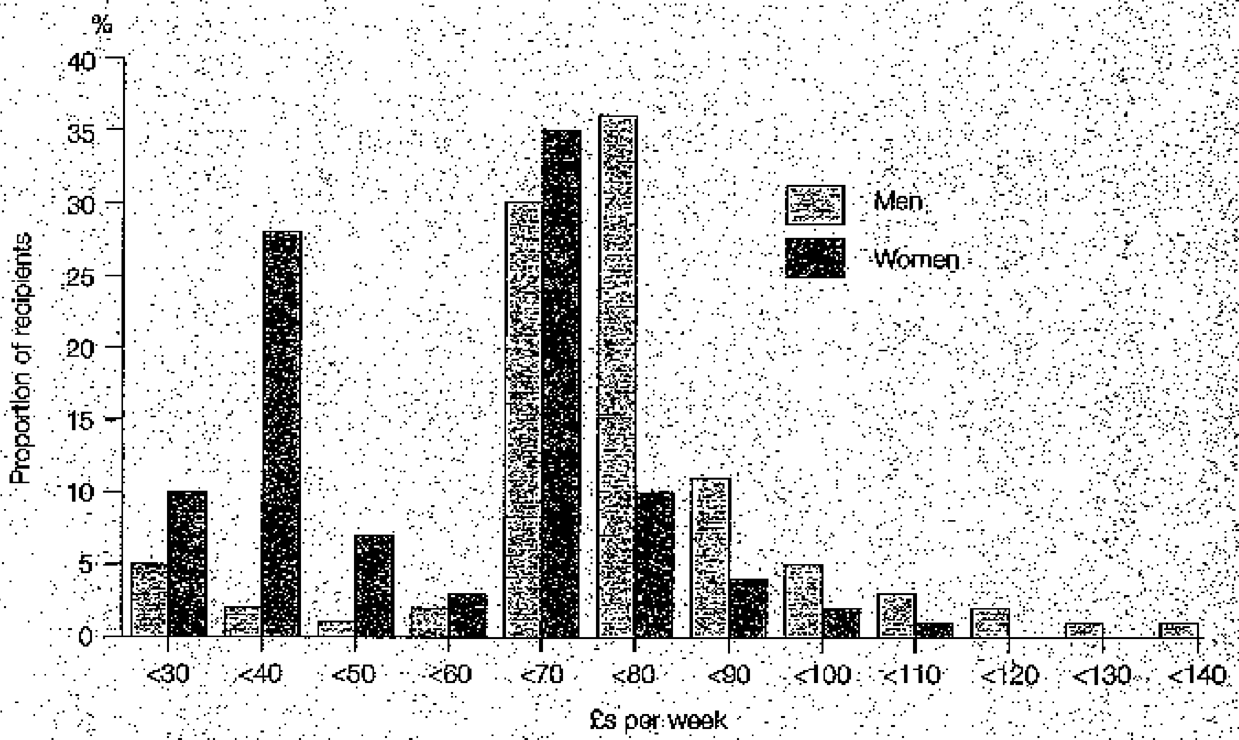
In his March 1998 Budget speech the Chancellor of the Exchequer announced his intention, in the future, to raise the lower earnings limit for National Insurance contributions to the level of the single person's tax allowance – now about £81 a week. We understand the details of how this will operate are still being examined. Depending on what precisely is put into effect, such a change could have a significant impact on state pension entitlements – particularly for the lower paid – and on the contracting-out arrangements.

Amounts of SERPS pension have been growing as each year people who reach state pension age have spent longer contributing to the scheme since it began in 1978. For people reaching state pension age now and who have been in SERPS since it began, the maximum SERPS pension is about £125 a week. The average amounts of new SERPS pensions for such people are about £44 a week for men and £22 a week for women. So, for many people retiring now SERPS (together with the basic state pension) provides enough income to keep them off means-tested benefits. But the recent increases in the amount of earnings-related state pension only apply to people who had earnings as an employee above the lower limit for National Insurance contributions. Periods of self-employment do not count for SERPS and there is no requirement on self-employed people to contribute to any second-tier pension, state or otherwise.

Gender differences in state pensions

In September 1997 the average weekly payment of state pension (basic, SERPS and certain other minor benefits that are, for administrative convenience, paid with state pensions) was £73.14 for men, £53.22 for women and £60.39 for men and women together. Individual amounts varied considerably and in different ways for men and women. Figure 5.2 shows the distribution of weekly payments. Almost two-fifths of women (38 per cent) received less than £40 a week compared with only seven per cent of men. Almost a quarter of men received more than £80 a week, in comparison with just seven per cent of women.

Figure 5.2: Distribution of amounts of state pension in payment, September 1997



Source: DSS, *Retirement Pension: Summary of Statistics*

One reason women have lower state pensions is that they participate less in the labour market and have lower earnings than men. But the main reason is that until 1977 married women were able to opt out of the National Insurance scheme and pay lower contributions. They were able to rely on their husband's insurance record instead, but could only receive a basic pension worth a maximum of 60 per cent of the full rate once he had retired. As Figure 5.3 shows, those who did this receive lower pensions than other women whilst their husbands are still alive.

Figure 5.3: Men and women's state pensions, September 1997

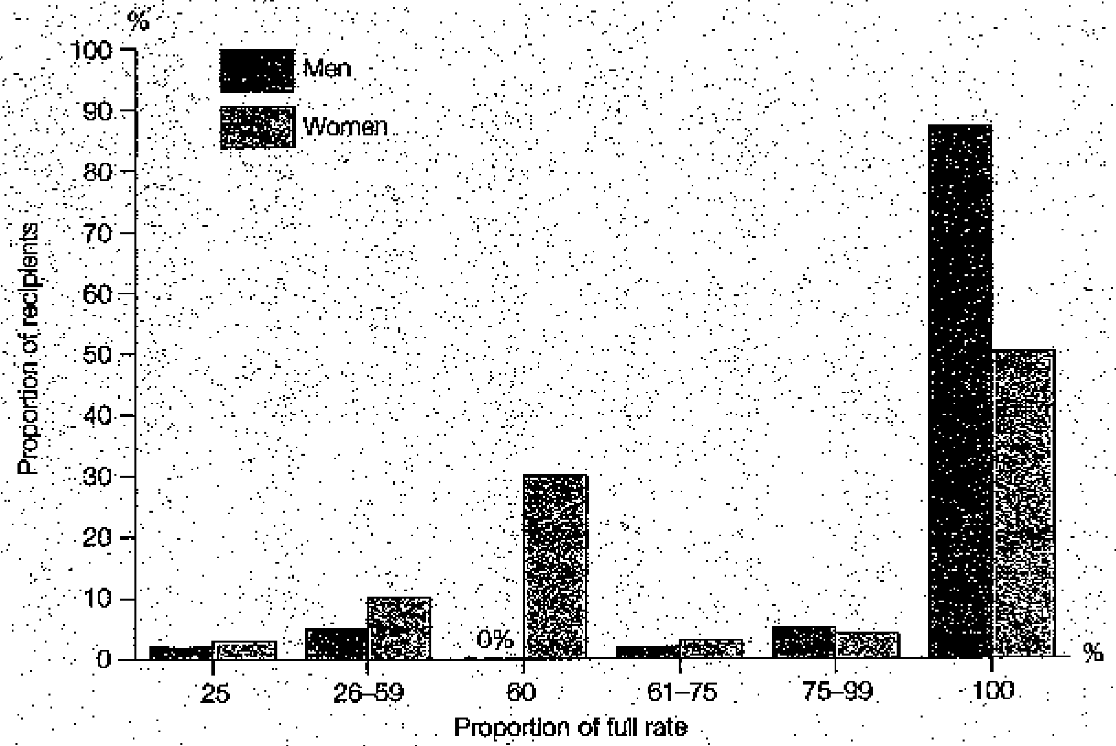
	£ per week
Men	73.14
Women	53.22
Women on own insurance	50.81
Women on live husband's insurance	37.14
Women on ex/deceased husband's insurance	68.08
Women on non-contributory pension	37.89

Source: DSS

Notes: (1) Table shows the average amounts of state pensions – including basic and earnings-related – being paid in September 1997.
(2) Non-contributory pension is explained in Annex E.

Figure 5.4 shows payments of the *basic* state pension as a proportion of the full single person's rate. It shows clearly the continued effect of the married woman's option. Only half of women receive a full rate basic state pension compared with 87 per cent of men. (The figures include pensions paid abroad, some of which are not uprated and inflate the proportions with less than 100 per cent of the full rate.) Thirty per cent of women receive a basic state pension equivalent to 60 per cent of the full rate, which is the maximum that a married woman can receive on the basis of her husband's National Insurance record.

Figure 5.4: Payments of basic state pension as a proportion of the full single person's rate, September 1997



Source: Special analysis for the Pension Provision Group by the DSS

The picture for women's state pensions is changing. In future, women will retire with better contribution records because more women now earn and married women are no longer able to choose to opt out of the National Insurance scheme. This is a very gradual process. Married women who had already opted out before 1977 are able to continue to do so. About 400,000 women are still paying the reduced rate of contribution. It will be well into the next century before the last married woman optant reaches pension age and even longer before the last one dies.

Home responsibilities protection (HRP) introduced in 1978 – primarily of help to mothers at home with children – will also improve women's basic state pension relative to men's. Although legislated, HRP for SERPS has not yet been introduced. (See Annex E for how HRP works.)

Cost

In 1997/8 total payments of state retirement benefits were £30.1 billion in basic pension and £3.2 billion in earnings-related pension – see Figure 5.5. Both have been growing during the 1990s due to increases in the number of people over pension age and to higher basic and earnings-related entitlements.

Figure 5.5: Rising cost of state pensions in the 1990s

	1991/2 £bn	1997/8 £bn	Increase %
Basic	28.9	30.1	4.1
Earnings-related	1.3	3.2	150.0
Total	30.2	33.3	10.4

Source: DSS

Notes: In 1997/8 prices.

Means-tested benefits

Pensioners may also be entitled to certain benefits on the grounds of low income. These are:

- Income Support;
- Housing Benefit; and
- Council Tax Benefit.

Income Support

About 1.8 million pensioners were receiving Income Support in August 1996, 70 per cent of whom were women without a husband or partner, many of them widows. The total number of pensioners who depend on Income Support is rather higher as only one partner in a couple may claim.

Income Support is based on a set of personal allowances and premiums which vary according to a person's status. Subject to savings being below certain thresholds, the amount someone is due is calculated as the difference between the total of their allowance and premiums and their income. For single pensioners the total of personal allowance plus premium increases from £70.45 per week under the age of 75 to £77.55 per week for those aged 80 or over. Figure 5.6 gives further information and compares these Income Support levels with the full rates of basic state pension. People with savings of more than £8,000 are excluded from Income Support. Annex E gives more detail on how Income Support is calculated.

Figure 5.6: Rates of basic state pension and Income Support, April 1998

Pensioner status and age	**Basic state pension £ per week**	**Income Support £ per week**	**Gap %**
Single			
60–74	64.70	70.45	9
75–79	64.70	72.70	12
80+	64.95	77.55	19
Couple			
60–74	103.40	109.35	6
75–79	103.40	112.55	9
80+	103.90	117.90	3

Source: DSS

Note: The amounts of basic state pension shown for couples are on the assumption that the wife's pension is based on her husband's National Insurance record. If, alternatively, she had a sufficient contribution record to receive a basic state pension in her own right, the couple's combined basic state pension would be higher than their Income Support entitlement.

The allowances and premiums in Income Support are not intended to cover housing costs, though additional amounts can be paid in respect of owner-occupiers' mortgage interest. As for other people on low incomes, Housing Benefit meets tenants' eligible rents, and Council Tax Benefit meets Council Tax liability – see below. Income Support can also meet the costs of people living in residential care.

Income Support payments for the over 60s were expected to total £3.9 billion in 1997/8, a 20 per cent increase over 1991/2 in real terms. This includes payments for residential care. Expenditure rose in the first part of the 1990s but has since fallen back a little.

Housing Benefit and Council Tax Benefit

In May 1996 1.9 million pensioners were receiving Housing Benefit and 2.7 million Council Tax Benefit. These figures include people on Income Support. As with Income Support, the total number of pensioners who gain from these benefits is rather larger as only one partner in a couple may claim.

The calculation of the two benefits is directly related to Income Support rules. For people who are entitled to Income Support, Housing Benefit meets their rent in full (subject to certain limits) and Council Tax Benefit covers all their Council Tax liability. For people whose incomes are above the Income Support level, entitlement to these benefits is calculated on a sliding scale. The amount of benefit due reduces in line with income according to a set of 'tapers' and with regard to amounts of savings. Housing Benefit and, to a greater extent, Council Tax Benefit are therefore received by pensioners who are further up the income distribution than is the case for Income Support. Again, more detail is at Annex E.

Total payments in 1997/8 to people over age 60 were expected to be:

➢ Housing Benefit	£3.9 billion.
➢ Council Tax Benefit	£1.1 billion.

The total amount that pensioners receive from these two benefits together is therefore more than they receive from Income Support.

Take-up

It is estimated that in 1995/6 the proportions of pensioners entitled to these benefits but who did not claim them were in the following ranges:

➢ Income Support	34 to 40 per cent.
➢ Housing Benefit	11 to 14 per cent.
➢ Council Tax Benefit	26 to 34 per cent.

Research is currently being undertaken by the DSS into the reasons why so many pensioners fail to claim. We strongly endorse the need for this research.

Other benefits

The *Pensioners' Incomes Series* produced by DSS shows that in 1995/6 16 per cent of pensioner units were receiving disability benefits of various kinds. This represents a four-fold increase over 1979.

The effect of means-tested benefits

Means-tested benefits play a significant role in pensioners' incomes and, on current policies, will continue to do so in the foreseeable future. In the context of pensions policy means-tested benefits have two main effects:

- providing a floor below which pensioners' living standards need not fall if they claim their entitlement; and
- potentially reducing the incentive to save.

A potential floor to living standards

The basic state pension alone does not provide an adequate retirement income and for those who claim them current means-tested benefits provide the floor to living standards. In 1997/8 the difference between Income Support pensioner allowances and premiums and the full rate of basic state pension ranged from about six per cent – for a pensioner couple under 75 where the wife's pension is calculated on the basis of her husband's contributions because he has the better contribution record – to about 19 per cent – for a single pensioner aged 80 or over. (See Figure 5.7.) If help with housing costs were included with Income Support, the differences would be considerably larger.

The return on saving

Entitlements to means-tested benefits are reduced by the amount of pension or other income people receive. For those getting Income Support, pension income attracts a pound for pound reduction, or a 100 per cent marginal withdrawal or 'tax' rate. For those not on Income Support but receiving Housing Benefit or Council Tax Benefit the rate of withdrawal is lower.

The state pension scheme requires all people who currently earn above £64 a week to pay National Insurance contributions which eventually attract pension entitlement. But as we have seen, ensuring an adequate income in retirement without the need for means-tested benefits depends on having a good second-tier pension or some other income. The state currently ensures an element of compulsory second-tier pension cover for employees but this compulsion is not extended to the self-employed or non-employed. Furthermore, given the projected fall in the value of SERPS which is discussed later in this chapter, the degree of compulsion for employees is also falling.

High marginal withdrawal rates may tend to discourage the people who are affected from saving for their retirement or continuing to earn once they become eligible for these benefits. If people in work know that means-testing

of benefits in retirement will mean that they will effectively get little return for the pension saving they undertake during working life, they might be inclined to save less. On the other hand, if greater means-testing goes together with lower levels of universal benefits there will be some people who will save more in order to achieve a higher target level of income in retirement.

In designing systems for means-testing it is always important to bear in mind that, if different sorts of savings are treated differently for the purpose of the means-test, then people might alter their behaviour accordingly. For instance, if the value of owner-occupied housing is not counted towards a means-test, then there will be some incentive to have a larger house and a smaller private pension than might have been optimal in the absence of the means-test. Pensions, financial assets and housing wealth are in fact each treated differently. Only pension income is always taken into account in full.

M. T. Benefits

We believe that many people may wish to make their own provision in order to avoid having to rely on means-tested help. This may apply particularly to the generations who have retired or are just reaching retirement. Given the difficulty of predicting one's own circumstances over a working life, many people may be unable to make the necessary calculations in advance to establish whether or not it will pay them to save for retirement.

In our opinion a means-tested safety net for those who cannot build up good second pensions is inevitable. Nevertheless, the key question for policy makers is how to achieve the right balance of compulsion and incentives to ensure that those who can avoid reliance on means-tested benefits do so while avoiding the position where significant numbers – encouraged, if not compelled, to make their own provision – find themselves no better off than if they had not done so.

The impact of current policies on the future level of state pensions

If earnings continue to rise faster than prices, the value of state pensions will decline in relation to earnings. Figure 5.7 shows calculations by the Government Actuary's Department which illustrate the effect of this for men and for women in full-time employment. The examples assume the people concerned have average earnings for their gender throughout their working lives. Although this is unrealistic – it is highly unlikely anyone would be on precisely average earnings throughout their life – they are the figures that are most commonly quoted. The examples also use a central assumption that average earnings grow faster than prices by 1.5 per cent a year.

Figure 5.7 shows that the basic state pension will fall from about 16 per cent of men's average earnings in 1997 to about seven per cent in 2050. Because

Figure 5.7: Basic state pension and SERPS as a proportion of earnings

Assuming price indexation of basic state pension and earnings limits

	Men		Women	
Year	**Basic pension** %	**SERPS** %	**Basic pension** %	**SERPS** %
1997	16	21	22	18
2000	15	21	21	18
2010	13	18	19	16
2020	11	17	16	16
2030	10	16	14	16
2040	9	15	12	16
2050	7	13	10	16

Source: Government Actuary's Department

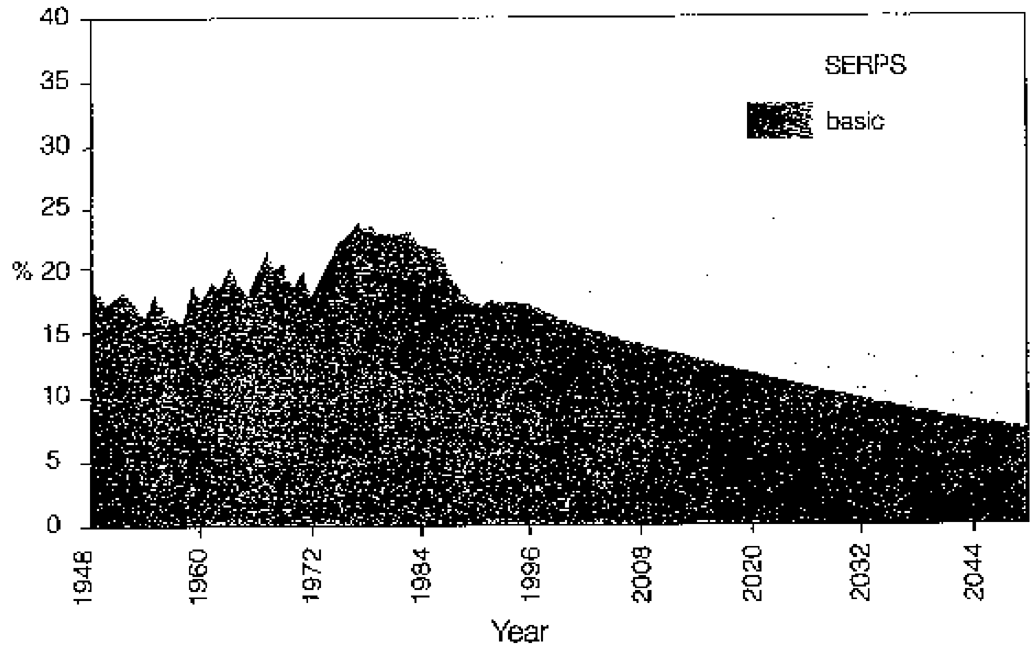
Notes:
(1) The table shows for men and women who reach state pension age in the years shown the proportion that basic state pension and SERPS will form of their respective full-time average earnings.
(2) The table is based on our central assumption that earnings rise faster than prices by 1.5 per cent a year. The examples also assume the men and women concerned have continuous full-time average earnings.
(3) Basic state pension is a higher proportion of women's earnings because their earnings are lower than men's.
(4) SERPS pensions for men on average earnings fall as a proportion of earnings initially because of the reduction in the target rate from 25 per cent of earnings to 20 per cent of earnings. In later years they also fall because men's average full-time earnings rise above the upper earnings limit (UEL) for National Insurance contributions, which is assumed to be linked to prices. Earnings above the UEL do not count towards SERPS pensions.
(5) SERPS pensions for women in this example also fall initially because of the reduction in the target rate from 25 per cent to 20 per cent. Because women's earnings are lower than men's, they remain – unlike men's earnings – below the UEL for most of the period shown.

women's earnings are lower, basic pension forms a higher proportion of their average earnings. The reduction for women is therefore from about 22 per cent to about ten per cent of their average earnings.

In this illustration SERPS pensions for men fall from about 21 per cent of average earnings for those reaching pension age now to about 13 per cent for a man reaching pension age in 2050. This is because men's average earnings will rise above the upper earnings limit for National Insurance contributions. For women, SERPS pensions fall from about 18 per cent of average earnings now to about 16 per cent for those reaching state pension age from about 2010 onwards. In these examples women's average earnings do not rise above the upper earnings limit.

Figures 5.8 to 5.10 illustrate the position in more detail for men and women reaching state pension age from 1948 to 2050. These examples are based on the same assumptions as Figure 5.7 except that they use median – as opposed to average – earnings and also make some allowances for years when people have no earnings. A further explanation of the assumptions used in Figures 5.8 to 5.10 is in Annex F.

Figure 5.8: State pensions for men on median earnings as % of average earnings

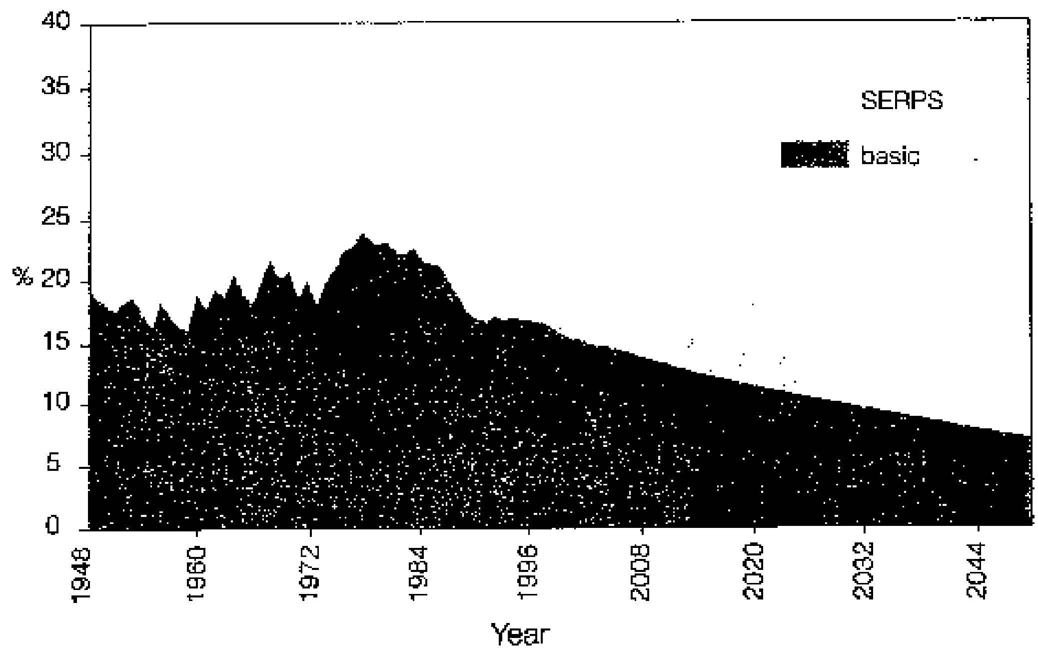


Source: Government Actuary's Department

Notes: (1) This example assumes the men concerned have six years without earnings. In each year that they earn, they are assumed to have the median earnings for men of that age.

(2) For SERPS, the chart shows the value in relation to average earnings for all full-time employees for the year the men reach state pension age.

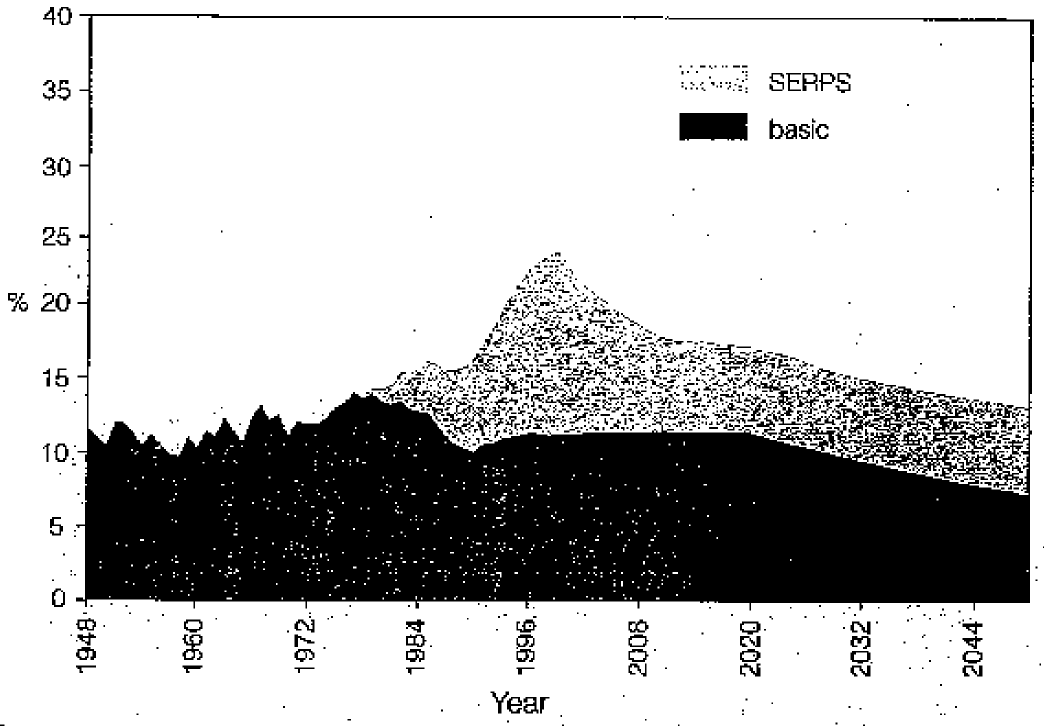
Figure 5.9: State pensions for women on median earnings as % of average earnings



Source: Government Actuary's Department

Note: See notes to Figure 5.8. In the years that they earn, women are assumed to have the median earnings for women of that age.

Figure 5.10: State pensions for women with 21 years not earning, as % of average earnings



Source: Government Actuary's Department

Notes: (1) This example is for married women who have 21 years without earnings. In each year that they earn, they are assumed to have median earnings for women of that age.

(2) For women reaching state pension age in the years up to 1990, it is assumed that their basic state pension was based on their husband's National Insurance record and that they received a pension at 60 per cent of the full rate. For women reaching state pension age from 2020, it is assumed that home responsibilities protection (HRP) will allow them to qualify for a full basic state pension on the basis of their own National Insurance records. For women retiring between 1990 and 2020, HRP has an increasing effect each year in raising the rate of basic state pension they receive on the basis of their own records. This effect broadly offsets the decline over this period in the full rate of the basic state pension as a proportion of average earnings.

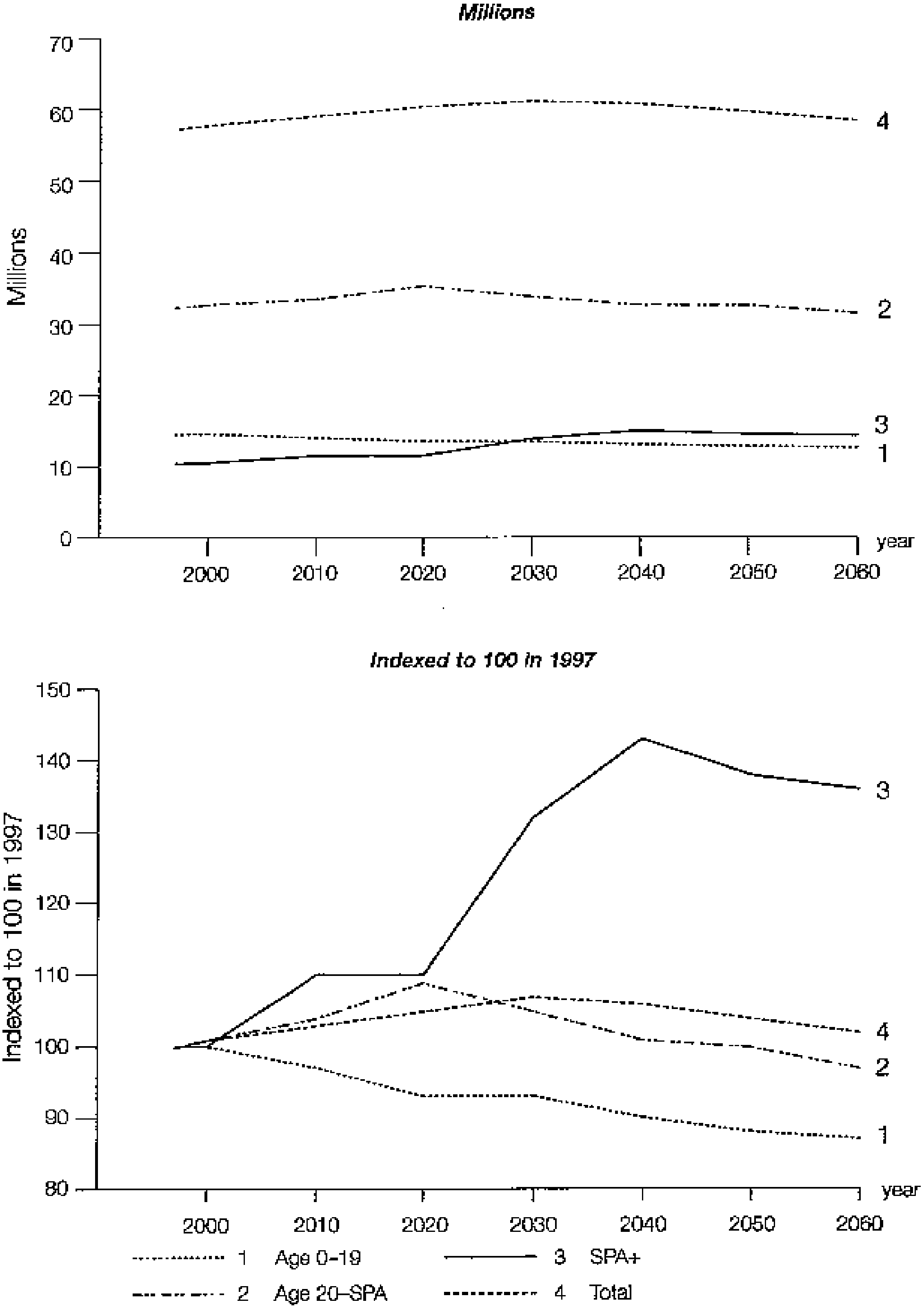
(3) This figure assumes no HRP for SERPS pensions.

(4) See also note (2) to Figure 5.8.

The figures show that for much of the last two decades, the value of state pensions – basic plus earnings-related – has been rising as a proportion of earnings for many people reaching state pension age. This has been due to the maturing of SERPS which has more than offset the falling value relative to earnings of the basic state pension. But changes made to SERPS in the 1986 Social Security Act and in the 1995 Pensions Act will reduce the amounts paid to people who reach state pension age from 2000 onwards. Apart from pensions not being based on the 20 best years' earnings – which had been the original promise made in the 1975 Social Security Pensions Act to people reaching pension age in the 21st century – new SERPS pensions will be affected by:

- the reduction in the target level of pension from 25 per cent to 20 per cent of earnings between the contribution earnings limits (currently £64 and £485 a week); and
- changes in the way that the lower earnings limit is applied in calculating SERPS pensions. These will very substantially reduce SERPS entitlements accruing in the future, with the greatest proportionate impact being on the lowest earners.

Figure 5.11: Age distribution of GB population



Source: Government Actuary's Department

Note: SPA = state pension age.

The removal of the best 20 years provision will have a particularly adverse impact on women's SERPS pensions. One way of addressing this would be to commence the provision for home responsibilities protection in SERPS, to which we referred earlier.

Figures 5.8 to 5.10 show that, for employees reaching state pension age, the total value of basic pension plus SERPS in relation to average earnings will, in a few decades' time, return to below the level applying before SERPS began.

Self-employed people have not benefited from SERPS pensions. For them, the important effect in Figures 5.8 to 5.10 is the falling value relative to earnings of the basic state pension.

SERPS pensions paid to people who are widowed from 2000 onwards will also be cut by half. Details are in Annex E.

The long-term cost of state pensions

The cost of pensions depends on the number of people to whom they are paid and the amounts they receive. Since 1951 there has been a large rise in the number of people over state pension age, from about seven million to over ten and a half million. The cost of state pensions also rose in that period – at 1996/7 prices – from about £5 billion to £32 billion. As a proportion of gross domestic product, the cost rose from two per cent in 1949/50 to 4.3 per cent in 1996/7.

Population projections for the future

The Government Actuary makes population projections for the period up to 2060 which are used for the purposes of estimating long-term state pension costs. Figure 5.11 shows that the number of people between the age of 20 and state pension age is projected to rise by about a tenth in the period up to 2020 – partly due to the rise in women's state pension age – but will return to about the current level by about 2040 and will continue to decline subsequently. This follows from the assumption that births will remain below the replacement level. (We show at Annex F notes kindly provided to us by the Government Actuary's Department which comment further on these changes.)

Figure 5.11 also shows that the number of people over state pension age will rise substantially:

- by about a tenth between now and 2010; and
- with a further 20 per cent rise after 2020.

In 2040 it is expected there will be 43 per cent more people over state pension age than now. The total then declines slowly for the rest of the period up to 2060. Figure 5.12 gives a more detailed breakdown.

Figure 5.12: Age distribution of GB population (detail)

Year	Age 0–19	20–SPA	SPA+	Total
		Millions		
1997	14.5	32.4	10.4	57.3
2000	14.5	32.8	10.5	57.8
2010	14.0	33.6	11.5	59.1
2020	13.5	35.4	11.5	60.4
2030	13.4	33.9	13.8	61.1
2040	13.0	32.7	14.9	60.7
2050	12.7	32.6	14.4	59.6
2060	12.5	31.5	14.2	58.3
		Indexed to 100 in 1997		
1997	100	100	100	100
2000	100	101	100	101
2010	97	104	110	103
2020	93	109	110	105
2030	93	105	132	107
2040	90	101	143	106
2050	88	100	138	104
2060	87	97	136	102

Source: Government Actuary's Department

Note: SPA = state pension age.

The numbers of the very old rise more sharply than the numbers over state pension age. For example, in 2040 there are projected to be nearly twice as many people aged 80 and over as there are now.

Pensioner support ratio

In Figure 5.13 we show the future trend in the 'pensioner support ratio', that is the number of people between the age of 20 and state pension age divided by the number of people of pension age. In the Government Actuary's main projection the ratio remains broadly constant until 2020 but falls sharply thereafter.

In all of our work we have assumed that state pension age remains at the ages currently planned, i.e. 65 for men and for women reaching that age from 2020. We have not considered the financial effect of, at some point, further raising state pension age beyond that date. Plainly, very wide issues would be involved which go beyond the scope of our work, for example the question of whether sufficient employment opportunities would be available for those affected.

Nevertheless, we note that in a number of countries around the world state pension ages are rising. Without in any way wishing to advocate this as a policy, we do remark that the support ratio in the middle of the next century would be little different to what it is now were a phased rise in the state pension age from 65 to 70 to be made over a 20-year period from 2020.

Figure 5.13: Pensioner support ratio

Year	State pension age: As planned	State pension age: To age 70 by 2040
1997	3.1	3.1
2000	3.1	3.1
2010	2.9	2.9
2020	3.1	3.1
2030	2.5	3.1
2040	2.2	3.2
2050	2.3	3.3
2060	2.2	3.3

Source: Government Actuary's Department

Note: Figure shows future trends in the pensioner support ratio defined as the number of people between the age of 20 and state pension age divided by the number of people over state pension age.

Future prospects for the National Insurance fund

We show in Figure 5.14 the Government Actuary's projections for spending on National Insurance benefits until 2050 measured in terms of constant 1997/8 earnings. Although the total cost of state pensions rises over the first decade of the next century, it declines again from 2030 to 2050 as the relative value of pensions in payment falls behind the assumed growth of earnings.

We believe that, when looking so far ahead, it is more realistic to assess costs in relation to earnings levels rather than in relation to prices. This is because the forecasts assume that earnings will continue to grow in real terms. The costs, measured in relation to constant prices, would appear higher, but this would give a misleading impression of the proportion of future earnings needed to meet these costs.

Figure 5.14: Projected expenditure on state pensions and other National Insurance benefits

Year	Basic state pension (£ billion, 1997/8 earnings terms)	SERPS	Other benefits	Total
2000	30	4	9	43
2010	28	8	8	44
2020	26	8	7	41
2030	27	8	6	41
2040	25	6	5	36
2050	21	5	4	30

Source: Government Actuary's Department

Note: Estimates assume that earnings grow faster than prices by 1.5 per cent *per annum* and that basic state pension and contribution earnings limits continue to be linked to prices.

A second point is that the band of earnings on which National Insurance contributions are levied will itself shrink in relation to total earnings. This is because the upper earnings limit is linked to prices and so will fall behind the growth in earnings. We have therefore expressed future costs, not only as the National Insurance contribution rates which will be levied on the appropriate band of earnings, but also as percentages of total earnings, including those of self-employed people. We believe that trends in these latter percentages give a fairer picture of the changing cost of state pensions.

Figure 5.15 shows that, with continued prices uprating of the basic state pension and of the contribution earnings limits, the standard rate of National Insurance contributions is projected to fall from about 18 per cent in the year 2000 to about 14 per cent in 2050. Expressed in relation to total earnings, the cost of state pensions and other National Insurance benefits will fall from about 12 per cent in 2000 to about nine per cent in 2050. Both sets of figures show that the increase in the number of people over state pension age – assuming it remains at 65 after 2020 – is more than offset by the falling value of state pensions relative to earnings. The net effect is particularly strong after 2030. For illustration, we also show in Figure 5.15 what would be the effects if the basic state pension and the contribution earnings limits were raised in line with earnings, instead of prices, and state pension age kept at 65 after 2020. The contributions required would be substantially higher than now and much higher than under prices uprating.

A note by the Government Actuary's Department on the basis of their calculations is at Annex F.

Figure 5.15: Future contribution levels

	Uprating of basic pension and contribution limits by:			
Year	***Prices***		***Earnings***	
	NIC rate %	***% of total earnings***	***NIC rate %***	***% of total earnings***
2000	18.2	11.7	18.6	12.0
2010	17.9	11.8	20.3	13.6
2020	16.9	11.4	21.2	14.7
2030	17.4	11.7	24.2	17.2
2040	15.9	10.4	24.9	17.8
2050	14.0	8.9	24.3	17.3

Source: Government Actuary's Department

Notes:
(1) Estimates assume that earnings grow faster than prices by 1.5 per cent *per annum*.
(2) Contributions are those needed to meet the cost of state pensions and other National Insurance benefits.
(3) 'NIC rate' is the standard rate of contribution in respect of the earnings of employees who are not contracted out of SERPS.
(4) Estimates for '% of total earnings' express costs as a proportion of *all* earnings of employees and self-employed people, not just the earnings on which NICs are paid.

Summary

Under our present system those with low lifetime earnings are provided for by the redistribution of resources, through the basic state pension and through means-tested benefits. The state is the most effective agent in achieving redistribution, and therefore it has an inescapable role in ensuring meaningful pensions for those who cannot realistically be expected, on their own, to build up good second pensions. The alternative will be greater reliance on means-tested benefits.

A series of major, long-term changes are altering radically many of the main features in state pension provision. These began in the 1970s but will not have their full effects until well into the next century.

Because it has been linked to the rise in prices since 1980 – and on current policies will continue to be so – the value of the basic state pension is falling in relation to average earnings. This makes it even more important that people have good second-tier pensions in order to have adequate incomes in retirement and to avoid the need to depend on means-tested benefits, which themselves can have adverse effects on people's incentives to save for retirement.

But it is also becoming easier to meet the contribution requirements for the basic state pension. This applies especially to those women who spend substantial parts of their lives with little or no earnings.

SERPS pensions have become increasingly important for newly-retired employees. Despite the fall in the value of the basic state pension relative to earnings, the total state pension – basic plus SERPS – paid to employees reaching pension age has been rising as a proportion of average earnings. In contrast to most of the post-war period, the state now pays higher pensions to younger pensioners and to those who had better earnings during periods of employment. The latter effect is offset to some extent by the greater likelihood that higher paid people are in occupational pension schemes (and, in the future, personal pension schemes) that are contracted out of SERPS.

The benefits of the growing value of SERPS pensions for newly-retired employees have not been shared by older pensioners who retired either before SERPS started, or before it began to pay significant amounts of pension, nor by self-employed people, nor by people with very low earnings.

The improvements brought about by SERPS for some people will, however, start to go into reverse from 2000 when the value of new SERPS pensions will also begin to fall in relation to average earnings. The long-term prospect is that the value of state pensions, even including SERPS, will form a lower proportion of earnings than they did before SERPS began in the late 1970s.

The number of people over state pension age will grow by 40 per cent between now and 2040 despite the rise in the women's state pension age. But because on present policies their value will fall relative to earnings, state pensions will be no less affordable than they are today. Whilst there can be no certainty about future demographic and economic conditions, we expect the contributions needed to meet the cost of state pensions will show little or no increase as a proportion of earnings and will eventually fall towards the middle of the next century.

6 Occupational and personal pensions

This chapter is largely descriptive, but it is also intended to enable the reader to begin to think about a framework for second-tier, non-state pensions which is both appropriate and fair.

It:

- summarises the benefits that occupational and personal pensions provide; and
- shows who is covered, who is not and why not, including eligibility, take-up and the extent of provision by employers.

In this chapter we look at occupational and personal pensions – both of which have attractions in helping people to save for their retirement. Our focus is on the reasons why people do *not* benefit from such schemes. As we showed in Chapter Three, non-state provision is the main reason that people are able to avoid being poor in old age, and so it is important to know why many people are excluded from benefiting in this way. We begin with occupational pension schemes.

OCCUPATIONAL PENSION SCHEMES

In this section we look at:

- the level and types of benefits occupational schemes provide;
- who is covered and who is not;
- the reasons people are not in occupational schemes; and
- other features of occupational provision.

Definition of an occupational pension scheme

We have taken the term occupational pension to mean a pension arrangement which has a sponsoring employer – or collection of employers, as in the case of industry-wide schemes – and provides pensions and/or benefits for, or in respect of, members on leaving service, or on death, or retirement. We excluded from this definition group personal

pensions (GPPs) which, whilst they may have a sponsoring employer, are essentially a collection of personal pensions.

Types of occupational pension scheme

There are basically two types of occupational pension scheme in the UK – defined benefit (DB) and defined contribution (DC). The exact nature and level of the benefits will depend on the scheme rules. Most commonly, DB schemes are final salary arrangements which provide a pension based on a fraction of the member's salary at or near retirement for each year of scheme membership. Scheme members are better able to anticipate in advance what their pension will be, subject to their continuing in pensionable employment. In DC schemes, on the other hand, it is the contributions paid into the scheme which are pre-determined, not the benefits. Benefit levels will depend on the level of contributions, on the investment returns they achieve and on annuity rates at the time the fund is converted into a pension. Schemes may determine the form in which the pension must be taken, but the level of the benefits cannot be known in advance.

Occupational pension schemes may also be a mixture of DB and DC. These are known as 'hybrid' schemes.

Until recently, occupational pensions were generally provided on a DB basis, particularly among larger employers. However, this position is gradually changing as growing numbers of employers switch from DB to DC, or to hybrid schemes. The Government Actuary's Department (GAD) found that in 1995 three per cent of schemes had introduced a DC system for some or all of their members in the previous four years – see Annex F. The National Association of Pension Funds (NAPF) found in 1997 that a total of 15 per cent of its member organisations who responded to its survey offered pure DC schemes, the same proportion as for 1996. The proportion offering hybrid schemes had grown from four per cent to six per cent since 1996. As the NAPF's membership tends to be concentrated amongst larger employers, the survey may underestimate the extent of the move since 1995 to providing pensions on a DC basis.

In the main, where new DC or hybrid schemes have been established, these have been for new entrants. Rarely has it been the case that an existing DB scheme has been wound up completely to be replaced by a DC scheme for both past and future service. Figure 6.1 shows the nature of pension provision by size of employer. Few companies are currently setting up new DB schemes.

In a 1997 Trades Union Congress/Union Pension Services report, employers cited the following reasons for moving to DC:

- improving and up-dating the benefit structure;

Figure 6.1: Pension provision by company size

Number of employees	***1–20***	***21–100***	***101–200***	***201+***	***All***
			Percentages		
Defined benefit scheme	23	27	35	51	35
Defined contribution scheme	63	59	37	28	47
Both	11	7	18	18	13
Respondent did not know	3	6	10	3	5

Source: Institute of Directors (1997)

Notes: (1) Percentages refer to employers who have an occupational pension scheme.
(2) Columns may not add to 100 due to rounding.

- greater freedom of choice for the individual, reflecting a change in the approach to personal savings in the 1980s;
- ease of implementing the 1995 Pensions Act;
- the greater cost certainty (for employers) associated with a DC scheme;
- the level of the contracting-out rebate;
- to introduce employees to pensions at affordable costs; and
- fewer and fewer people stay with the same employer throughout their working lives, and the DC option could offer some of these people a better deal.

However, the extent of the shift to DC schemes should not be over-estimated.

Amounts of occupational pension in payment

Provisional findings from the 1995 GAD survey of occupational pension schemes show 7.5 million people were receiving an occupational pension from a former employer's scheme of whom:

- four million men were former employees;
- two million women were former employees; and
- 1.5 million were widows, widowers or dependants of former employees.

It is estimated that about a quarter of the people receiving a pension from their former employer's scheme were under state pension age.

The prospect of a good occupational pension depends on a significant number of years of pensionable service; scheme benefit rules; and, in the case of DC schemes, a high level of contributions and investment returns.

Even where people have the opportunity to belong to a good scheme, very few will eventually receive the maximum benefits allowed under Inland Revenue rules. The main reasons that people do not receive the maximum level of benefits are the fact that many people do not have pensionable service for the 40 years normally required to get close to the limits and the effect on pension rights of people changing jobs.

Figure 6.2 shows the proportion of pensioners receiving an occupational pension in 1995/6 and the average and median amounts they received.

Figure 6.2: Proportion of pensioners receiving pensions and amounts

	Proportion with occupational pension income %	**Average amount** £ per week	**Median amount** £ per week
All pensioner units			
Total	65	78.70	44.10
Single pensioners	60	58.40	33.10
Married pensioners	75	102.20	60.00
Recently retired pensioner units			
Total	69	99.10	63.80
Single pensioners	55	68.30	39.40
Married pensioners	79	111.60	72.20

Source: DSS *Pensioners' Incomes Series 1995/6*

Notes: (1) Average amounts are the averages for those receiving an occupational pension.
(2) Recently retired pensioner units are defined as single women aged 60–64; single men aged 65–69; and married couples of whom the husband is aged 65–69.
(3) Amounts are at July 1995 prices.

The difference between the median and average amounts reflects the unequal distribution of these payments. For example, half of all single pensioners with income from this source had occupational pensions of less than £33.10 a week in 1995/6. Even so, that figure had grown 60 per cent more than prices since 1979.

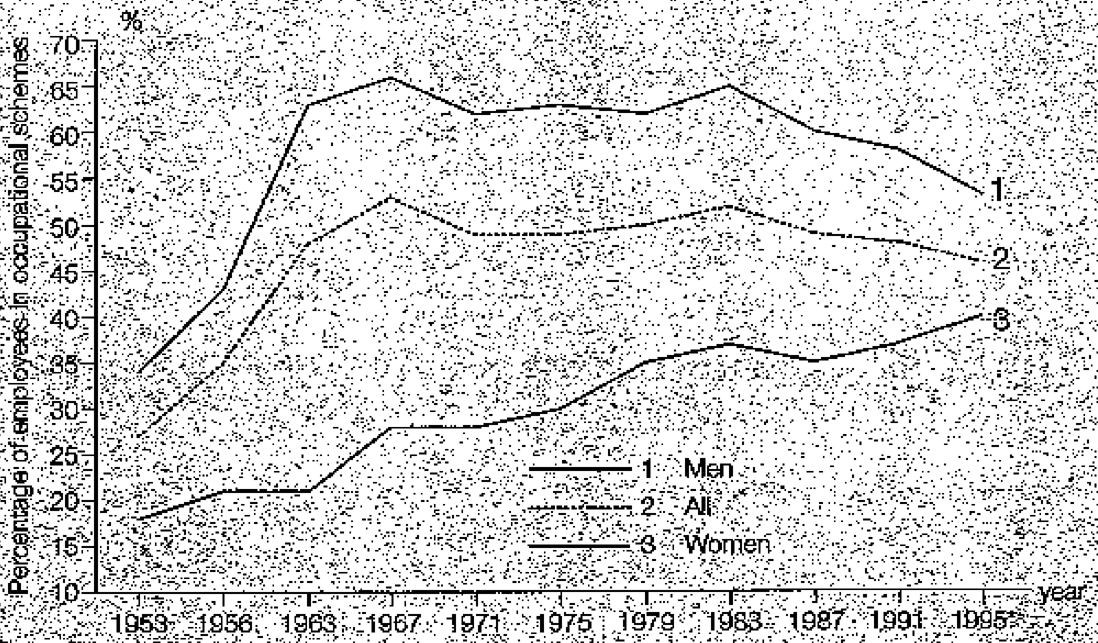
Who is covered and who is not

According to the latest published GAD survey, in 1991, 48 per cent of all employees – 10.7 million people – were members of an occupational scheme, nearly double the proportion 40 years before. But there is evidence of decline since the early 1980s – see Figures 6.3 and 6.4. Provisional estimates from GAD indicate that the proportion has continued to fall and was down to 46 per cent – 10.5 million people – in 1995. (Further information from the 1995 GAD survey is in Annex F.)

defining OCP membership

Active membership of occupational pension schemes is, by definition, not open to the self-employed, unemployed and 'non-employed' such as parents at home, other carers, students and those who have already retired. *At any one time* non-members constitute two-thirds of the working age population. But a high proportion of people reaching retirement –

Figure 6.3: Proportion of employees in occupational pension schemes since 1953, by sex



Source: Government Actuary's Department
Note: *Provisional.

Figure 6.4: Employees in occupational pension schemes since 1953

Year	Total members Millions	Total employees Millions	Percentage of employees in schemes %
1953	6.2	21.9	28
1956	8.0	22.7	35
1963	11.1	22.9	48
1967	12.2	23.2	53
1971	11.1	22.5	49
1975	11.4	23.1	49
1979	11.6	23.4	50
1983	11.1	21.1	52
1987	10.6	21.6	49
1991	10.7	22.5	48
1995*	10.5	22.6	46

Source: Government Actuary's Department
Note: *Provisional.

particularly men – have been members of an occupational scheme at some time in their working lives. Disney *et al* (1997) – based on a sample of people aged 55–69 in 1988 – show that 81 per cent of men and 42 per cent of women at retirement age had, at some time, belonged to an occupational scheme.

Employment sector

Provision of occupational pension schemes is virtually universal in the public sector. In the private sector, the 1994 Employer's Pension Provision (EPP) survey – Casey *et al* (1996) – found that provision was most common in:

- larger companies. Nearly 90 per cent with more than 100 employees had schemes compared with only 65 per cent for firms with 12–19 staff and as few as 31 per cent of companies with five or fewer employees; and
- longer-established firms. 88 per cent of those firms established before 1900 had provision, falling to 61 per cent for those started in the 1960s and 1970s and to 23 per cent among those set up in the 1990s.

Manufacturing companies were more likely to make provision than the service sector (60 per cent to 51 per cent).

Scheme eligibility

Where there is a scheme, access may be limited to sections of the workforce or to individuals meeting certain criteria. Access is widest in the public sector. In the private sector the EPP survey found:

- openness – i.e. being open to all sections of the workforce – of occupational scheme membership increased with company size; and
- a marked similarity in the criteria used to offer membership. The most common were as shown in Figure 6.5.

Figure 6.5: Eligibility criteria for individual employees, by type of pension provision

	Defined benefit %	***Defined contribution*** %
Length of service	49	49
Hours worked*	32	29
Permanent status	91	86
Minimum age	56	35
Maximum age	44	31
Employee grade/salary	14	22

Source: Casey *et al* (1994)

Note: *Under the 1995 Pensions Act, access cannot be denied to part-timers if this has the effect of discriminating against men or women.

Characteristics of those who are scheme members

The following picture emerges of people who belong to occupational pension schemes:

Gender and whether in full- or part-time employment

- Men are more likely to be members of occupational schemes than women – 6.3 million men compared with 4.2 million women – according to provisional findings from the 1995 GAD survey (see Figure 6.3). This in part reflects their respective patterns of employment.
- The proportions of men and women employees who belong to occupational pension schemes have been changing. The General Household Survey shows the following:
  - amongst men working full-time, membership is down from 64 per cent in 1988 – when compulsory membership became illegal – to 58 per cent in 1995;
  - amongst women in full-time jobs there has been little change in membership (up from 54 per cent to 55 per cent); but
  - amongst women in part-time employment, membership has doubled from 12 per cent to 24 per cent.

Earnings levels

- Low earners are less likely to be scheme members. The New Earnings Survey shows that only about a third of full-time employees earning less than £170 a week in 1997 were scheme members, compared with about three-quarters of those earning over £450 a week. Differences between men's and women's earnings levels may be a factor in women's generally lower rate of scheme membership. This may be particularly so in schemes which make a deduction from earnings based on the National Insurance lower earnings limit (or some fraction of it) in calculating pensionable pay.

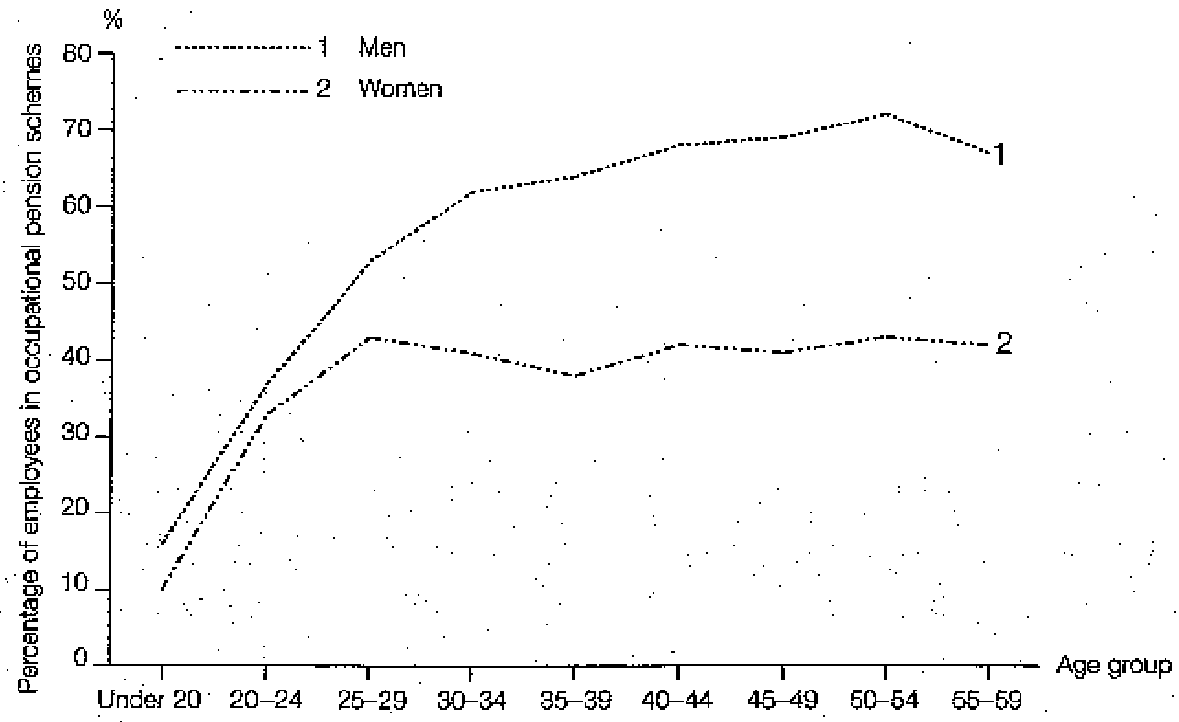
Age

- Figure 6.6 shows that scheme participation *at any one time* rises amongst men under 30 reaching a plateau of around two-thirds at age 35. For women, participation declines during their 30s settling at about 40 per cent. Over the age of 55 active scheme membership declines, possibly the result of early retirement being disproportionately focused on those who have built up good occupational entitlements.

Ethnic origin

- A forthcoming report by the Centre for Research in Social Policy, Loughborough University – McKay *et al* – finds that non-whites were more likely never to have belonged to an occupational pension scheme (or to

Figure 6.6: Coverage of occupational pension schemes, by age and sex, 1991



Source: Government Actuary's Department

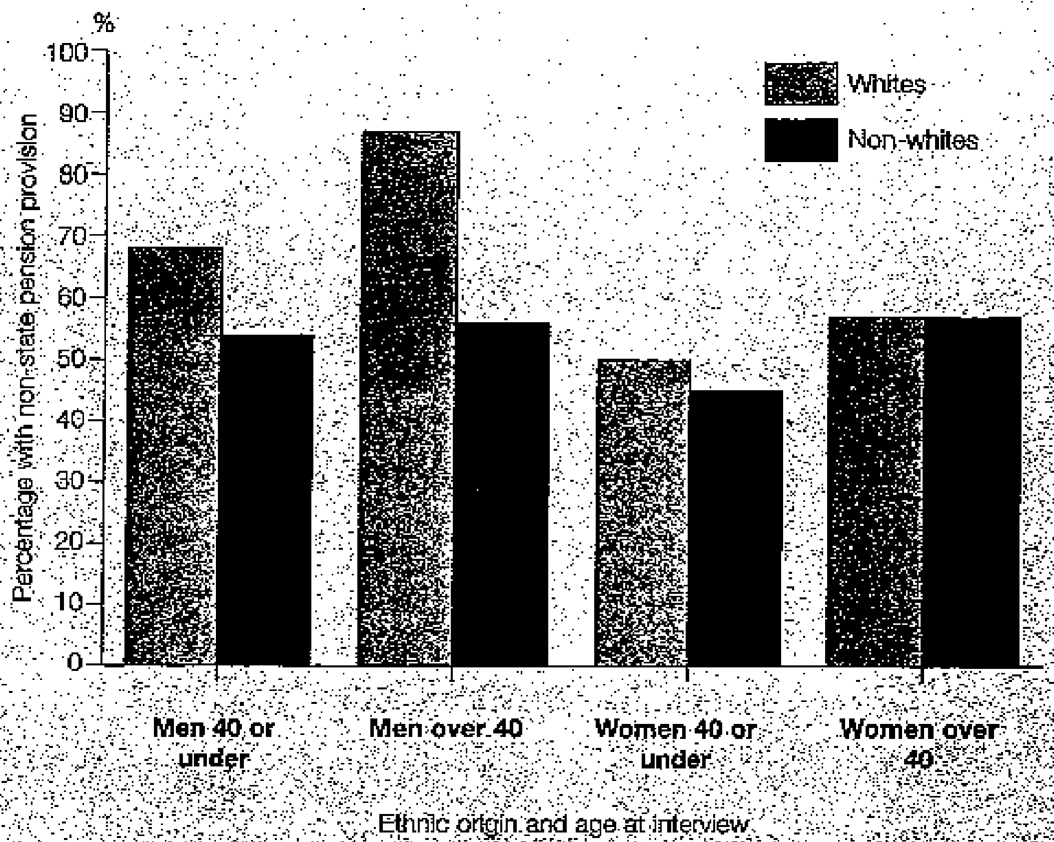
have taken out a personal pension) than their white counterparts, although the difference is less marked among women than men (see Figure 6.7).

However, the lack of available evidence has meant we have found it impossible to determine whether the lower levels of pension coverage for black and other minority ethnic groups is a factor of lower levels of pay and job opportunities or a factor of ethnic origin *per se*.

Length of service

- Length of service is also an important factor in determining who is and is not covered by an occupational pension scheme.
- Of employees who work full-time and have been with their employer for more than five years, 75 per cent of men and 70 per cent of women belong to a scheme. Only 37 per cent of women working part-time and with their employer for more than five years are in an occupational scheme.
- Under a third of people with their employer for less than two years belong to schemes. However, it may be the case that if they stay beyond two years they will subsequently join the pension scheme. In the vast majority of cases, scheme members leaving with less than two years' service will only receive a refund of their own contributions. A series of short-term contracts can therefore have damaging consequences for final pension levels.

Figure 6.7: Pension coverage and ethnic origin



Source: McKay *et al* (forthcoming)

Why people are not covered by occupational schemes

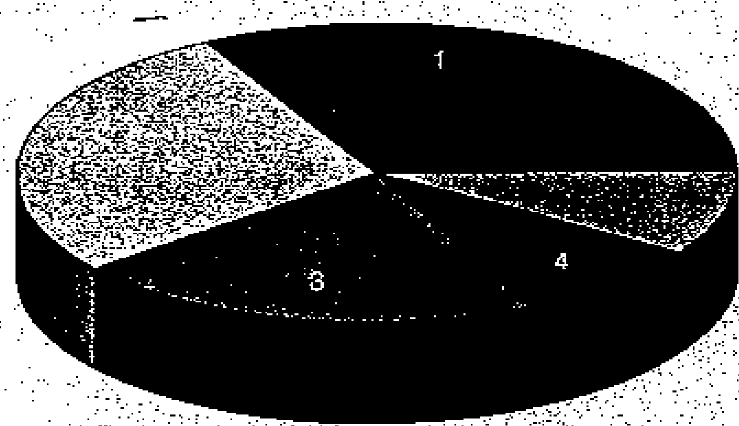
In the UK an employer's decision whether to provide a pension scheme has always been a voluntary one. Until 1988 the majority of employers who did provide schemes were able to require employees to join as a condition of employment. But since 1988, when personal pensions were introduced, making membership a condition of employment has been illegal. So membership of an employer's scheme is now entirely voluntary. Employees are able to choose instead to make their own arrangements through a personal pension or to rely on SERPS. To understand why people in work today are not in occupational schemes we need therefore to consider two sets of decisions:

- those that employers make about providing pension schemes; and
- those that employees make about joining a scheme where one is available.

Decisions that employers make

In addition to wanting to provide for their employees in old age, employers offer pension schemes because they see it is in their own interest to do so. Most importantly, employers believe that the provision of a pension scheme will help attract, retain and motivate employees. They may also consider that providing pensions enhances their reputation in the community generally and avoids the bad publicity that can be associated with employees retiring into poverty. Schemes can also assist in altering the structure of a workforce through early retirement. This pattern is borne out in a 1994 report by the Confederation of British Industry which ranked employers' reasons for providing pension schemes. See Figure 6.8.

Figure 6.8: Companies' motivation for providing a pension scheme



	Companies' motivation towards pension scheme	***% ranking as most important***
1	Ensures the company is competitive in the labour market	33
2	Is part of the company's paternalistic approach and contributes to image as good employer	28
3	Acts as an aid to motivation	21
4	Has been in existence for many years and could not be easily discontinued	9
5	Provides for the ability to retire employees on reasonable pensions at the company's convenience	9

Source: Confederation of British Industry (1994)

Employers operate in a competitive labour market so each company's decision is likely to be affected by what other employers do. Many will want to match their competitors' practice in terms of the range and level of benefits they provide for their employees. While pay is usually the main reward that employers are able to offer their staff, membership of a pension scheme is often the most valuable benefit in addition to pay, although it is not always seen as such by employees.

The EPP survey found that the main reasons employers did *not* provide schemes were:

- ‘cost’. We take this to mean contributions, administration and management time (21 per cent);
- a view that pensions were the employee’s responsibility (12 per cent); and
- the organisation was too small (11 per cent) or too new (11 per cent). This may not be a problem in those industries which operate an industry-wide scheme.

Other possible uncertainties which might dissuade employers from making provision which were not specifically mentioned in the survey include:

- the risk for employers in having to guarantee future benefits. This may arise because of poor investment returns or because the nature of their business alters. These considerations apply particularly in the case of defined benefit schemes; and
- changes in the legal, regulatory and tax framework which may impose unanticipated costs which the employer may find difficult to avoid.

Decisions that employees make

The only requirement the state makes on individuals to have private, second-tier provision is on employees who contract out of SERPS who – as a minimum – must aim to make at least broadly equivalent provision.

For employees, membership of a scheme can be attractive because it:

- allows them to benefit from their employer’s contribution;
- offers, in return for locking away income until it is needed, a tax-efficient way to provide for their retirement and usually also life insurance, ill-health and survivors’ cover; and
- relieves the individual employee of the need to make potentially complex investment decisions.

But membership of schemes can also have drawbacks for employees. Hawkes & Garman (1995) found the main reasons given by people for not joining a scheme were:

- they might not stay with the employer (11 per cent);
- they did not know enough about the scheme or had not thought about it (ten per cent);
- they considered themselves covered by some other financial arrangements (six per cent); and

➢ they could not afford the expense (four per cent).

A further 41 per cent were ineligible and 20 per cent had alternative pension arrangements.

The youngest age group (aged 16–24) were more likely than older age groups to say that they did not know enough about the scheme or had not thought about it (21 per cent) or that they preferred to spend money on other things (nine per cent).

The way in which the invitation to join a scheme is presented to employees is also important. The National Association of Pension Funds found in 1997 that 44 per cent of private sector final salary schemes and 85 per cent of public sector schemes automatically enter new employees into membership. Where membership is automatic, the proportion of employees who join is 74 per cent for final salary schemes and 90 per cent for hybrid schemes. Where there is no automatic entry, the proportions are about 50 per cent for final salary and 46 per cent for hybrid.

Other features of occupational provision

Additional contributions

All schemes are required to offer members the opportunity to make additional voluntary contributions (AVCs) up to Inland Revenue limits in order to secure additional benefits, but it is for each individual member to decide whether to do so. About 15 per cent of people do, some through contributions to their employer's scheme, some through free standing AVCs (FSAVCs) to a separate pension arrangement not run by their employer.

Pensions in payment

A good pension throughout retirement also depends on increases once the pension is in payment.

Pension increases

Full linking to the retail prices index (RPI) has been the norm for the public sector since the early 1970s. The 1991 GAD survey showed guaranteed RPI linking was the case for only about one in nine private sector scheme members. They were more likely to be offered guaranteed increases at various rates up to five per cent a year. A quarter had no guarantees at all. A recent survey by Incomes Data Services, on the other hand, suggests that in practice most schemes have given more or less full price protection over a period of time – because most have a facility to award *ad hoc* increases and take the opportunity to do so when finances allow.

The 1995 Pensions Act now requires all rights accrued after April 1997 – except those based on AVCs – to be increased on a yearly basis in line with prices up to five per cent a year throughout retirement.

Survivors' benefits

Almost all schemes offer benefits to dependants of active members who die before taking their pension. These take the form of lump sum payments at the time of death and/or – particularly in the case of DB schemes – continuing pensions for survivors including child dependants. Schemes have adapted to social change, and many will pay death benefits to unmarried adult partners. However, provision in the statutory public sector schemes is more restrictive and benefits are only payable to legal spouses.

In the case of death after retirement the 1994 EPP survey (Casey *et al* [1996]) found that 90 per cent of DB schemes offered some survivors' benefits, as did 70 per cent of DC schemes. Almost all of these offered benefits to a former spouse, and almost four in ten offered pensions for dependants. Similarly, approximately four in ten provided benefits for a 'nominated' person in cases where the pensioner was unmarried.

PERSONAL PENSIONS

We look at personal pensions under the following headings:

- who is covered and who is not;
- the reasons people do not have personal pensions; and
- problems with personal pension provision.

It should be remembered that personal pensions are relatively new and benefits are not yet generally in payment.

Definition of a personal pension scheme

We have taken the term 'personal pension' to refer to pension arrangements that people make with a provider without the direct involvement of an employer. We are not concerned here with retirement annuity contracts. While we acknowledge that a number of people are currently benefiting from them, they are less significant in the overall context of retirement provision than the post-1988 personal pension arrangements.

But we do include group personal pensions (GPPs) under this heading. GPPs are a collection of individual personal pensions held by employees with the involvement of the employer who may – and generally will – have made a special arrangement with a provider. While they may have the

backing of an employer, GPPs are essentially a collection of separate personal pensions rather than an occupational scheme. The 1994 EPP survey found that 17 per cent of private sector employers used GPPs as the main means of pension provision for their organisation. They mainly had small numbers of employees, as the survey also showed that GPPs cover only two per cent of employees in companies with either an occupational scheme or a GPP. However, evidence from pension providers suggests that the number of GPPs has grown substantially since then.

Background

A personal pension may comprise two parts – an appropriate personal pension (APP) and an ordinary personal pension. Each is described in greater detail below.

Appropriate personal pensions (APPs) used for contracting out

APPs are used where an employee takes out a personal pension in place of SERPS or a contracted-out occupational scheme. The DSS pays amounts directly into the individual's APP based on some of the earnings on which National Insurance contributions are paid. These amounts provide a 'protected rights pension', i.e. a pension which is paid instead of SERPS, in a standard form.

For about two million people, an APP is the only second-tier pension scheme in which they are currently participating. For many of these people the additional income an APP will provide in comparison with SERPS is likely to be marginal and may be equivalent to having taken no action. Indeed, some will receive less than SERPS would have provided.

Ordinary personal pensions (PPs)

These are available to both employees and self-employed people. Employees may contribute to them in addition to an APP or SERPS. Employees cannot simultaneously contribute to a PP and earn entitlements in an occupational pension scheme.

Employers may also contribute to a personal pension. This may be through a GPP. According to a 1997 survey by the Institute of Directors, 11 per cent of employers said they contributed to an employee's personal pension. However, we believe that where employers sponsor an occupational pension scheme, they will rarely contribute to an employee's personal pension as an alternative.

It should be noted that our subsequent observations do not distinguish between APPs and ordinary PPs, unless otherwise stated.

Self-employed people

As noted in Chapter Five, people in self-employment are not covered by SERPS and there is no requirement for them to contribute to any second-tier pension. Before 1988 they were able to buy retirement annuity contracts, policies which were similar to today's ordinary personal pensions.

Who is covered by a personal pension

The number of people with APPs increased from 3.1 million in 1987/8 to 5.4 million in 1995/6 (DSS [1998]). These figures include those APP contracts where the DSS paid no contribution because the holder had no earnings in the year on which National Insurance contributions were payable – 1.9 million in 1995/6. (These people were building up no second-tier pension, either through SERPS or an APP.) So in that year, only about 3.5 million people had payments made by the state into their APP.

There is little information available on the contributions being paid to personal pensions above the APP minimum, but we have deduced that about 1.5 million employees may be making additional contributions.

According to the 1995 General Household Survey (GHS) a half of self-employed people were contributing to a personal pension. We estimate that leaves around one and a half million self-employed people who were not at the time contributing to a second-tier pension.

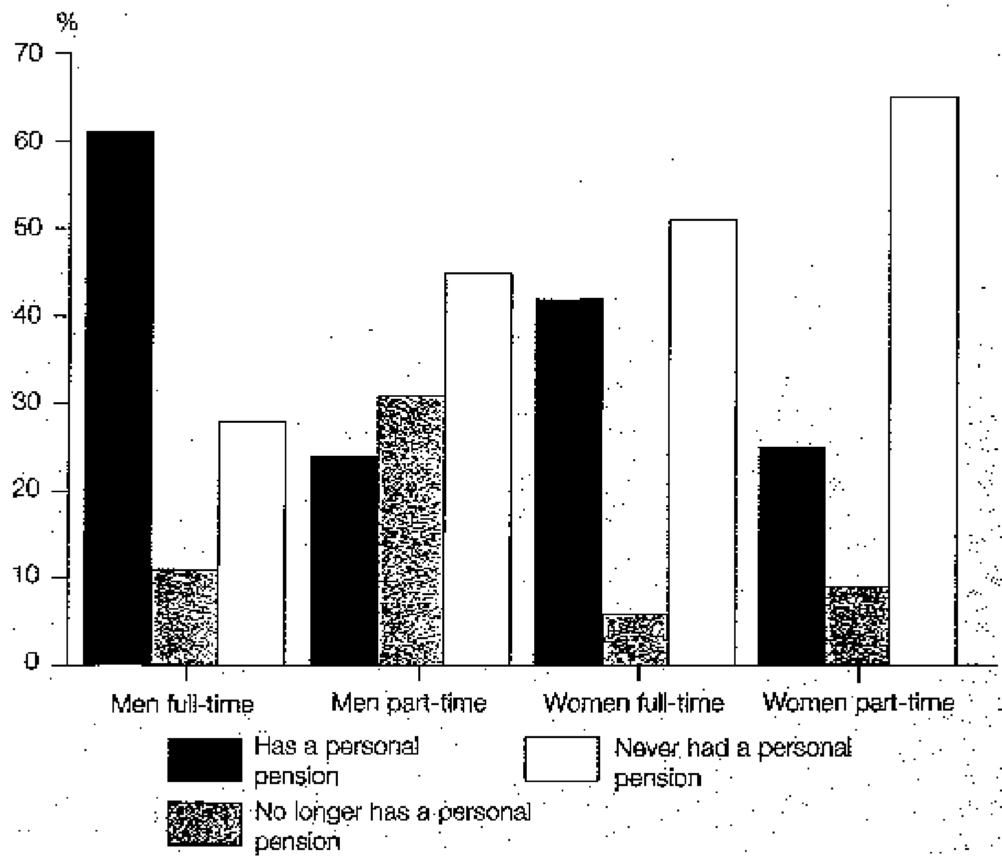
As personal pensions mature, and benefits start to become payable, the absence of reliable data in this area will be a matter of concern if any assessment of their adequacy is to be made.

Gender and employment status

Part-time women employees are the least likely to have a personal pension – only 11 per cent do (GHS). This may be attributable to a number of factors. Personal pensions have high fixed costs, and lower levels of pay for women, and especially part-time women employees, mean that the amounts they are able to contribute cannot support the costs and provide a satisfactory benefit. If earnings are high enough for a SERPS benefit, then continuing SERPS membership is likely to be more cost-effective and less risky. No comparable data are available for part-time men employees, as the sample size was too small.

Figure 6.9 shows the extent of pension coverage amongst self-employed people, including retirement annuity contracts. As with employees, self-employed women are less likely to have personal pensions than their male counterparts.

Figure 6.9: Pension coverage amongst self-employed people



Source: Office for National Statistics; *General Household Survey, 1995*

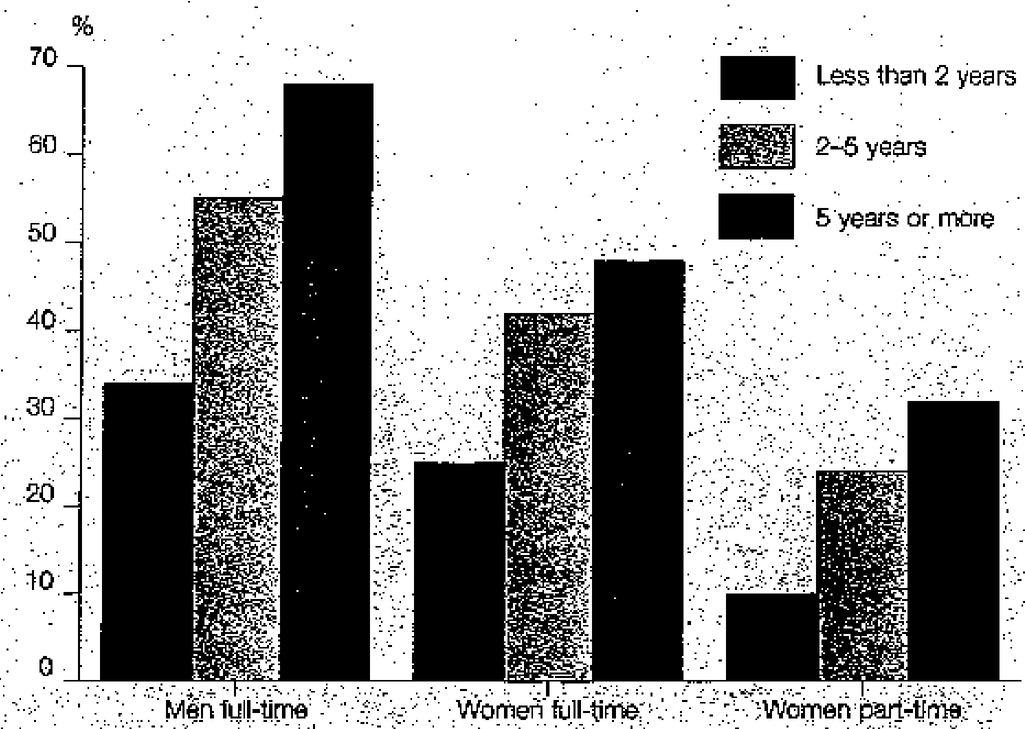
Self-employment and job security

Personal pension coverage for self-employed people increases with the time they have spent in self-employment, as Figure 6.10 shows. This may suggest that their participation is related to confidence in the future of their enterprise. The facility to carry forward unused tax allowable contributions from earlier years may also influence a decision whether to have a personal pension from the beginning of self-employment.

Earnings level

Those earning less than £100 a week in 1995 were least likely to have a personal pension (GHS). Above that level there was no discernible pattern. Further information on non-state second-tier pension take-up by earnings level is at the end of this chapter.

Figure 6.10: Personal pension coverage by length of time in self-employment



Source: Office for National Statistics: *General Household Survey, 1995*
Note: Sample size for men in part-time employment is too small to give reliable estimates.

Why people do not have personal pensions

Participation in personal pensions is voluntary. In addition to the upper limits on contributions set by the Inland Revenue, providers may also set minimum contribution levels. Apart from these there are usually no other eligibility criteria to satisfy in the case of ordinary personal pensions.

The decision to take a personal pension should be based on financial advice as the range of choices is very complex. Not only do people need to understand the way a personal pension works, they need also to understand their rights to SERPS benefits or to an occupational pension if their employer provides one. The following paragraphs summarise the reasons which might, or might not, lead someone to take a personal pension.

(a) Employees

Employees may be attracted to a personal pension because:

➢ there is no occupational scheme available where they work;

➢ they anticipate they will change jobs frequently (and may be employed on a short-term contract);

- ➢ their employer will contribute to the personal pension;
- ➢ they believe it is a cheaper option than joining an occupational scheme. In the short run their take-home pay may increase because they do not have to contribute to their employer's scheme;
- ➢ the expectation that SERPS will not provide an adequate pension by itself; and
- ➢ they believe they will have more control and choice with a personal pension.

The reasons people may decide *not* to take out a personal pension include:

- ➢ loss of the benefits from belonging to their employer's occupational pension scheme;
- ➢ competing spending or saving priorities;
- ➢ lack of knowledge about available products;
- ➢ time and effort – taking out a personal pension requires a positive act;
- ➢ knowledge of, and attitude to, investment risk;
- ➢ administration costs; and
- ➢ adverse publicity over mis-selling.

(b) Self-employed people

Reasons why self-employed people may not take a personal pension include:

- ➢ they see pensions as a low priority;
- ➢ their income may be unpredictable so financial planning is difficult;
- ➢ investment in the business may appear to offer a better return;
- ➢ they see their business as a source of pension; and
- ➢ lack of knowledge about available products.

P/P
cost a lapsing
of contributions

Problems with personal pension provision

As we shall see in the next chapter, the costs of running personal pensions are significantly higher than those for most occupational pension schemes. Inevitably, administration costs reduce the share of contributions which result in pension rights.

Another problem is that many people fail to keep up payments to a personal pension. Of personal pension contracts sold in 1993, about 30 per cent were no longer in force three years later (Personal Investment

Authority [1997]). As costs are often loaded towards the start of a personal pension contract, these pensions will give particularly poor value.

Early leavers from personal pension schemes have been heavily penalised by the effects of these front-end loaded charges (administration costs and commission). These charges can leave very little to transfer to a new pension arrangement. The effect of poor transfer values has come as a shock to many of the people affected.

The mis-selling of personal pensions has also greatly tarnished them and those who provide them. Many employees opted out of an occupational pension scheme (or transferred deferred rights) in favour of a personal pension, often on the basis of bad advice.

This mis-selling is now the subject of a major review by the Financial Services Act (FSA) regulators and the personal pensions industry. The aim of the review is to re-instate holders of mis-sold personal pensions into their former occupational pension schemes, where possible, and/or to award compensation to ensure that the policy holders are no worse off than they would have been had they remained in their occupational pension schemes.

We would be concerned if this unfortunate episode has dissuaded people from making second-tier pension provision. It is clear that any future pensions developments will need to learn the lessons from this.

A number of the structural weaknesses in personal pension schemes are now being addressed as some providers begin to adapt their policies to better meet the needs of policy holders.

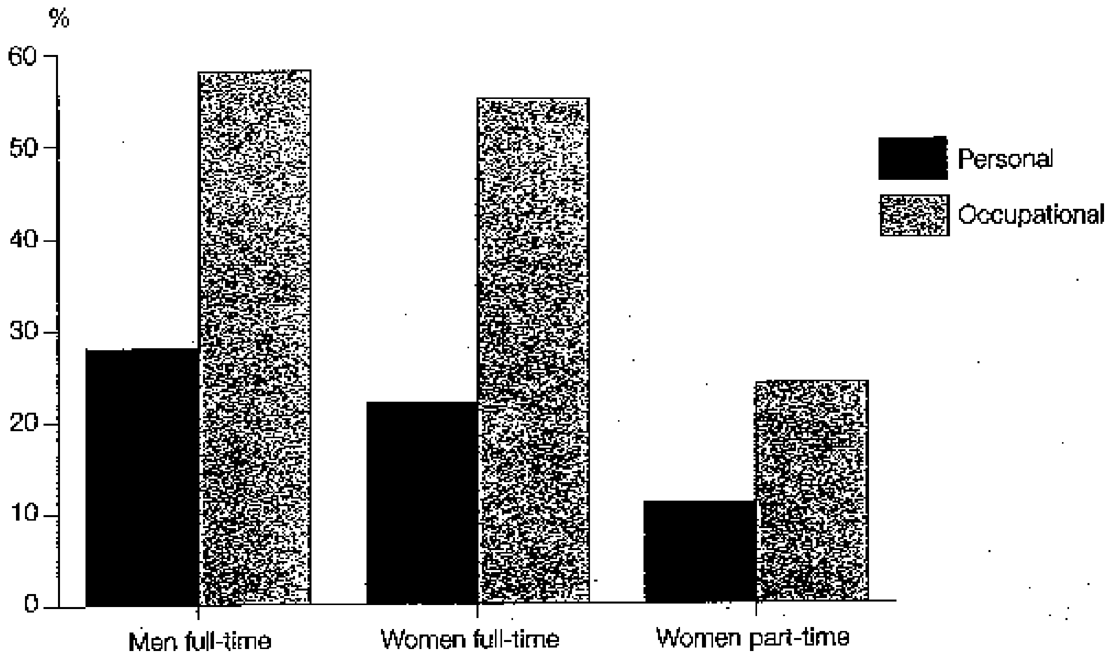
OCCUPATIONAL AND PERSONAL PENSION PROVISION

In this section we look briefly at certain aspects of the combined effects of occupational and personal pension provision, in particular the links with paid work and earnings levels.

Figure 6.11 shows occupational and personal pension coverage amongst employees in 1995. If we allow for the overlap between the two forms of provision reported in the survey concerned, 78 per cent of men in full-time employment had either an occupational or a personal pension or both. Amongst women in full-time employment the corresponding figure was 69 per cent, but for women in part-time employment it was only 33 per cent.

Figure 6.12 shows the coverage of occupational and personal pensions for employees by earnings level. It is very clear that people with the lowest earnings are the least likely to have an occupational or a personal pension. For example, 80 per cent of women in part-time employment earning less than £100 a week in 1995 had neither type of pension.

Figure 6.11: Proportion of employees with non-state pension provision



Source: Office for National Statistics: *General Household Survey, 1995*

Notes: (1) Some individuals will be accruing future pension entitlements through both occupational and personal pension schemes. Coverage of the two types of scheme together is as follows:
78 per cent of men in full-time employment;
69 per cent of women in full-time employment; and
33 per cent of women in part-time employment.
(2) Sample size for men in part-time employment is too small to give reliable estimates.

Some couples will look at their retirement income expectation as a unit, and this could be an important determining factor in whether one or both of them decide to join an occupational pension scheme, or to take out a personal pension. If only one of them joins, it may be on the assumption that that pension alone will provide both of them with an adequate standard of living in retirement.

Figure 6.12: Non-state pension coverage by earnings level (employees)

	Usual gross weekly earnings (£)							
	Up to 100 %	100–200 %	200–300 %	300–400 %	400–500 %	500–600 %	600 or more %	Total %
Men, full-time								
Neither	54	50	24	12	6	3	4	21
Occupational pension only	30	23	46	61	67	73	64	51
Personal pension only	13	22	24	19	18	13	16	20
Both	3	5	7	8	9	10	16	8
Women, full-time								
Neither	51	50	23	12	7	8*	10*	30
Occupational pension only	31	29	56	63	75	67*	69*	48
Personal pension only	15	15	16	13	5	8*	8*	14
Both	3	4	6	11	13	18*	13*	7
Women, part-time								
Neither	80	46	23	15*	29*	50*	0*	67
Occupational pension only	11	39	50	60*	29*	50*	67*	21
Personal pension only	8	11	20	20*	29*	0*	0*	10
Both	1	5	6	5*	14*	0*	33*	2

Source: Office for National Statistics: *General Household Survey, 1995*

Notes: (1) *Denotes base sample of less than 100 cases.
(2) Proportions are given to the nearest one per cent and may not add to 100 per cent due to rounding.
(3) Sample size for men in part-time employment is too small to give reliable estimates.

Summary

For many retired people, occupational pensions have been a success. The take-up of these schemes and of personal pensions by people of working age is substantial, although it appears that there are some people whose current provision is very modest – for example, the two million employees who rely solely on APPs and many self-employed people.

Long-term membership of occupational pension schemes generally offers the prospect of good pensions in retirement. As a general rule, where occupational pension schemes are available, they are more attractive to people than a personal pension because employers usually pay more into an occupational pension than they do to a personal pension.

For people whose employers do not offer an occupational scheme, personal pensions have extended the opportunities to make provision for retirement. However, personal pensions are often complex products, with high costs of administration and regulation.

Personal pensions have been tainted by the mis-selling that took place in the late 1980s and 1990s and, as we shall see in the following chapter, they can expose people's savings to a degree of risk that many may not understand.

Some people may choose other savings products, home ownership or investment in a business instead of a non-state pension. But they will need financial advice to weigh up the advantages and disadvantages of the alternatives.

Failure to take up non-state provision may, however, also be due to lack of understanding, poor knowledge, other pressures on the household budget or an unwillingness to think about the future.

In the absence of compulsion it seems inevitable that, under current policies, non-state pensions coverage will continue to be higher for those with higher incomes.

7 Risk and efficiency in pension provision

In this chapter we discuss the risks involved in pension provision and the efficiency of different types of scheme, particularly second-tier pensions.

The nature of risk

The different ways in which pensions are provided – whether a state scheme promising pensions paid from future taxation or an occupational or personal scheme providing pensions from accumulated funds – all have a common underlying effect. This is that they provide a means by which people stake a claim on a share of the future economy of the country when they are retired.

This is an important point. Regardless of how pensions are arranged, the standard of living of tomorrow's pensioners will be derived from tomorrow's economy, not today's.

A further important fact is that providing pensions is a very long-term undertaking. A lot can go wrong between the time that state promises are made, or private contributions set aside, and the time when people are retired.

At the most general level, risk in relation to pension provision can be represented as the possibility that the claims on tomorrow's economy, which are implied by today's pension arrangements, will not be realised. That is, that people's aspirations, expectations and perceived rights will be undermined.

It is worth noting that those with the very lowest pension expectations do have some protection against risk – provided that means-tested benefits continue to underpin their low expectations. The most vulnerable group may, therefore, be those who plan for an expected pension to keep them modestly above the minimum level, but who could fall below that level if the risks act against them.

Risks in state provision

We suspect that, at least until recently, many people believed that the promise of a pension by the state was the safest form of pension provision.

However, we think that belief is misplaced. For example, as we saw in Chapter Five, the benefits of SERPS were cut significantly, for those retiring in the next century, twice in the past 12 years. Moreover, the policy that state pensions should be increased by the greater of the increases in prices or average earnings was changed with the November 1980 uprating to provide increases in line with prices only.

We have no wish to express a view on the merits of these changes. What is striking, though, is that, despite their considerable significance, they were put into effect with very little public debate.

Because the state system aims to cover the vast range of circumstances of the population as a whole, it will inevitably be complex. Its complexity is, in our view, a major factor in its riskiness. Very few people understand it.

A second risk factor in the state system is that future taxpayers may refuse to pay the level of taxes needed to sustain the level of expected benefits. Looking ahead, we do not think that this should be seen as a major risk in the UK because state pensions will be relatively modest and hence affordable. It is, however, vital that people understand the limits of the state scheme and that they are regularly told, clearly and unambiguously, the benefits which they can expect to receive. Otherwise they will not realise the importance of making additional provision for themselves.

Thirdly, state provision is vulnerable to changes in governments and to accompanying changes in political and social philosophy. This is inevitable, but it does point again to the need for a system that is as simple and transparent as possible and to the need for a high level of awareness and understanding by the public. While not a panacea, this would increase the likelihood that, when changes are made, the position of disadvantaged groups can be highlighted and catered for in a way that is fair and consistent.

Risks in funded schemes

Pension arrangements involving the setting aside of contributions in advance (funded schemes) have a different array of risks, some of which apply to all funded schemes and some to particular types of funded scheme. We deal with the former first.

The ability of funded schemes to deliver what people expect from them depends crucially on the rate of return achieved on the investments over the long term. More specifically, it is the rate of return in excess of price and earnings inflation which matters, after allowing for tax and expenses. The reason for focusing on these returns is that people generally measure their retirement objectives by reference to their living standards before they retire. Broadly speaking, therefore, it is only the investment return in

excess of prices and earnings which is counting towards the retirement income goal.

Real investment returns in funded schemes can be undermined in several ways. First, as we saw in July 1997, the taxation basis of pension investments can be changed for the worse, without any compensating tax concessions for the lower pensions which will inevitably emerge. Particularly insofar as such a change relates to funds that have already been accumulated, it undermines people's expectations and damages confidence and trust in the system.

Real returns can also be damaged by high inflation. Higher real returns are more likely to be achieved in an environment of low (and hence stable) inflation than in one of high inflation.

Funded pensions, whether occupational or personal, depend for their build-up on contributions from earnings. The risks of unemployment, and periods of low pay, are therefore of considerable significance. As well as the loss of contributions, this can affect the real investment returns in many personal pension schemes, due to the effect of continuing fixed charges on a fund which is not being increased by further contributions.

Another risk to pension funds lies in fraud and the theft of assets as occurred in the case of the Maxwell pension schemes. This type of behaviour is, we believe, rare but when it happens it has the potential to cause very serious damage to people's living standards in retirement. There can unfortunately be no guarantee that it will not happen again, although the compensation scheme put in place by the 1995 Pensions Act provides scheme members with some important re-assurance.

We now turn to the particular risks which apply to the two types of funded scheme – defined contribution and defined benefit.

Risks in defined contribution funded schemes

In defined contribution schemes, the contributor's pension is entirely dependent on the investment return credited to his or her contributions and on the terms on which the accumulated funds can be converted into an income on retirement. There is little doubt that, in the long term, investment in equity shares holds out the best prospects for real returns. But equity values are quite volatile and the individual can do badly if values are depressed at the time of conversion to a retirement income by the purchase of an annuity.

Thus the individual shoulders the investment risks in defined contribution schemes. The risks can be reduced by investment in assets with more stable capital values – such as cash or government stocks – as retirement approaches, but this too has disadvantages. First, people often do not know when they will retire and so such planning is difficult. Second, the more stable assets are likely to produce a lower investment return than would equities.

A further risk faced by those with defined contribution schemes is that interest rates may be unusually low at the time when the accumulated fund is converted into an annuity. The resulting amount of annual income, for a given amount of capital, would then be lower than expected. Mechanisms to counter this risk, and the risk of depressed investment values at retirement, have recently been introduced for some types of defined contribution scheme through the so-called income drawdown facility. This entails deferring the realisation of the individual's investment fund to buy an annuity until a more propitious time, and drawing a certain amount of income in the meantime. But this too is risky (a more propitious moment may never come) and in any event the level of advice needed is such that this approach is unlikely to be cost effective except for those people with large amounts of funds to their credit.

The risks described in the last three paragraphs are of particular significance for those whose expected pensions are low and who cannot, therefore, tolerate much downside risk.

A group who are particularly exposed to the downside risk described above are those who have contracted out of SERPS on a defined contribution basis, through either an appropriate personal pension or a contracted-out money purchase (COMP) occupational scheme as their only second-tier pension. Although, on average, it might reasonably be expected that an individual will obtain a larger pension than SERPS would have provided, there is a wide distribution about this average and simulations suggest that a significant minority of people may be worse off – particularly if they are modestly paid, are already part way through their working lives and do not invest in equities for most, if not all, of the time up to retirement. There is, however, also a contrasting upside, whereby young people on higher incomes who are prepared to rely on equity investment would be very likely to benefit from contracting out of SERPS on a defined contribution basis.

Given the variability of pension outcomes in defined contribution schemes and that it is people on modest incomes who are least able to bear downside risk, we believe that a key challenge for providers must be the further development of mechanisms which allow for the pooling of members' risk, both before and after retirement.

Risks in defined benefit schemes

Occupational defined benefit schemes (which are usually of the final salary variety) entail rather different risks for the individual. In these schemes, much of the direct investment risk is taken by the employer who, in effect, undertakes to provide the pension benefits that are set out in the scheme's legal documents. This does not, however, amount to an absolute guarantee – indeed no such thing can ever exist in pensions. The employer's commitment to meet the cost of a given scale of benefits is an important one, but it also highlights employer insolvency as a significant risk in defined benefit schemes.

In the past few years it has become very expensive to buy the annuities and deferred annuities from life insurance companies which are the main means of providing pensions for scheme members where employer insolvency has occurred or the scheme is wound up for other reasons. As a consequence, defined benefit schemes which appear to be adequately funded taking a long-term view of the future, may suddenly be found to be insolvent if the employer ceases to contribute and the scheme has to be wound up.

The 1995 Pensions Act introduced a minimum funding requirement which stipulates the minimum level of assets that a defined benefit scheme should hold. But this minimum might well not be sufficient to meet the cost of securing all the scheme members' pension rights were it to be wound up. This is because, to meet their solvency requirements, life insurance companies need to invest in less risky, lower yielding assets than a typical continuing defined benefit pension scheme would hold.

Thus, even with the minimum funding requirement arrangements in place, there remains a risk that members of defined benefit schemes will not receive the benefits they expect should the employer be unwilling or unable to maintain contributions. We very much doubt whether members of defined benefit schemes understand the nature of this risk.

But the most significant risk faced by the individual, specific to defined benefit schemes, is that of changing jobs.

Prior to 1975, there was no requirement on schemes to provide any benefits for a member who left before retirement age other than a return of the member's contribution – often without interest – if the scheme was contributory. That said, many schemes in the public sector, and a few more enlightened schemes in the private sector, voluntarily provided preserved benefits to early leavers though they were often not indexed.

However, it needed legislation to achieve universal good practice. First, in the 1970s, came a requirement to preserve a pension, calculated *pro rata* to what would have been available at retirement, for those who left with five or more years of service. In the 1980s the five-year requirement was

reduced to two years. Also, and very importantly, came the requirement to revalue the preserved pension from leaving service up to retirement in line with price inflation over that period, to a maximum of five per cent *per annum*.

These measures have helped to reduce the job changing risk, provided inflation remains at a modest level. However, to the extent that earnings inflation exceeds price inflation, the protection required by law will still leave the early leaver's pension lower than the pension for a similar person who does not change jobs. And people whose jobs last less than two years are not normally entitled to a preserved pension.

Efficiency of second-tier provision

Economies of scale are very important in keeping down the costs of all types of second-tier provision. The main types of costs are:

- administration (including investment management in funded schemes);
- compliance with regulations; and
- advice to individuals.

cost of OCPs, PPs & SERPS.

They are, to some extent, interlinked.

The costs of administering SERPS, despite its complexity, are low when measured per unit of benefit provided by comparison with an equivalent funded scheme. This is particularly true for those with relatively modest benefits, who represent a significant proportion of those who remain fully in SERPS (i.e. who are not contracted out). This cost-effectiveness is largely achieved through the automatic provision by employers of earnings and contributions information to the National Insurance system and because SERPS can be regarded as a marginal addition to the cost of administering the basic state pension. Taken as a whole, the weekly DSS administration cost for state pensions in 1995/6 was 60p per beneficiary, or 1.1 per cent of total state pension costs.

An indication of the costs involved in running funded pension schemes can be seen in the levels at which rebates of National Insurance contributions are set for contracted-out schemes. Figure 7.1 shows the Government Actuary's calculations of the estimated cost of rebates in 1997/8 and the value of the corresponding future SERPS benefits that will not have to be paid as a result. The difference between the two reflects the costs which contracted-out schemes incur in providing the benefits that replace SERPS. On average, across all types of scheme, the difference is about 15 per cent. For defined benefit occupational schemes, the difference is only 12 per cent as their costs are relatively low, but in the case of personal pensions there is a difference of 22 per cent, reflecting their much higher costs per unit of benefit provided.

Figure 7.1: Contracting-out rebates and the value of SERPS saved in respect of 1997/8

Type of contracted-out pension scheme	*Rebates*	*SERPS saved*	*SERPS/rebates*
	£ billion, 1997/8 levels		*Ratio*
Occupational – defined benefit	5.2	4.6	0.88
Occupational – defined contribution	0.2	0.2	0.80
Personal pension schemes	2.1	1.6	0.78
Total	*7.5*	*6.4*	*0.85*

Source: Government Actuary's Department

Note: The value of SERPS benefits saved is the capitalized value in 1997/8 terms of the SERPS pensions that would have to have been paid by the state in the future if those concerned had not contracted out.

Second-tier funded schemes – whether occupational or personal – bear a heavy burden of relatively fixed regulatory compliance costs. In the case of occupational schemes, this relates both to regulations to protect the members (e.g. the 1995 Pensions Act and the various enactments dealing with early leaver protection, sex equality and the like) and to tax-approval rules to protect other taxpayers. In the case of personal pension schemes, the dominant legislation is the Financial Services Act, although the tax-approval rules are also extensive.

There can be no doubt that the costs of funded second-tier pensions would fall if the regulatory framework were simplified. Existing regulations have grown over a long period in some cases. Like Professor Goode and his committee in their 1993 report, we believe there would be merit in going back to basics, by examining the objectives of regulation and whether these objectives could be achieved in a less complicated and prescriptive way 'through more general and clearly expressed statements of principle'. Indeed, we feel that this is an essential pre-requisite of further material expansion of funded second-tier pensions.

Advice on pensions tends to be expensive. This is partly because of avoidable complexity but also, unavoidably, because the planning required is long term. In our view, two important elements which would reduce the need for extensive advice for individuals are, first, a reduction in the complexity of the system and the choices within it and, second, the provision of clear, unambiguous information on a regular basis of what each individual can expect to receive from the different parts of the system.

The key principle in regulating funded second-tier pensions must continue to be the protection of members' benefits. While we believe simplification is both necessary and achievable, it must not be to the detriment of scheme members' interests.

Summary

The main conclusions emerging from this chapter are:

- all forms of pension provision involve risks;
- it is the low or modestly paid who are least able to shoulder the downside risks of second pensions, particularly of the defined contribution type;
- provided means-tested benefits continue to underpin the expected pensions of those with the lowest incomes, the most vulnerable group may be those whose expected pension is planned to keep them just above the minimum level;
- contracting out of SERPS on a defined contribution basis involves a material degree of downside risk, particularly for the relatively low paid who are already part way through their working careers;
- investment in equities over long periods, while potentially volatile, affords the most effective response to the risks involved;
- in funded schemes, mechanisms which allow for risk sharing amongst the participants are important. It is an important challenge for providers of all types of defined contribution products to introduce such mechanisms;
- legislation over the last 25 years has reduced substantially the job-changing risks for future early leavers from defined benefit schemes;
- SERPS is efficient from an administration point of view; and
- a reduction in complexity, coupled with the provision of clear information to individuals about their pension expectations, would help in three ways. First, it would help in the management of the risks involved. Second, it would result in lower costs and higher benefits for a given level of contributions. Third, it would help people to plan for their retirement with greater confidence. We believe governments need to spell out unambiguously the likely future value of state pensions in relation to future living standards, and all future recipients of non-state pensions should be given regular estimates of the pensions they can expect to receive set out at least in real terms in relation to prices.

8 Financing pension provision

Building on the previous discussion and information, in this chapter we consider the ways of financing pension provision. In particular we look at:

- the respective merits of pre-funding pension rights and of meeting their cost through 'pay-as-you-go' financing;
- the role of incentives, disincentives and compulsion in second-tier pensions; and
- the tax regime for pensions and competing savings products.

In previous chapters we have looked at the benefits that the various types of pension scheme provide, at some aspects of cost – notably the cost of benefits in the state pension scheme and the costs of administering different forms of pension provision – and at the risks involved in pensions. We now turn to some key aspects of the way in which pensions are financed.

We begin with the differences between pay-as-you-go and pre-funding.

The mix of pension finance

In the UK pay-as-you-go (PAYG) and pre-funding are the main methods used to provide the financial resources from which pensions are paid. PAYG involves directly transferring resources from today's contributors or taxpayers to meet the cost of pensions and benefits paid to today's pensioners. With the pre-funding approach, today's contributions are saved and invested to accumulate assets that are used to pay pensions when today's contributors retire.

Other methods are possible. For example, governments can issue debt to meet the cost of today's pensions which will fall to tomorrow's taxpayers to redeem. Under the book reserve approach favoured in Germany, pension contributions are in effect invested in the employer's company with an insurance underpinning. Unfunded public sector occupational schemes in the UK – such as those for the armed forces, civil service, health service staff, police and teachers – are best seen as another form of PAYG.

The mix between financing methods varies between countries and over time. In comparison with other countries, the UK meets a relatively high proportion of its pension liabilities through funded schemes. Figure 8.1 gives estimates for 1993 of the respective levels of pension fund assets in relation to gross domestic product (GDP) for a number of developed countries. UK pension fund assets have continued to grow since then.

In Figure 8.2 we show our estimates of the extent of both funded and unfunded pension provision in the UK. In the case of unfunded schemes, we have used estimates of the value of rights accrued within them in 1995 on the basis of a cautious assumption about the future investment returns that could be achieved if these pensions had to be paid from an invested fund (four per cent *per annum* above the rise in prices). For funded schemes, we have used the amounts of assets they hold as an estimate of the value of rights accrued in them. The estimates in Figure 8.2 are therefore based on different approaches to valuing pension rights and give only a broad indication of the position.

Figure 8.1: Pension fund assets in relation to GDP, 1993

	Assets as % of gross domestic product
Belgium	3
Denmark	20
Germany	6
Spain	2
France	3
Ireland	40
Italy	1
The Netherlands	89
UK	79
European Union (total)	20
US	59
Japan	45

Source: Commission of the European Communities (1997)

Figure 8.2: The financing of UK pension rights in 1995

Type of pension	***Estimated value of accrued rights, £ billion***	
State scheme – basic	605	
– SERPS	150	
Unfunded public sector schemes	195	
Total, unfunded		*950*
Funded occupational schemes	585	
Personal pensions	165	
Total, funded		*750*
All UK pension rights		*1700*

Source: Pension Provision Group calculations from various sources

Unfunded rights

With these *caveats* in mind, the broad picture is that less than half of all pension rights are within the state scheme. Another 11 per cent of pension rights are in unfunded public sector occupational schemes. In total, unfunded rights account for about 55 per cent of all pension rights in the UK.

Funded rights

About a third of all pension rights are in funded occupational schemes, and about ten per cent in personal pensions. In total, about 45 per cent of all UK pension rights are backed by investment funds.

Each method of pension finance has its own set of effects including:

- economic;
- financial;
- social; and
- political.

Attempts to quantify these effects and determine the impact of moving from one method to another have not always produced clear cut conclusions or, where they have done so, have been criticised for their analytical methods and assumptions. The inferences drawn from such studies often depend on the nature of the goals set for the pension system concerned. Here we concentrate on evidence about the economic effects of pension finance.

The economic effects of pension finance

The UK has a mixed approach to pension financing with a relatively high proportion of funded provision. Studies have looked at the effects of moving towards more funding. It is argued that funding may raise the level of saving, so leading to greater investment and better productivity. If people see their contributions as a form of saving rather than taxation, moving to funding may improve financial incentives in the labour and capital markets. (Funded schemes may also improve the sense of personal responsibility and ownership, leading to an increase in total contributions.)

For a scheme covering the whole population, funding might reduce required contribution rates if, in the long run, the rate of return on investment exceeds the sum of the rate of population growth and the rate of earnings growth. This condition has applied to much of western Europe since the war – including the UK – but cannot of course be predicted with confidence in advance.

The scale of the potential economic benefits of making a change to more funding can only be assessed using models. Results appear to depend heavily on the underlying assumptions. For example, Professor Martin Feldstein's predictions for the large potential benefit to the US economy from funding its state pension scheme have been criticised for the high rate of investment return that was assumed (see, for example, Feldstein and Samwick [1997]).

A further argument that has been put forward for preferring a funded approach is a greater perceived security of the pension promise. It may be more difficult for governments to make adverse changes to funded schemes, though it is always open to governments, for example, to make changes to tax arrangements.

Funded schemes are, however, not generally redistributive from the better off to the less well off. If they were, this could undermine any sense of personal ownership they offer. In contrast, financing the basic state pension on a PAYG basis – with earnings-related contributions – has the advantage of making redistribution clear and explicit.

There is indeed a good economic rationale for pursuing a mixture of funding and PAYG methods. The argument is that a pension portfolio should be invested across a wide range of assets in order to spread risk. A large part of a country's stock of wealth lies in the investment in its people's skills. It has been argued that PAYG is a good means of investing in this asset (see Merton [1983], and Miles [1997]). PAYG may also be particularly suited to meeting the future cost of pensions as the return from human capital is less volatile from year to year than is the case for financial assets.

The 'double burden'

The potential benefits from more funding are also likely to depend on the exact proposal being put forward. Moving from an existing PAYG scheme to a funded one may have a very long payback period because of the 'double burden' involved. This is where the cost of pension rights already built up in an unfunded scheme has to be met from current contributions or taxes for a long time into the future, at the same time as additional contributions are needed to build up funds for the new system.

In a recent study, Professor David Miles of Imperial College has examined the consequences of raising the extent of pension funding in the UK and other western European countries as a possible way to meet the cost of demographic change. He finds, for example, that if the UK were to fund its state pension scheme then, on his central assumptions, because of the double burden problem, it would be at least a quarter of a century before the contribution rate returned to the level predicted under the existing PAYG regime. In the meantime contributions would be substantially higher than with PAYG.

Is there a need to change in the UK?

We have found no objective criteria by which to judge whether the UK has the right mix of pension finance. We do not believe there is evidence available which would justify a dramatic change in the balance of pension finance. The two parts of second-tier pensions that are not pre-funded are SERPS and some public sector occupational schemes. These public sector schemes might be more suitable candidates than SERPS if a further move towards pre-funding were considered to be desirable.

Compulsion

There are already compulsory pension arrangements in the UK. The state provides first-tier provision for everyone subject to their contribution record. It also compels every employee with earnings currently above £64 a week to have some form of second-tier provision, either through SERPS or an occupational or personal pension.

There is no similar requirement for self-employed people to make second-tier provision, and although many self-employed people have good second-tier pensions or make alternative arrangements such as the sale of their business on retirement, the lack of compulsion could leave many to rely on means-tested benefits in retirement. With the recent increase in self-employment we see this issue having increasing importance. From the perspective of providing good pensions it is difficult to see how the current distinction can be defended.

Owing to the cutbacks in SERPS we described in Chapter Five, the degree of compulsion will fall in the next century. Under the current policies of continued uprating of the basic state pension and of the National Insurance contribution limits in line with prices, the level of earnings covered by compulsory provision will also decline in the long term.

Reducing the amount of compulsory coverage is bound to have an impact on the total level of pension provision. Given a choice, some people will prefer immediate consumption or other forms of saving.

Some of the consequences of reducing the extent of compulsion were seen in the late 1980s. From 1988 employers were no longer able to require employees to join their pension scheme. Other effects clearly played a part, such as structural changes in UK industry and the aggressive selling of personal pensions. Nevertheless, some of the fall in occupational pension scheme membership since then must be attributed to the removal of compulsion. Many chose personal pensions instead – though often not providing equivalent-level benefits – but others made no alternative provision. They either postponed joining their employer's scheme or did not join at all, or left the scheme if they were already in it.

This is not to say that we agree with compelling people to join occupational pension schemes because there will always be some people for whom contributing to certain types of occupational scheme would not be suitable.

In our view, in setting a compulsory level of provision any government needs to strike a balance between the long-term advantages to individuals from better income in retirement – and to future taxpayers from lower expenditure on means-tested benefits – with the right of individuals to have freedom of choice in how they use their money.

Financial incentives

Both in Chapter Five and in the preceding section, we drew attention to the links between making pension provision during working life and expecting a potential entitlement to means-tested benefits in retirement. The prospect of receiving means-tested assistance must influence some people to save less, though no doubt many also want to ensure that as far as possible they do not have to rely on such help. In this section we look at two other forms of financial incentive for pension provision:

➢ tax, in the context of other forms of saving; and

➢ the arrangements to contract out of SERPS.

The tax treatment of pensions and other forms of saving

We begin with an overview of the main forms of saving and the distribution of personal wealth. We then go on to discuss the pensions tax regime in the context of the tax treatment of the main forms of personal saving.

Four types of investment dominate UK personal savings:

➢ home ownership;

➢ pension rights;

➢ interest bearing accounts and cash; and

➢ life insurance.

The tax arrangements for each are different and, along with factors such as accessibility, affect their relative attractiveness. We comment on the position as it is at the time of preparing our report, for example before the introduction of the proposed Individual Savings Accounts (ISAs).

Home ownership and other property

The total value of owner-occupied property is well in excess of £1,000 billion. In 1995 there were over 16 million owner-occupied dwellings with an average value of £63,200 – two-thirds of the total housing

stock. Wealth from property probably extends to around half the adult population, allowing for joint ownership of most households not occupied by a single adult.

The proportion of older people who own their homes will continue to rise for the foreseeable future (Forrest *et al* [1997]). Schemes to enable older people to release some of the wealth tied up in their homes have existed in the UK for more than 30 years. A number of new equity release products have been launched very recently, and there is considerable interest in how the market will develop. Growth in home ownership, particularly through the 'right-to-buy' scheme, means that home ownership in old age now reaches further down the income distribution. But substantial proportions of the poorest older people do not own their homes, limiting the scope for equity release to supplement the lowest incomes.

Pension rights

As we saw earlier in this chapter the total value of occupational and personal pension funds in 1995 was about £750 billion. If unfunded public sector pension rights are included, the total is still below the figure for homes and property. In 1995 occupational schemes had:

- over ten million active members;
- about five million deferred members (some of whom will be active members in other schemes); and
- more than seven million pensions in payment.

About eight million personal pension arrangements of all types were also in force in 1996/7, including those into which payments were no longer being made.

Interest bearing accounts and cash

The total value of interest bearing bank and building society accounts and cash in 1995 was about £225 billion. Inland Revenue figures record the amounts held by about 15 million people – many of these will be very small amounts. Only about £27 billion was held in Tax Exempt Special Savings Accounts (TESSAs) which, it could be argued, enjoy tax advantages broadly comparable to those enjoyed by pensions, despite their greater accessibility.

Life insurance

The total funds held in life insurance (excluding any pensions element) in 1995 were also about £225 billion.

Other forms of personal saving

According to the Inland Revenue the amounts held in 1995 were:

- listed company securities (including unit trusts) of about £110 billion, held by about five million people;
- national savings totalling about £56 billion;
- unlisted company securities of £49 billion, held by 500,000 people;
- Personal Equity Plans (PEPs) with a total capital value of about £38 billion; and
- UK government and municipal securities of £30 billion, held by 4.4 million people.

The distribution of personal wealth

The distribution of wealth is such that much is concentrated amongst a relatively small proportion of the population. For example, in 1994 the Inland Revenue estimate that the most wealthy ten per cent of the population owned about half of total personal wealth, excluding the value of pension rights. Many people are unlikely to be able to finance much retirement income from their non-pension assets.

The pensions tax regime

Broadly speaking, the tax position of funded pensions is that tax is paid on pensions and other benefits when these are paid out, whilst no tax is paid on contributions or investment income received by the fund. It is convenient to refer to this structure as EET (Exempt contributions; Exempt investment build-up; Taxed outgoings).

Pensions are different from other forms of savings – indeed some might say that pension provision has more of the characteristics of insurance than savings. The two key differences are, firstly, that resources put aside for retirement are not accessible before then, and hence are locked away for long periods, and secondly that the pension stops when the recipient dies – there is no 'pensions capital' for the next generation to inherit. Thus funded pensions represent, in essence, a redistribution of an individual's income, deferring income during the working years to be used during retirement. An important element of insurance also plays a part, with pensioners who die young effectively subsidising those who survive to extreme old age.

The EET tax regime is neutral as between consumption now and consumption later. It ensures that income is not taxed twice. And it taxes income as and when it is received, which strikes a fair balance between pensioners who die young and those who survive for a long time. It therefore appears to be particularly suitable for pensions.

In practice the EET regime is not applied rigorously. First, the benefits are not all taxable. In particular, part of the pension (usually about one quarter) can be exchanged for a lump sum which is tax-free. Second, not all investment income is tax-free. In particular, funds cannot now reclaim any part of the corporation tax paid by companies on the profits which are distributed as dividends on UK equity shares. Third, there are strict and complex limits imposed on the amounts that can be contributed and/or on the benefits that can be paid under an approved scheme.

Measured against the EET system – which we believe is appropriate – the UK tax regime for approved pension schemes is not privileged. Measured against some other major forms of saving it is privileged, but in comparison to PEPs and TESSAs this is not so.

Other avenues for saving have different tax regimes, which can be characterised as either TEE (as in owner-occupied housing [broadly], PEPs and TESSAs) or TTE (as in some savings accounts). Since pensions require savings to be tied up for very long periods of time, the return on them needs to be as much – if not more – than for other forms of saving. Given that most people are probably choosing between the forms of saving listed above, increasing the return on saving via tax relief on pensions can help to encourage people to choose pensions. Otherwise people will have a strong incentive to avoid having pensions. Given that a TEE regime is about equivalent to EET, the incentives in the current tax system for pension provision are, in our view, small relative to other forms of saving such as owner-occupied housing, PEPs and TESSAs.

Because the EET tax regime is largely appropriate, and because there are other ways in which it is possible to save which attract similar (TEE) tax treatment, it is wrong to attribute substantial costs to the current way of taxing pensions. By comparing the current system with one in which contributions and investment returns are both taxed, the Inland Revenue comes up with a cost of the current system (£13 billion a year) which in no sense measures its real cost relative to an appropriate system or with respect to other relevant types of saving.

Contracting out

About two-thirds of employees are in occupational or personal pension schemes that are contracted out of SERPS. They are allowed to pay lower National Insurance contributions towards the cost of state pensions and benefits provided they make alternative provision through an occupational or personal pension which aims to pay them at least the level of pension they would have received from SERPS. Contributions paid by employers with contracted-out pension schemes are also reduced. The difference

between the contributions paid by full members of SERPS and those who are contracted out is known as the contracting-out rebate.

The rebate

The amount of the rebate can have large incentive effects. In arriving at the amount of the rebate, governments have to balance two sets of interests. They must:

- compensate those who are contracted out for the cost of providing the pensions the state would otherwise have to pay; and
- ensure a fair deal for those who are not contracted out and who also tend to be amongst the lower paid.

If the rebate were set significantly above the cost of providing SERPS-level benefits, this would create an incentive to contract out. Conversely, setting the rebate at too low an amount would create an incentive to be a full member of SERPS.

The effect of age

Age is an important consideration. SERPS is a form of defined benefit scheme – an average salary scheme as opposed to the more usual final salary arrangements found in most defined benefit occupational schemes. For each year of membership, SERPS pays a defined level of benefit in retirement. In a funded defined benefit scheme the cost of providing people with a pension increases as they grow older, because as each year passes there is less time before retirement for contributions to earn a return before the pension is paid. This applies equally to contracted-out funded schemes that undertake to pay pensions in place of SERPS, so the cost of providing SERPS-level benefits rises as people grow older. This effect was magnified when SERPS was first introduced because, in addition, benefits for older people were phased in at a faster rate than for younger people.

Defined benefit and defined contribution schemes

When SERPS began in 1978, only defined benefit occupational pension schemes were allowed to contract out. These covered people of all ages and a flat-rate rebate was set which offered an average level of compensation across all ages. But in 1988 it became possible to contract out using defined contribution schemes, either those run by employers or the new personal pensions. These schemes were not required to provide the same guaranteed level of pension as were defined benefit schemes, and contribution rebates had to be paid into each individual's account.
The scope for averaging the cost of providing SERPS-level benefits across

people of different ages that applies in the case of defined benefit schemes does not apply in the case of defined contribution schemes.

Despite this, a single flat-rate rebate was retained for all types of contracted-out scheme. As before, the rebate was intended to give an average level of compensation across people of all working ages. This still had some logic in the case of defined benefit occupational schemes covering a cross-section of ages. But in the case of personal pensions and defined contribution occupational schemes it created a huge incentive for younger people to join. The proceeds of investing their contribution rebates would far exceed the level of pension they could get in SERPS. (This applied particularly to young men because of their later pension age and lower life expectancy.) In addition to the rebate, a further two per cent of earnings within the National Insurance limits was paid to those who went into a defined contribution occupational scheme or personal pension. It is no wonder so many people were attracted out of SERPS by such schemes.

Age-related rebates

New arrangements for contracting-out rebates were introduced in 1997. Rebates for people in defined contribution occupational schemes and personal pensions are now set on an age-related basis. In 1998/9 these range from 3.1 per cent of relevant earnings in the case of defined contribution occupational schemes (3.4 per cent for personal pensions) up to a maximum of nine per cent. The rebate for defined benefit schemes is still a single flat rate regardless of age – 4.6 per cent of relevant earnings.

The introduction of age-related rebates has done much to restore a more balanced position between contracting out and not doing so. Amongst defined benefit occupational schemes the flat-rate rebate still creates potential incentives favouring schemes whose membership is predominantly young and have the lowest administration costs. But, as Figure 7.1 in Chapter Seven showed, the higher costs of personal pensions in particular continue to be reflected in larger rebates for those schemes relative to the value of the pensions they will pay in place of SERPS.

Summary

However they are provided, pensions are a charge on the economy at the time they are paid. We have found no overriding economic reason to change policy in order to alter significantly the balance between pre-funding and pay-as-you-go. There are good economic reasons for not putting all pension eggs in one basket by over-reliance on either system.

Financing the basic state pension on a pay-as-you-go basis, with earnings-related contributions, has the advantage of making redistribution clear and explicit.

The compulsory level of pension provision must strike a balance between the long-term benefits to individuals from better income in retirement – and to future taxpayers from lower expenditure on means-tested help – with the right of individuals to have freedom of choice in how they use their money.

If policy makers did wish to extend pre-funded pensions to the low paid, they would need to overcome the problems of:

- low-paid people's ability to afford the necessary contributions;
- the low level of pension low contributions deliver; and
- the current costs of administering small amounts of pension rights.

We believe that the existing system of tax treatment for pensions is largely appropriate. It does not provide large incentives compared to some other forms of saving.

The introduction of age-related rebates for defined contribution schemes has done much to restore a more balanced position between contracting out and not doing so.

9 The future prospects for pensioner incomes

In this chapter we look ahead to what is likely to happen to pensioner incomes in the first quarter of the next century. We:

- ➢ review the main forces that will determine pensioners' incomes; and
- ➢ summarise special analyses we have commissioned using the PENSIM model to assess the effects of alternative assumptions on the future incomes of single and married pensioners.

Forces that will determine pensioner incomes

We start by looking at what currently are the main components of pensioner incomes. The DSS *Pensioners' Incomes Series* for 1995/6 shows these are:

- ➢ state pensions and benefits (51 per cent);
- ➢ occupational pensions (24 per cent);
- ➢ investment income (16 per cent); and
- ➢ earnings (eight per cent).

Because of the way that income statistics are assembled at present, income from personal pensions comes under the heading of 'investment income' in these figures. (As the amounts paid through personal pensions grow, it will in future be important to show them separately.) We consider each of the main components in turn, including personal pensions.

As we have seen in previous chapters, changes are taking place in all sources of pensioner incomes. For some of these changes it will be many years before their full effects feed through.

As has been the case throughout our report, our concern is to look at the implications of current policies. However, we do look at the consequences of uprating means-tested benefits faster than prices, which we think is inevitable in the long run. This could be regarded as a change in explicit policy but is in keeping with what has happened in the past, at least over the long term.

State pensions and benefits

We saw in Chapter Five that – when viewed in the longer term – state provision is going through a period of dramatic change. To recap, the main elements of change are:

- increasing the level of the basic state pension in line with prices so that its value falls further and further behind average earnings;
- the introduction of SERPS in 1978 and subsequently the significant cutbacks made to the benefits promised under it;
- the phased rise in women's state pension age to 65 – the same as men's – starting with women retiring in 2010;
- ending the right for married women to opt out of the National Insurance pension scheme and the introduction in 1978 of home responsibilities protection for people looking after children or caring for a disabled person; and
- the impact of linking the National Insurance contribution earnings limits to prices so that they too are falling in relation to average earnings.

As far as the first tier of state pension provision is concerned, the net effect of these changes will be that in the future more people will receive some basic state pension and more will qualify for the full rate. This will affect women more than men. But the value of the basic state pension will form a declining proportion of people's earnings. If earnings grow faster than prices by 1.5 per cent a year, the full rate of basic state pension will fall from about 16 per cent of men's average earnings now to reach about nine per cent in 2040.

Second-tier state pensions will also fall in relation to average earnings for people retiring in the next century as the various sets of changes to SERPS come into effect and reduce the value of new SERPS pensions coming into payment each year.

We illustrate the combined effect of changes to the basic state pension and to SERPS in Figure 9.1. It shows what the amounts of state pension for people reaching pension age in 2000, 2020 and 2040 will be in constant earnings terms. The examples assume that the people concerned are full members of SERPS and have had the particular levels of earnings shown throughout their working life, or since SERPS began in 1978, if shorter.

For someone on earnings of £200 a week, basic state pension plus SERPS will fall from about half their earnings in the year 2000 to a third in 2040. For someone on £300 a week, the fall is from about 40 per cent of their earnings to just over a quarter. These are the proportions that state pensions

Figure 9.1: Future amounts of state pensions

	Basic pension + SERPS	
Reaching pension age in	**Amount in constant earnings terms £ per week**	**As proportion of earnings %**
Earning £200 a week in 2000/1 terms		
2000	98	49
2020	78	39
2040	66	33
Earning £300 a week in 2000/1 terms		
2000	123	41
2020	99	33
2040	84	28

Source: Government Actuary's Department

Notes: (1) Earnings are assumed to grow faster than prices by 1.5 per cent a year.
(2) The proportions shown are of the earnings of the *individual* and not of, for example, average earnings.

form of earnings when people reach state pension age. Once state pensions are in payment they are increased in line with prices, so the longer people are retired, the further behind earnings their pensions will fall.

Means-tested benefits

In our view – given past experience – it is very unlikely that the floor provided for pensioner incomes through means-tested benefits will be held to the rise in prices in the longer term. This would leave poorer pensioners falling further and further behind those in work. For the modelling which we describe later in this chapter we have, therefore, examined the likely effect both of linking the rates of means-tested benefits to prices and of linking them to the rise in average earnings. We have also assumed that the limits which apply to amounts of savings (which are used in calculating entitlements to these benefits) will also increase, respectively, in line with prices or with earnings. If these limits did not increase, more and more people would be excluded from these benefits on the grounds of their savings as the real value of the limits fell. Eventually, very small amounts of savings would be sufficient to exclude people from being able to receive means-tested benefits. Such an assumption does not look sensible to us.

Other benefits

The number of pensioners receiving disability benefits has grown substantially in recent years. We have taken no view about what will happen in the future to these benefits.

Occupational pensions

We saw in Chapter Six that membership of occupational pension schemes is still growing amongst women, particularly those in part-time work, but that the proportion of men who are in such schemes has been falling since the early 1980s. There are no indications that on current policies these trends will reverse in the future.

The amount of benefits that occupational schemes pay has been rising and is likely to continue to do so. One reason for this is the requirement on schemes – introduced in 1986 and extended in 1990 – to revalue the benefits of people who leave a scheme before pension age ('early leavers') in line with prices up to five per cent a year. The forthcoming report *Building Up Pension Rights* by the Centre for Research in Social Policy, Loughborough University, also shows that on average people are accumulating greater rights in occupational pension schemes than did earlier generations.

A key influence on the amount of occupational pensions is the growth in people's earnings. Average earnings tend to grow faster than prices. So the average amount of new occupational pensions coming into payment increases when measured against the rise in prices.

The statutory requirements to increase pensions in payment in line with prices will cover an increasing proportion of people's occupational pension rights. Much of this protection is subject to an upper limit of five per cent a year so they are therefore highly vulnerable to any sharp bursts of inflation. If inflation remains low, we expect occupational schemes in general to continue their recent practice of broadly matching the rise in prices for pension rights not covered by such statutory requirements.

Personal pensions

Few of the five million people who took out a personal pension as a result of the reforms introduced in 1988 have so far retired. As they reach pension age over the next few decades, amounts of personal pensions in payment will rise substantially.

Investment income

Other forms of investment income – for example, from savings accounts and shares – are also, in our view, likely to rise in significance. As people's living standards rise, they tend to save more. This is reflected in our modelling in which we also make assumptions about the rate of return on savings.

Earnings

We saw in Chapter Four a long-term trend for fewer men to continue earning after state pension age. This has been associated with growing sources of pension income and – for many pensioners – higher living standards and increased ownership of homes and other assets. On balance, we would expect the trend for fewer men to earn after state pension age to continue, at least until the number over 65 years of age rises sharply in the second quarter of the next century.

The position for women is more complicated. Their state pension age is due to rise, and many occupational schemes have chosen to equalize at 65 years of age, too. This may have the effect of increasing the proportion of women who earn after the age of 60, though there is no guarantee of this. Nor may it apply after the age of 65. The general tendency for women to spend more time in paid work may also feed through into more continuing to earn after pension age. But against these effects, some women will benefit from receiving higher pensions in their own right. As for men, higher pensions and the general growth in living standards may reduce the need that some women have to work past pension age.

For our modelling we assume that the proportion of people who earn in retirement remains at about its current level and that the amounts they earn increase in line with average earnings.

Projections of pensioner incomes

We report here the results of special analyses we have commissioned using the PENSIM model developed for the DSS. Curry (1996) describes the model in detail.

PENSIM

The aim of the PENSIM model is to give an indication of future trends in the growth and distribution of pensioners' incomes. This is an especially difficult and complex exercise as so many diverse factors influence a person's income in retirement. It involves, for example, making estimates of people's circumstances throughout both their working lives and their retirement until they die.

The PENSIM model is based on survey data collected from representative samples of the population at different stages in their lives. It uses various techniques to estimate what happens to them subsequently, in particular those of their circumstances which determine their incomes in retirement, for example:

- their employment and earnings levels;

- their membership of the various forms of pension scheme; and
- other forms of savings which they are able to accumulate.

The information the model generates in this way is then used to calculate how much people in different situations receive from each income source. The results are intended to be representative of the pensioner population living in private households, excluding, for example, people living in residential care or nursing homes.

With two exceptions, PENSIM models all the main sources of pensioner income and makes deductions for income tax. The exceptions are Council Tax Benefit and disability benefits. As a result PENSIM tends to understate the levels of pensioner incomes.

Another important *caveat* is that the model does not fully reflect the effects on retirement incomes of single people marrying after they were interviewed or of married couples separating or divorcing after being interviewed. This will also have an impact on the model's results, but we have found no evidence to indicate its possible scale or direction.

We have looked carefully at the construction of the PENSIM model, its data sources, assumptions and other specifications. Whilst like all models it inevitably has shortcomings, we believe PENSIM is a useful tool for identifying the likely consequences of alternative economic and policy assumptions. Its results are not, of course, forecasts of what will happen in practice. We are grateful to DSS economists for the help they have given us.

Our assumptions

We asked for estimates to be made of pensioners' incomes in:

- 1997, as the base year for comparison. There are some differences between these figures and the *Pensioners' Incomes (PI) Series* that we showed in Chapter Three. Some of these are due to the fact that PENSIM does not include Council Tax Benefit and disability benefits, others are the inevitable result of using survey data and statistical models that can only approximate the real world. PENSIM's estimates for amounts of occupational pension in 1997 also look low in relation to the PI Series. But PENSIM's purpose is to show how the position will change in the future, and we do not believe that this particular difference detracts significantly from the model's value in that respect; and
- 2025, the furthest ahead for which PENSIM is able to give tenable estimates.

We also looked at results for intervening years (see Annex G).

2025 is not very far ahead in pension planning terms. People who are 20 years old today will not reach the state pension age of 65 until 2043. So our results reflect the position of people who are now in their late 30s – who will reach 65 years of age in 2025 – or older, including some who have already retired. For many of the people who will be over 65 years of age in 2025, a large part of their pension provision has already been made.

Economic assumptions

We have made a number of assumptions about the economy between now and 2025. In our central projection the most important ones are:

- average earnings grow faster than prices by 1.5 per cent a year;
- unemployment is in the range of one to one and a half million for most of the period up to 2025 (ILO definition);
- returns on investment are four per cent above the annual rise in prices;
- prices rise by an average of 3.8 per cent a year (see Curry [1996] for further details); and
- rents rise in line with prices.

In Annex G we show the effects of varying some of these assumptions. Of the economic assumptions, it is varying the rate of growth of earnings that has the greatest impact. The faster that earnings and the economy grow, the higher also will be future pensioners' living standards.

State pensions

We have assumed that state pensions and the National Insurance contribution earnings limits continue to be increased in line with prices.

Means-tested benefits

As noted earlier, we have also made alternative assumptions about the rates of means-tested benefits and the limits used in their calculation for amounts of savings. The two assumptions are that they are increased either:

- in line with the rise in *prices*; or
- in line with the rise in *earnings*.

Our results

General growth in incomes

Over the period from 1997 to 2025 average earnings will rise by 52 per cent more than prices on our central economic assumptions. This suggests that for the working population in general living standards will be about half as high again as they are now.

Our projections suggest that in the period to 2025 the average incomes of married pensioners will rise by slightly less than the rise in average earnings to reach about £350 a week in today's prices. But single pensioners' incomes will rise rather more than average earnings and will be two-thirds higher than now, about £200 a week in today's prices.

Sources of pensioner income

State pensions and benefits will continue to comprise a large proportion of pensioner incomes, though less so than now. The state will provide about half the income of single pensioners in 2025 (compared with about 60 per cent now), and about 40 per cent of married pensioners' incomes (about 45 per cent now). However, one source of state income, SERPS, will rise substantially, as will occupational and personal pensions and investment income. These are all sources that are strongly related to the level of people's earnings during their working lives, and in total they will provide around two-thirds of pensioners' incomes in 2025, compared with under half now.

Income Support

Means-tested benefits will also continue to be a significant income source. For example, on the assumption that Income Support rates and savings limits increase in line with earnings, around one million pensioner units are likely to receive that benefit in 2025 despite the rise in other sources of pensioner income. That compares with about 1.8 million pensioner units who receive Income Support now, though some of the reduction will be because the rise in women's state pension age will mean that women on Income Support under the age of 65 will no longer be included as a 'pensioner unit'. (If Income Support rates and savings limits were, instead, to rise only in line with prices, the number of pensioner units receiving Income Support in 2025 would be rather lower, around 0.5 million.) These calculations are very approximate. They assume, for example, that there is no change in the proportion of pensioners entitled to Income Support who claim it.

Individuals and economic growth

On current policies, the future rise in pensioner incomes will not be spread evenly. The majority of individual pensioners who have already retired are unlikely to see any rise in their own living standards because their sources of income are likely to rise only in line with prices, at best. The exceptions are likely to be, at one end of the distribution, those who can claim means-tested benefits – which we believe governments will raise in line with earnings over the long run – and, at the other, the very well-off who receive a large share of their income from investments such as equities and real assets whose value tends to increase with economic growth.

How the distribution of pensioner incomes will change

In Figure 9.2 we show, on our assumptions, PENSIM's estimates of the rate of change in income between 1997 and 2025 for each fifth of the single and married pensioner income distributions. It is important to note that this analysis involves comparing the incomes of different people at the two points in time, although some individual pensioners will be in the same fifth in both years.

Figure 9.2: Growth in pensioner incomes 1997–2025

Position in income distribution by fifths	***Single pensioners***		***Married pensioners***	
	prices	***earnings***	***prices***	***earnings***
	Increases from 1997 to 2025			
	%	%	%	%
Lowest fifth	23	57	27	40
2	31	53	40	41
3	35	44	47	47
4	52	53	48	48
Highest fifth	93	93	54	54
Average	*58*	*66*	*47*	*48*

Source: Projections for the Pension Provision Group using the PENSIM model

Notes: (1) The table shows the extent to which the income of each fifth of the income distribution in 2025 has risen faster than prices compared to the income of each fifth in 1997.

(2) The comparisons are between the people who are in each fifth of the income distribution in that particular year. The comparisons are not therefore between the same people.

(3) 'Prices' and 'earnings' refer to our assumptions about the increase in the rates of means-tested benefits and the savings limits used to calculate entitlements.

In the single pensioner income distribution, the largest rise is likely to be at the highest fifth – more than 90 per cent above the rise in prices. On our assumption that means-tested benefit rates and savings limits keep up with average earnings, for all parts of the distribution – except the middle fifth – the rise is at least as fast as the rise in average earnings (52 per cent).

The pattern of a large rate of increase confined to the upper end of the single pensioner income distribution probably has no single cause. It would be wrong to place too much emphasis on this result since it may be partly because the model does not reflect fully the prospect that single people will marry. Significant improvements in the retirement incomes of some, but not all, groups of women who will have recently reached 65 years of age in 2025 could also be an explanation. Changes in the incomes of women have a substantial impact on the incomes of single pensioners as a whole since single women pensioners greatly outnumber men.

In the married pensioner distribution, the rise in income is likely to match the rise in average earnings only for the highest fifth. For married pensioners, a rise of only about 40 per cent is projected for the lowest two-fifths.

Figure 9.2 also shows that the incomes of single pensioners are more sensitive to assumptions about means-tested benefits than are married pensioners' incomes. This is because single pensioners will remain more dependent on these benefits than married pensioners.

Pensioner income inequality

Given the results in Figure 9.2, it is not surprising that we find that the extent of income inequality amongst pensioners is likely to rise between now and 2025. In Figure 9.3 we show this in terms of the ratio between the income of the top fifth and the income of the lowest fifth. For single pensioners, the ratio rises from 3.3 now to about 4.0 (assuming means-tested benefits and savings limits rise in line with earnings). The rise in this ratio for married pensioners is smaller, from 3.5 now to 3.9. Were means-tested benefits to be linked instead to prices, income inequality would increase at a much faster rate, particularly for single pensioners.

Figure 9.3: Extent of pensioner inequality

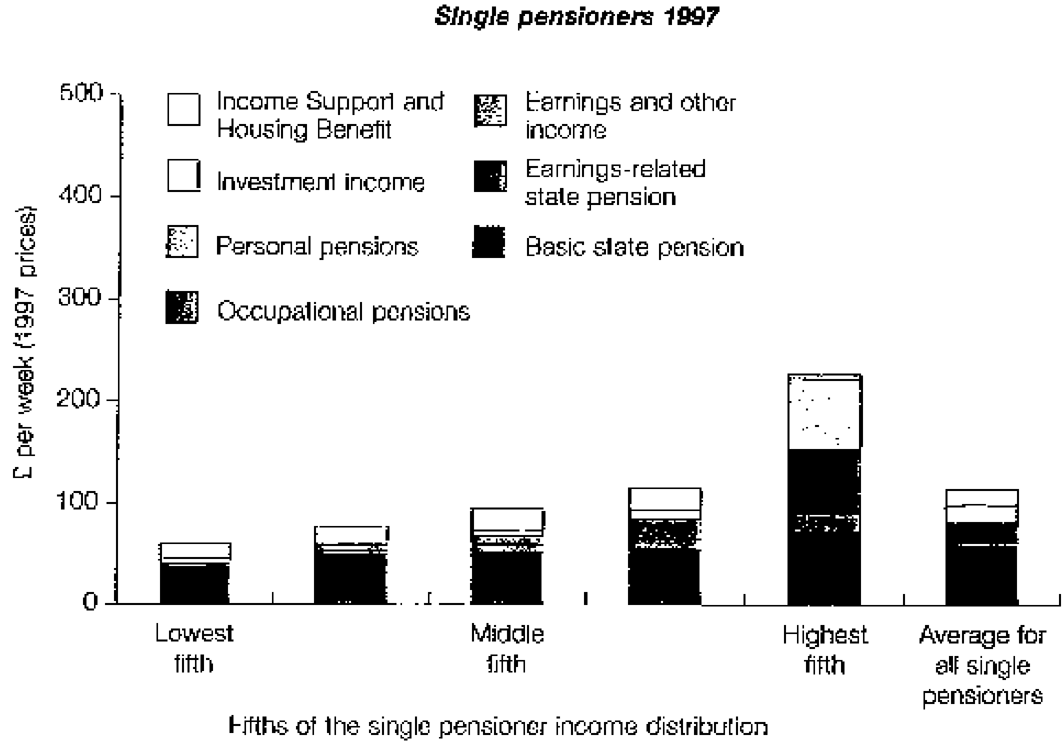
	Income of highest fifth as a ratio of income of lowest fifth		
	1997	***2025***	
		Means-tested benefit rates and savings limits rise in line with:	
		prices	***earnings***
Single pensioners	3.3	5.2	4.0
Married pensioners	3.5	4.3	3.9

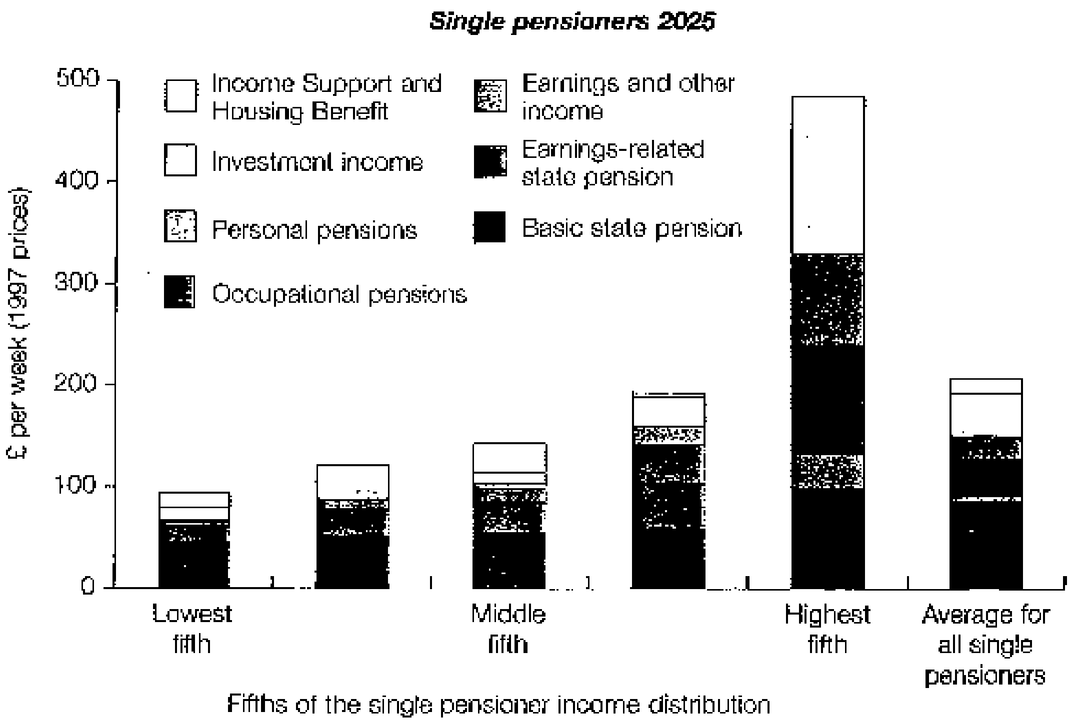
Source: Projections for the Pension Provision Group using the PENSIM model

Note: Figures show the ratio of the average income of the top fifth of the single and married pensioner distributions to the average income of the lowest fifth.

Linking the basic state pension – which is currently the largest single source of income for pensioners – to only the rise in prices is a major cause of the continuing growth in pensioner inequality. But the growth in inequality is also to a large extent a reflection of the success in encouraging occupational and personal provision. The bigger role for earnings-related pensions – state and non-state – which has been a feature of the policy of governments for several decades, must inevitably lead to more inequality in income in old age. Figure 9.4 illustrates these points.

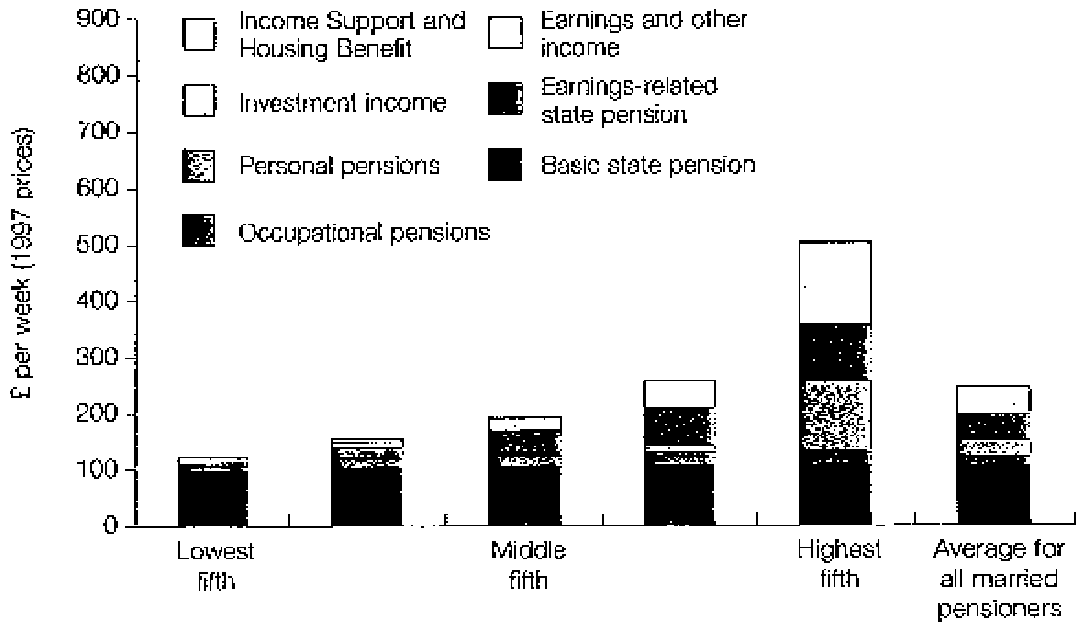
Figure 9.4: Pensioner incomes before tax in 1997 and 2025

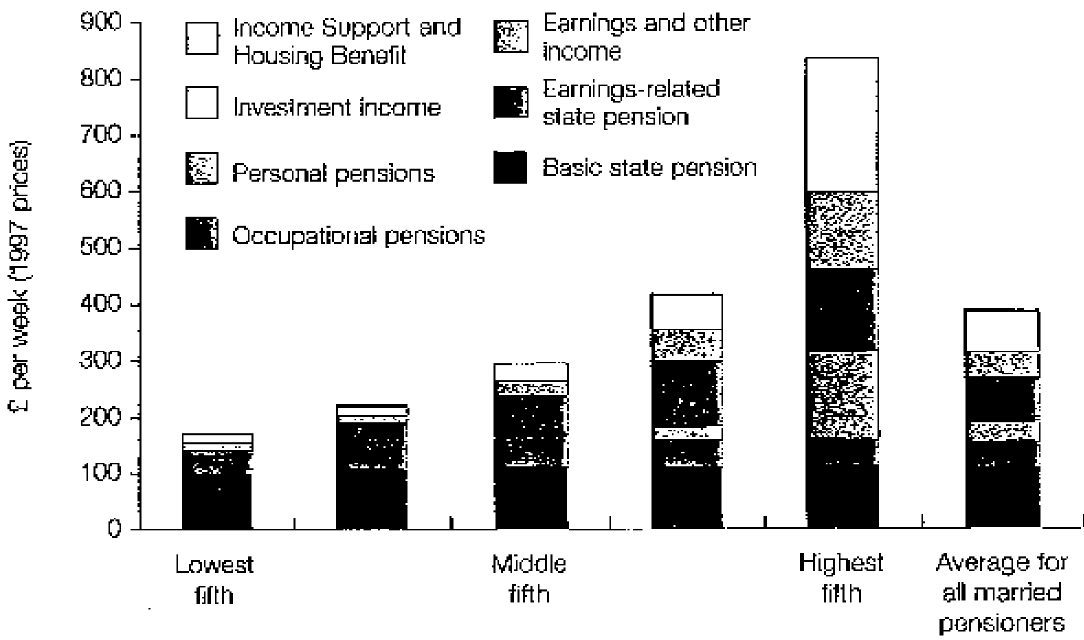




continued

Figure 9.4 (continued)





Source: Projections for the Pension Provision Group using the PENSIM model

Note: Based on central economic assumptions and the assumption that means-tested benefits and savings limits rise in line with earnings.

Summary

The main forms of pension provision – state, occupational and personal – have undergone major changes in recent decades. The effects of these changes on pensioner incomes will continue to be felt for decades ahead.

We have looked in particular at 2025 and have found:

- state pensions and benefits will continue to have a substantial role in pensioner incomes, but to a lesser extent than now;
- earnings-related pensions – state, occupational and personal – will be more important than now;
- average pensioner living standards are likely to be half as high again as now, similar to the projected average rise for those in paid work;
- the rise in average income for single pensioners will be greater than for married pensioners;
- most individual pensioners will continue to see their own income fall behind the living standards of people in paid work, because for most pensioners – once they have retired – their incomes are, at best, likely to rise only in line with prices; and
- there will be a rise in pensioner income inequality as a result of the move to greater reliance on earnings-related forms of provision.

Beyond 2025 current policies will lead to a continuing erosion of the value of state pensions relative to earnings. We would expect the trend to greater income inequality in old age to continue.

10 Conclusions

In this chapter we set out the conclusions and messages that we have drawn from our examination of pension provision in the UK. We have worked on the basis that the current policies which shape pension provision will continue; we were not asked to look at new policy options. But we have commented, where we think it appropriate, on areas where we think a change to current policy is inevitable.

1 The state's role is necessary and affordable

- On current policies, state pensions will be no less affordable than they are today; but this is because state pensions will be a falling proportion of average earnings. While we recognise that the future is uncertain, it is our opinion that the contributions required to meet the cost of state pensions will show little or no increase as a proportion of earnings and will eventually fall towards the middle of the next century.
- Cutbacks in state pensions lead to a greater role for non-state provision if people are to retire on adequate incomes. But non-state provision currently depends on being in paid work, and good non-state pensions depend on people earning enough over their working lives to afford the necessary contributions.
- Because the basic state pension alone will not be adequate, the effect is to raise the extent to which many people will have to depend on means-tested benefits assuming, as we believe, that the level of means-tested benefits will have to rise faster than prices.
- Only the state can effect redistribution to those with low lifetime incomes. The state has, therefore, an inescapable role in ensuring that meaningful pensions are provided for those on low pay or who spend long periods without earnings. So, just relying more in the future on existing forms of non-state pension will leave gaps in provision for the most vulnerable groups.
- *The key challenge for policy makers is to find ways to prevent these gaps arising.*

2 Occupational schemes have boosted some pensioner incomes

- Past growth in the coverage of occupational pension schemes and improvements in benefits, as the result of higher earnings and legislation, will continue to raise incomes for many new pensioners who have better provision than their predecessors. But there is still scope for schemes to change and adapt to social and labour market developments – as indeed they have in the past.
- It will always be the case, however, that many people – especially the low paid – will not retire with significant income from occupational schemes and that for some employees these schemes will not be suitable because of their working patterns.

3 SERPS is currently better than many people think, but it will decline

- For many people retiring in the next few years, SERPS and the basic state pension will provide enough income to keep them off means-tested benefits.
- But the value of SERPS pensions for the newly retired will start to fall further and further behind earnings from the start of the next century. Furthermore, SERPS coverage has narrowed and for many higher paid people it serves only as a benchmark and not as a provider of benefits.
- SERPS also does not cover the self-employed.

4 A further rise in pensioner inequality seems very likely

- The conclusions in 1, 2 and 3 above, together with the growth of earnings inequality for those in work, will result in the gap between rich and poor pensioners – which has already widened considerably since 1980 – continuing to do so. This will happen, although to a lesser extent, even if the floor provided by means-tested benefits rises in line with earnings.

5 Means-tested benefit levels will inevitably continue to rise

- Given that the basic state pension is rising only in line with prices, it will not provide an adequate income in itself.
- If the Income Support floor is linked to prices, the rate of benefit for a single pensioner over the age of 80 will, for example, fall from about 19 per cent of men's average earnings now, to about eight per cent by 2050. We cannot envisage any government will find this acceptable in

isolation. We therefore believe that the level of Income Support will have to rise faster than prices.

- We also therefore expect the poorest pensioners to have to rely on Income Support to an increasing extent.

6 Personal pensions provide some opportunities

- Personal pensions have encouraged non-state provision resulting in some people saving more and others starting to save for their retirement.
- In their current form personal pensions are not suitable for everyone, especially the low paid, and now have a bad reputation because of the problems of 'mis-selling'.
- Any future development of non-state pensions needs to build on the good experience and learn the lessons from the bad experience.

7 Compulsory provision is not new

- We already have compulsory second pensions paid for by employees and employers through SERPS and the contracting-out arrangements.
- The compulsory level of pension provision must strike a balance between the long-term benefits to individuals from better income in retirement – and to future taxpayers from lower expenditure on means-tested help – with the right of individuals to have freedom of choice in how they use their money.
- There is no requirement for the self-employed to have second pensions. It is difficult to see how the current distinction can be defended.

8 Those who *can* save more should be encouraged to do so

- There is a role for the state in encouraging those who *can* afford it to save for their retirement.
- But if the Government's aim is to extend non-state provision to low earners we see three key problems that will need to be overcome:
  - the ability of the low paid to afford the necessary contributions;
  - the low level of pensions that low contributions provide; and
  - keeping the cost of administering small amounts of pension rights low.

➢ The low paid have very little financial incentive to save for their retirement if the only effect is to reduce their entitlement to means-tested benefits once they have retired. In practice, this disincentive may be counteracted by a desire to avoid having to rely on means-tested benefits. But the loss of these benefits still tends to be seen as unfair by those who do not qualify for them as a result of having saved.

9 Pensioners do not share in economic growth

➢ With pension increases unlikely to exceed price inflation, standards of living in retirement for most pensioners will fall relative to the rest of the population. This will become more of an issue with people living longer and spending more of their lives in retirement.

10 The position of women is changing

➢ Women tend to have lower pensions than men because they often spend less of their working lives in paid work and because of past discrimination in occupational schemes. Future prospects for women are better relative to the past, but their improvement relative to men is constrained by their different patterns of paid work and levels of earnings.

➢ State pensions for women retiring over the next two decades will continue to improve relative to men's, but against a declining level of state provision.

➢ Pensions policy in isolation can only go so far in resolving pension provision problems for women. Labour law and employment, family and child care policies have a role to play too.

11 Self-employment can increase people's risk of being poor in old age

➢ The number of people experiencing periods of self-employment has risen substantially. The nature of self-employment has changed. Today, many self-employed jobs are insecure and low paid.

➢ In contrast to the position for employees, SERPS does not cover periods of self-employment, nor is there any requirement to make private pension provision. It is difficult to see how the current distinction can be defended.

➢ Pensions policy in isolation can only go so far in resolving the pension provision problems of self-employed people. Employment policy and labour law have a role to play too.

12 Everyone must be able to plan with confidence for retirement

- Governments need to spell out unambiguously the likely future value of state pensions in relation to future living standards.
- All future recipients of non-state pensions should be given regular estimates of the pensions they can expect, at least in real terms in relation to prices. People also need to be warned that over long periods they will measure their living standards, not against price rises, but against earnings levels, which rise faster than prices.
- We think that the current tax system is broadly suitable for pensions. Further increasing the tax burden on funded pensions risks damaging the amount of provision being made, especially as pensions are not now greatly tax privileged by comparison with some other forms of saving.
- Improved public awareness and understanding of pensions are important ingredients of better pension provision. The current complexity in all types of provision – and in pensions regulation – makes it very difficult for a satisfactory level of awareness and understanding to be achieved.

13 Pensions have had, and always will have, an element of risk for the individual

- All forms of pension provision – including state pensions – have inherent risks and uncertainties which can affect the pensions people receive relative to what they expect.
- The low paid are the least able to cope with the adverse effects of risk.
- With non-state pensions, some of these risks are already being managed better than in the past. But improvements are still needed, particularly if non-state pensions are to be extended further to the low paid.

14 More pre-funding is not a panacea

- However they are provided, pensions are a charge on the economy at the time they are paid. We have found no overriding economic reason to change policy in order to alter significantly the balance between pre-funding and pay-as-you-go. There are good economic reasons for *not* putting all pension eggs in one basket by over-reliance on either system.
- The role of the first tier (i.e. the basic state pension) is redistributive and we believe it should continue to be financed on a pay-as-you-go basis.

- It will be clear from other conclusions that we expect there will be more non-state second-tier pension provision in the future. We think it is appropriate that this is provided on a pre-funded basis.
- Two parts of second-tier pensions that are not pre-funded are SERPS and some public sector occupational schemes. Those public sector occupational schemes might be more suitable candidates than SERPS if a further move towards pre-funding were considered to be desirable.

15 Better informed and co-ordinated policy making is needed

- A consistent approach is needed across the several government departments involved in pension policy making. This is conspicuously lacking at present.
- An organisation, independent of government, needs to have lead responsibility for accumulating, analysing and publishing information about current and future pension provision and its implications for pensions policy.

Annex A – Glossary of terms

The terms in this glossary draw on those in *Pensions Terminology* and extracts are reproduced by kind permission of the Pensions Management Institute.

ACTIVE MEMBER

A member of an occupational pension scheme who is at present accruing benefits under that scheme in respect of current service. A member of a personal pension scheme currently contributing to that scheme.

ADDITIONAL VOLUNTARY CONTRIBUTIONS (AVCs)

Contributions over and above a member's normal contributions, if any, which the member elects to pay to an occupational scheme in order to secure additional benefits.

ANNUITY

A series of payments, which may be subject to increases, made at stated intervals until a particular event occurs. This event is most commonly the end of a specified period, or the death of the person receiving the annuity, or of the person's widow(er).

APPROPRIATE PERSONAL PENSION

A personal pension scheme granted a certificate by the Contributions Agency, enabling its members to use it for contracting out of SERPS.

APPROVED SCHEME

A retirement benefits scheme which is approved for tax purposes by the Inland Revenue. The term may be used to describe an occupational pension scheme, a personal pension scheme or a FSAVC scheme.

AVERAGE INCOME

Average – or mean – income is the total income everyone receives divided by the number of people receiving it. Average or mean income is usually higher than the median income.

BASIC STATE PENSION

The flat-rate (not earnings-related) state pension paid to all who have met the necessary National Insurance contribution requirements.

CONTRACTING OUT

A pension scheme is contracted out where it provides benefits in place of SERPS and has been given a contracting-out certificate, or appropriate scheme certificate, by the Contributions Agency.

CONTRACTING-OUT REBATE

The amount by which the employer's and employee's National Insurance contributions are reduced or rebated in respect of employees who are contracted out by virtue of their membership of an appropriate personal pension scheme or an occupational pension scheme.

CONTRIBUTION EARNINGS LIMITS

See National Insurance earnings limits.

CONTRIBUTORY SCHEME

A scheme which requires contributions from active members, even if such contributions are temporarily suspended during a 'contribution holiday'.

COUNCIL TAX BENEFIT

A means-tested state benefit for people with low income and savings to meet the cost of their Council Tax.

DEFERRED MEMBER

A member entitled to preserved benefits.

DEFINED BENEFIT SCHEME

A scheme where the benefits are defined independently of the contributions payable, and benefits are not directly related to the investments of the scheme. The scheme may be funded or unfunded.

DEFINED CONTRIBUTION SCHEME

A scheme which provides a pension based on the contributions paid into the scheme in respect of each member, the investment return on the pension fund and the cost of buying an annuity at retirement.

DRAWDOWN FACILITY

See income withdrawal.

DSS

Department of Social Security.

EARLY LEAVER

A person who ceases to be an active member of a pension scheme, other than on death, without being granted an immediate retirement benefit.

ELIGIBILITY

The conditions which must be met for a person to be a member of a scheme or to receive a particular benefit. These may, for example, relate to age, service, status or type of employment.

EQUAL TREATMENT

The principle requiring one sex to be treated no less favourably than the other.

FINAL SALARY SCHEME

A defined benefit scheme where the benefit is normally based on an individual's pay close to retirement and on their length of scheme membership.

FIRST-TIER PENSIONS

In the UK this is the basic state pension.

FREE STANDING ADDITIONAL VOLUNTARY CONTRIBUTIONS (FSAVCs)

Contributions to a pension contract separate from an occupational pension scheme, made by an active member of that scheme. Benefits are secured with a pension provider by contributions from the member only.

FUNDED/FUNDING

Provision for meeting future pensions liabilities by the saving and investment of contributions to accumulate assets which are used to pay pensions when today's active members retire.

GRADUATED PENSION SCHEME

The state earnings related scheme which began on 3 April 1961 and ended on 5 April 1975. The forerunner of SERPS.

GROSS DOMESTIC PRODUCT (GDP)

The sum of all economic activity taking place in UK territory.

GROSS NATIONAL PRODUCT (GNP)

GDP plus the net income the UK receives from abroad.

GROUP PERSONAL PENSION (GPP) SCHEME

An arrangement made for the employees of a particular employer, or for a group of self-employed people, to participate in a personal pension scheme on a grouped basis. Within the arrangement, each personal pension is a separate legal entity.

HOME RESPONSIBILITIES PROTECTION (HRP)

Protection of entitlement to the basic state pension for people not in regular employment because they are caring for children or a sick or disabled person at home.

HOUSING BENEFIT

A means-tested state benefit for people with low income and savings to meet the cost of rent.

HYBRID SCHEME

1. An occupational pension scheme in which the benefit is calculated as the better of two alternatives, for example on *either* a final salary or a defined contribution basis.

2. An occupational pension scheme which offers *both* final salary and defined contribution benefits.

ILL HEALTH EARLY RETIREMENT

Retirement on medical grounds before normal pension date. The benefit may exceed that payable on early retirement in other circumstances.

INCAPACITY BENEFIT

A state benefit paid to those who have met the necessary National Insurance conditions and who cannot be expected to work due to sickness or disability. It is not means-tested.

INCOME SUPPORT

A means-tested state benefit for people who are not required to be available for work and who have little or no income and savings.

INCOME WITHDRAWAL

Withdrawal of pension income from a personal pension or defined contribution occupational scheme, while annuity purchase is deferred.

INDEX LINKING

An adjustment in line with the change in an index (usually of prices or earnings).

INDUSTRY-WIDE SCHEME

An occupational pension scheme operated on behalf of several employers in a particular industry.

INFLATION PROOFED

Commonly used to describe a system whereby pensions in payment and/or preserved benefits are *automatically* increased at regular intervals by reference to a specified index of prices or earnings.

ILO (INTERNATIONAL LABOUR ORGANISATION) UNEMPLOYED

The ILO's definition of unemployment. People without a job who are available to start work in the next two weeks and who have either looked for work in the previous four weeks, or are waiting to start a job they have already obtained.

LIABILITIES

Amounts which a pension scheme has an obligation to pay now or in the future.

LIMITED PRICE INDEXATION (LPI)

The legal requirement to increase pensions in payment under an occupational pension scheme (excluding AVCs and FSAVCs) and protected rights under an appropriate personal pension scheme, by five per cent *per annum* or the increase in the Retail Prices Index (RPI) if less. It applies to pensions accrued in respect of service after 5 April 1997.

LOWER EARNINGS LIMIT (LEL)

The minimum amount, approximately equivalent to the single person's basic state pension, which must be earned in any pay period before National Insurance contributions are payable.

MEANS-TESTED BENEFITS

A benefit paid by the state that depends on the income and other financial resources available to the payee.

MEDIAN INCOME

The midpoint of the distribution of incomes.

MINIMUM FUNDING REQUIREMENT (MFR)

A legal requirement that, under a prescribed set of actuarial assumptions, the value of assets of a defined benefit scheme should not be less than its liabilities.

MONEY PURCHASE SCHEME

See defined contribution scheme.

NATIONAL INSURANCE EARNINGS LIMITS

National Insurance earnings limits are weekly, monthly or annual amounts fixed for each tax year. National Insurance contributions are not payable by the employee or employer if the employee's reckonable earnings are below the lower earnings limit (LEL). Employees pay contributions on reckonable earnings over the LEL and up to the upper earnings limit (UEL). Employers' contributions are payable on all reckonable earnings above the LEL. Separate limits apply for self-employed people.

NON-STATE PENSIONS

Pensions provided by an occupational pension scheme (including those for public sector employees), or by a personal pension provider.

OCCUPATIONAL PENSION SCHEME

A scheme organised by an employer, or on behalf of a group of employers, to provide pensions and/or other benefits for, or in respect of, employees on leaving service or on death or at retirement.

PAY-AS-YOU-GO (PAYG)

An arrangement under which benefits are paid out of current contributions and taxes, and no funding is made for future liabilities.

PERSONAL PENSION SCHEME

A scheme under which an individual who is self-employed, or in non-pensionable employment, or employed but not a member of an occupational pension scheme (except a death in service only arrangement), can make pension provision. All personal pensions are defined contribution schemes.

PRE-FUNDED/PRE-FUNDING

See funded/funding.

PRESERVED BENEFITS/PENSION

Benefits or pension arising on an individual ceasing to be an active member of an occupational pension scheme and payable at a later date, usually the scheme's normal pension age.

PROTECTED RIGHTS

The benefits from a contracted-out defined contribution pension scheme – either an occupational or personal pension – deriving from the minimum contributions which must be paid into the scheme as a necessary condition of contracting out. The minimum amount is the contracting-out rebate plus (in the case of a personal pension) the tax relief on the employee's part of the rebate.

PUBLIC SECTOR PENSION SCHEME

An occupational pension scheme for employees of central or local government, a nationalised industry or other statutory body, for example the schemes for the armed forces, civil service, health service and local authority staff, the police and fire services, and teachers.

RATE OF RETURN

The percentage change in the value of an investment over a period, taking into account both the income from it and the change in its market value.

REAL RATE OF RETURN

The difference between the rate of return of an investment and a selected measure of inflation over the same period.

RETIREMENT ANNUITY CONTRACT

An annuity contract between an insurance company or friendly society and a self-employed person or someone in non-pensionable employment, which was established before 1 July 1988 and approved by the Inland Revenue.

SECOND-TIER PENSIONS

Pension paid through SERPS or an occupational or personal pension scheme.

STATE EARNINGS RELATED PENSION SCHEME (SERPS)

The earnings-related pension for employees paid in addition to the basic state pension.

STATE PENSION AGE

The age from which pensions are normally payable by the state pension scheme.

UNFUNDED SCHEME

A scheme where assets are not accumulated in advance of the benefits starting to be paid.

UPPER EARNINGS LIMIT (UEL)

The maximum amount of earnings (equal to approximately seven times the lower earnings limit) on which National Insurance contributions are payable by employees.

Annex B – Sources of information and bibliography

In this annex we:

- ➢ acknowledge and thank those people whom we have consulted in the preparation of our report;
- ➢ express our gratitude to the representatives of the organisations which provided assistance in many ways; and
- ➢ set out a bibliography of the publications we have used.

Acknowledgements

We are extremely grateful to the individuals and organisations listed below who helped us with advice, research and comments on this report, or who provided facilities or support for our deliberations. Without their valued help and co-operation, we could not have completed our task.

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We hope we have included everyone and we offer our apologies for anyone we have omitted to mention.

Individuals

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Government Actuary's Department

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National Association of Pension Funds

Pensions Management Institute

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Annex C – Income surveys and definitions

In this annex we:

- describe the main sources of information that we have used in our report on the incomes of today's pensioners and how they have changed recently;
- outline the approach used in Chapter Three to compare the incomes of pensioners and those of the rest of the population on an 'equivalent income' basis; and
- show more detailed tables for single pensioners.

The Pensioners' Incomes Series

The *Pensioners' Incomes (PI) Series* is published annually by the DSS. It is based on sample surveys of private households in the UK. People living in residential care or nursing homes, for example, are not covered. Participation is voluntary. The response rate is known to reduce amongst the oldest age groups.

Consistent data have been published for each calendar year from 1979 to 1993 and for the financial years 1994/5 and 1995/6. Households are interviewed once so each year's figures are based on different households. Interviews are held continuously throughout the year except around general election campaigns.

Gross income comprises cash income from all sources, including Housing and Council Tax Benefits (for earlier years, rent and rate rebates and community charge benefit) plus the value of certain forms of income in kind, such as free meals provided by employers and free coal or coke in the mining industry. Net income is gross income less income tax, National Insurance contributions and contributions to occupational pension schemes, but not to personal pensions. (It is proposed to bring treatment of the last two types of contribution into line.)

Income figures are usually shown both before and after the cost of housing and council tax expenditure.

With one exception, the *PI Series* gives figures for 'pensioner units'. A pensioner unit is either a married couple where the man is aged 65 or

over, or a single person – the term 'single' including also divorced, separated or widowed people – who is aged 60 or over in the case of women, 65 or over in the case of men. The exception to the use of income units is where comparisons are made between pensioners and the rest of the population. These use the HBAI basis which is described below.

Most of the pensioner income statistics used in the *PI Series* and in this report are based on the Family Expenditure Survey. In 1993, the DSS started a new survey, the Family Resources Survey. This is the basis for Figure C.1 which shows details of incomes for single pensioners under 75 and for those aged 75 or over, both according to whether they have never married, are widowed, or are separated or divorced.

Figure C.1: The incomes of single pensioners, 1995/6

	Single pensioners aged under 75				**Single pensioners aged 75 or over**			
	Never married	**Widowed**	**Separated/ divorced**	**All**	**Never married**	**Widowed**	**Separated/ divorced**	**All**
Gross income, of which:	160	142	156	147	131	128	118	128
State pensions and benefits	82	91	93	90	80	92	94	91
Occupational pension	41	31	22	31	33	22	15	23
Investment income	21	13	18	15	16	12	6	12
Earnings	14	7	20	11	2	2	2	2
Other income	*	*	4	1	*	*	1	*
Net income BHC								
Mean	131	118	119	120	109	107	101	107
Median	105	100	104	102	96	97	101	97
Net income AHC								
Mean	110	97	91	98	89	86	71	86
Median	82	72	67	71	68	69	65	69

Source: Special analysis by the DSS of the Family Resources Survey for the Pension Provision Group

Notes: (1) * = less than £1 a week.

(2) BHC = before housing costs; AHC = after housing costs.

(3) Components may not add to gross income due to rounding.

Households Below Average Income

Households Below Average Income (HBAI) is also published annually by the DSS. It is based on the same surveys of the private household population as the *PI Series* and uses similar methods. The main differences are as follows.

As its name suggests, HBAI results are given in terms of household incomes. So, for example, where a pensioner shares a household with

others, in HBAI the pensioner is assumed to share in the income of the whole household. The *PI Series* takes into account each pensioner unit's own income. So a low income pensioner in the *PI Series* may appear in a relatively high income household in HBAI.

'Equivalent incomes'

HBAI makes an adjustment to household incomes to reflect the differences in composition between households. The resulting measure of income is known as 'equivalent income'. For example, two adults living together are assumed to need between about 1.7 and 1.8 times the income that an adult living alone would need to achieve the same living standard. A child aged 11 is assumed to require just under half the income that a single person household needs.

HBAI figures are given in terms of the numbers of individuals living in the household population.

The Retirement Surveys

In November 1988 the Office of Population Censuses and Surveys (OPCS) – now part of the Office for National Statistics (ONS) – began interviewing a sample of people aged 55 to 69 about their plans for, and experiences of, retirement and collected details of their work and pension histories. Interviews were completed by January the next year. It is known as the 1988 Retirement Survey. The main results were published by Bone *et al* (1992).

A follow-up survey of the 1988 respondents was held in 1994. An analysis linking the two surveys is published in Disney *et al* (1997).

Annex D – Income adequacy

In this annex we look at some of the issues concerning adequacy and at recent evidence on people's expectations about their retirement income.

Absolute standards

One approach to an absolute standard of adequacy is to construct a budget needed to support a particular pattern of expenditure. The Family Budget Unit (FBU) have calculated for Age Concern what Margaret Wynn – borrowing an American term – called a 'modest but adequate' budget for older people (see Oldfield and Thirlway [1997]). The authors recognise the difficulties in arriving at the necessary judgements about what is included in the budget. They adopt as a rule of thumb that 'where more than 50 per cent of households possess an item or use a service, it is included'. Their comparison appears to be with 50 per cent of all households, not just pensioner households. The FBU's latest estimate is for 1997 – see Figure D.1.

We have also looked at how many pensioners could afford such a budget by comparing the 1994 version of the budget with available data on pensioner incomes in the *Pensioners' Incomes Series*. We looked at data for the financial year 1994/5 and for the calendar year 1979:

- for 1994/5 we found that the poorest 60 per cent of pensioners – whether single or married – could not have afforded the FBU budget from their incomes; and
- for 1979, when pensioners' incomes were on average much lower, even amongst the top 20 per cent of pensioners, many would have had difficulty affording the 1994 budget. Of course, a comparable budget for 1979 might have been lower.

Another approach is to canvass public opinion. In 1991 the British Social Attitudes Survey asked people whether they thought that a married couple living on £75 a week – a little under the standard rate of basic state pension for a couple if the woman had opted out of National Insurance – 'are really poor', 'are hard up' or 'have enough to live on'. Around a half of people selected 'hard up' with the rest split roughly equally between 'really poor' and 'have enough to live on' (Askham *et al* [1995]).

Hancock *et al* (1995) asked people who were in work for their views on the adequacy of their own expected pension level. In February 1995

Figure D.1: 'Modest but adequate' budgets for four pensioner households, April 1997 prices

	Single woman Owner-occupier No car	**Single woman Tenant No car**	**Married couple Owner-occupiers Car**	**Married couple Tenants Car**
	£ pw	**£ pw**	**£ pw**	**£ pw**
Housing (1)	29.08	50.30	30.60	57.47
Council tax (2)	6.76	6.76	10.29	9.01
Fuel	12.84	8.34	11.38	14.87
Food	21.83	21.83	43.11	43.11
Alcohol	5.70	5.70	13.23	13.23
Tobacco	0.00	0.00	0.00	0.00
Clothing	6.58	6.58	11.76	11.76
Personal care	3.93	3.93	6.76	6.76
Household goods (3)	13.61	11.49	16.05	16.36
Household services (4)	3.95	3.08	5.65	5.65
Motoring (5)	0.00	0.00	37.29	37.29
Fares etc	5.45	5.45	4.99	4.99
Leisure goods (6)	7.01	6.97	8.48	8.48
Leisure services (7)	9.28	7.60	16.18	16.18
Pets	3.93	3.93	4.11	4.11
Total expenditure	*129.95*	*141.96*	*219.88*	*249.27*
plus income tax (8)	7.39	10.39	9.53	18.31
Gross weekly income required	*137.34*	*152.35*	*229.41*	*267.58*
Annual gross income required	*7,150*	*7,900*	*11,950*	*13,900*

Source: Family Budget Unit, April 1997 prices

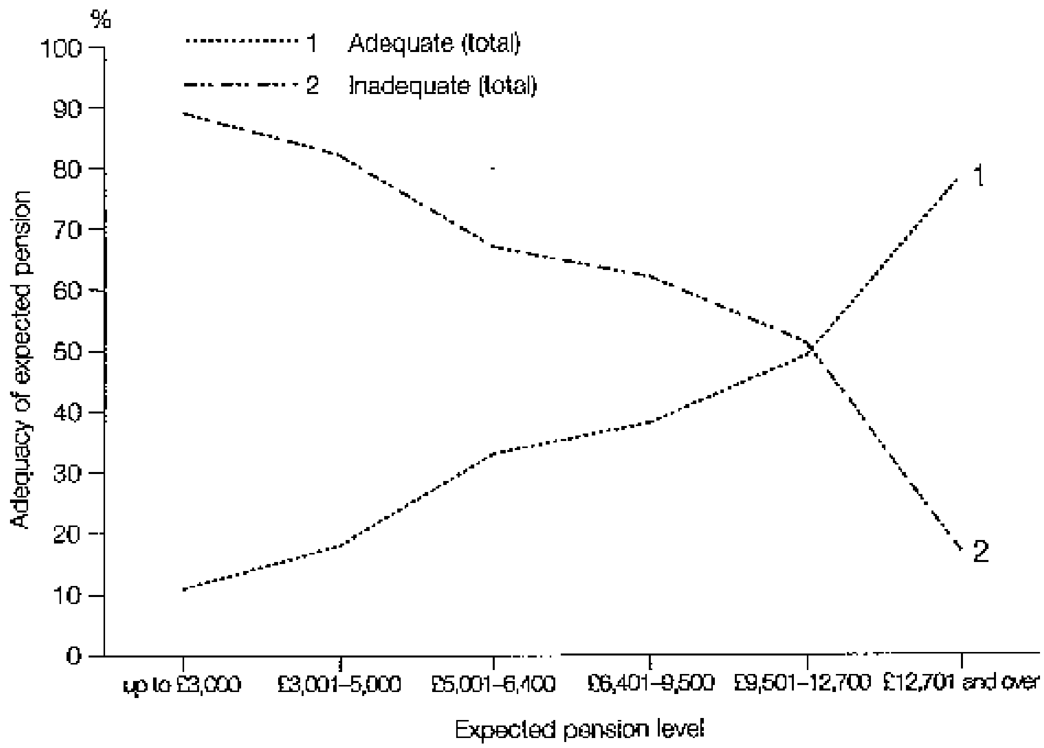
Notes: (1) York Unitary Authority average rents by dwelling type for April 1996 (CIPFA Statistical Information Service, April 1996, Housing Rent, pp 16-17) uprated to April 1997 prices by the increase over the previous year of 4.8 per cent (CIPFA, p2).
(2) Council tax referenced to York Unitary Authority.
(3) Costs of durables are spread over product lifetimes.
(4) Includes telephone and postage.
(5) Second-hand Ford Fiesta 1,100 cc hatchback.
(6) Includes daily newspaper, magazines, books and television.
(7) Includes health-promoting activities and an annual holiday in Blackpool (four-day package for single pensioner, seven days half-board for pensioner couple).

78 per cent of those with an expected pension of £12,700 per year or more thought it would definitely, or probably, be adequate. Half that proportion thought so whose expected pension was in the range £6,400 to £9,500 per year. Only 11 per cent of those with expected pensions below £3,000 per year thought they would be adequate. See Figure D.2 for more detail.

The same study asked married men and married women on middle incomes if they thought a pension of £6,000 per year would be adequate. Two-thirds of those over the age of 60 thought it would be adequate, compared with less than a third of those under 45 years of age. At all ages, more women thought the pension would be adequate than men. See Figure D.3.

Figure D.2: Views on adequacy of expected pension by expected pension level

	Adequacy of expected pension							
	Adequate			***Inadequate***			***All***	
Expected pension level	***Def.***	***Prob.***	***Total***	***Prob.***	***Def.***	***Total***	***%***	***Sample size***
			Percentages					
up to £3,000	2	9	11	17	72	89	100	600
£3,001–5,000	7	11	18	23	59	82	100	155
£5,001–6,400	11	22	33	23	44	67	100	147
£6,401–9,500	12	26	38	25	37	62	100	163
£9,501–12,700	17	32	49	24	27	51	100	117
£12,701 and over	38	40	78	7	16	23	100	86

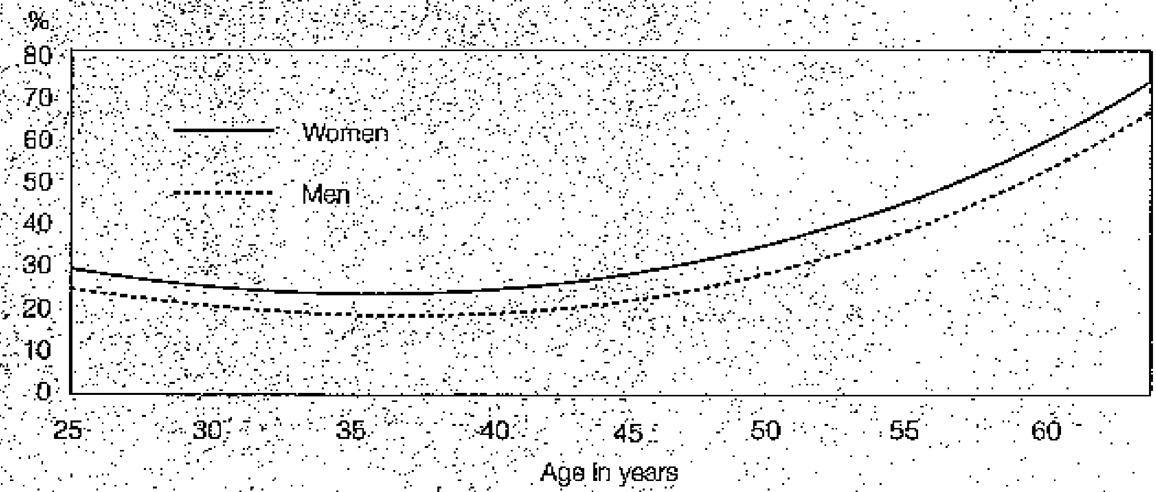


Source: OPCS Omnibus Survey, February 1995, reported in Hancock *et al* (1995)

Notes: (1) Def. = definitely.
Prob. = probably.
(2) Totals may not sum due to rounding.

A third approach is to estimate the number of people with incomes below – or within a certain range of – the rates of benefit paid under Income Support or its predecessor schemes. These rates represent the minimum level of income (after housing costs) on which Parliament expects people to be able to live. But this approach produces the perverse result that, if benefit rates are improved to help those on low incomes, more people

Figure D.3: Effect of age and gender on likelihood of thinking a pension of £6,000 a year will be adequate, married men and women on middle incomes



Source: OPCS Omnibus Survey, February 1995, reported in Hancock *et al* (1995)

appear to be poor even though many of them have higher incomes as a result. Official figures are no longer produced on this basis. It is also notable that the minimum income level for pensioners in the Income Support scheme and its predecessors has generally been above the value of the basic state pension.

Because of the difficulty in reaching agreement about what constitutes adequacy it is now not unusual for studies of low income to look at the position of a range of lower income groups, without attempting to define in precise terms what constitutes poverty or inadequacy.

Relative standards

In Chapter Three we showed the extent to which pensioners are concentrated towards the lower end of the distribution of income for the population as a whole. As individual pensioners grow older, the living standards of people in work increase, but each pensioner's own income will only increase if she or he goes out to work, or if her or his savings and investments yield high returns, or if benefit rates increase faster than prices.

A specific relative standard might be set as a fraction of average income. Thus, for example, the European Commission has adopted a working definition that people face social exclusion if their income is below half the national average. On the basis of the DSS HBAI statistics in 1993/4 this corresponded to £123 a week for a married couple or £68 a week for a single person. About a quarter of married pensioners and a third of single pensioners were in that position.

Replacement ratios

Another relative approach is to compare a person's income just after retiring to her or his pre-retirement income. These are known as replacement ratios. Recent research by Disney *et al* (1997) into the 1988 and 1994 Retirement Surveys suggests that, for people retiring towards the end of the 1980s, there was a wide range in these ratios. The median ratio was between 70 and 80 per cent, depending on the exact definitions used. That is equal to a drop in income after retirement of between 20 and 30 per cent. But as many as a fifth of people saw their incomes fall by over 50 per cent on retirement, whilst for one in six people their income rose to be more than 50 per cent above its pre-retirement level.

This last statistic requires further explanation. Essentially, the people whose incomes rose after retirement were those who had low incomes before. The authors identify three main groups in this position:

- people in relatively unprofitable self-employment or part-time employment before retirement for whom pensions represented an improvement in their regular income;
- people whose income from investments had risen sharply; and
- people who were widowed between the two surveys and whose personal income as an individual rose as a result of, say, starting to receive a survivor's pension or becoming eligible for means-tested benefits.

Perhaps, more importantly, the research challenges the notion of retirement as a single step everyone takes at a particular point in time to stop doing paid work. For many people retirement is a more gradual transition. But for the vast majority of people, however, the process of retirement is associated with a fall in their disposable income.

Financial expectations in retirement

Disney *et al* (1997) found that the majority of those who retired between the two Retirement Surveys correctly estimated or underestimated the level of their financial wealth in retirement . However, those who retired before they had expected to were more likely to have less wealth than they had anticipated, which may suggest that these individuals were unable to fulfil their retirement savings plans.

Annex E – Further detail on state provision

In this annex we give further information about the way state pensions and means-tested benefits are calculated.

State pensions

Basic state pension

Basic state pension is a flat-rate contributory benefit paid to men aged 65 and women aged 60 and over who have adequate National Insurance records. A married woman can earn a retirement pension in her own right, or she can be entitled to a pension on the basis of her husband's contribution record at 60 per cent of his rate. Widows, certain widowers and divorced women who have reached pensionable age can use their spouse's contribution record to help them obtain a full basic pension.

To receive a full basic pension, men must have 44 qualifying years of National Insurance contributions out of a working life of 49 years (age 16 to 64), women 39 years out of 44 (age 16 to 59).

Contributions can be credited for spells of unemployment or sickness.

Home responsibilities protection (HRP) is available for people who do not work or whose earnings are below the (annual) lower earnings limit because they are caring for children or for a sick or disabled person. HRP reduces the number of qualifying years needed for a full basic pension.

Currently over 87 per cent of men qualify for a full basic pension, but only about 50 per cent of women do. More women will get a full basic pension in the future, as the effects build up of both the abolition of the provision whereby married women could opt out of the National Insurance scheme and the introduction of HRP.

Earnings-related pension

SERPS, which began in 1978, provides an earnings-related top-up to the basic state pension. The rules are complex, and major changes have been made that reduce the rights of people reaching state pension age after the turn of the century.

SERPS for people reaching state pension age before April 1999 is calculated as follows:

- for each year from 1978/9 onwards, an 'earnings factor' is calculated for each individual. This is derived from the earnings on which she has paid National Insurance contributions. For most people, their earnings factor calculated in this way is the same as their earnings as an employee;
- the earnings factor is then revalued for each year except the one before pension age in line with the increase in average earnings. The annual National Insurance lower earnings limit (LEL) for the last complete tax year is then taken away from each year's revalued earnings to give a 'surplus' for each year; and
- these surpluses are added up and divided by 80 to give an annual amount.

For people reaching pension age in 1998/9 this calculation gives a pension equal to 25 per cent of their earnings between the lower and upper contribution limits. But for people reaching pension age after April 1999, the 1986 Social Security Act significantly reduces the amount of the SERPS pension they will receive compared to people retiring now. For people reaching pension age in 2010, their SERPS pension will be, at most, 20 per cent of their relevant earnings. The pension will also be calculated over a lifetime's earnings (or since 1978, if shorter) rather than on the best 20 years' earnings which was the original promise made in the 1970s.

Widows and certain widowers currently inherit their spouse's full SERPS entitlement accrued up to the date of death, subject to their total SERPS pension being no more than the maximum pension that can be paid to someone at the upper earnings limit (UEL). But for the survivors of people who die after April 2000 this is reduced to 50 per cent of their spouse's SERPS entitlement.

Annualization

The 1995 Pensions Act also made a change to the way in which the surpluses are calculated that determine the amount of an individual's SERPS pension. This will apply to people reaching state pension age from April 2000. It was termed 'annualization', but is a further cut to most people's state pensions, which hits the lowest paid proportionately hardest.

The present calculation revalues an individual's total earnings (up to the UEL) for each year in line with the increase in average earnings and then deducts the annual LEL for the last complete tax year from each year's revalued earnings to give a surplus for each year. Because the LEL grows in line with prices rather than with average earnings, a larger proportion of each person's earnings are above the LEL than would have been the case if

the LEL had been linked to average earnings, which was the original intention in the 1970s.

So called annualization will change the calculation so that the annual LEL is deducted for each year before the revaluation described above takes place. The effect will be that a larger deduction is made from each person's earnings before the amount of his SERPS pension is calculated.

Family Credit/Disability Working Allowance

Payments of Family Credit and Disability Working Allowance made from April 1995 count as earnings towards SERPS entitlement for people who reach pension age from April 1999.

Contracting out

Individuals can contract out of SERPS by joining a contracted-out occupational pension scheme if their employer provides one, or by taking out an appropriate personal pension (APP). The contracting-out arrangements have applied to defined benefit occupational schemes since 1978, to defined contribution occupational schemes since 1988 and – because of a backdating provision – to APPs since 1987.

Equalisation of state pension age

The 1995 Pensions Act provided for state pension age to be equalised at 65 years of age. The increase in women's pension age will be phased in between 2010 and 2020. The lead-in time means that no woman born on, or before, 5 April 1950 will be affected, and those born between 6 April 1950 and 5 March 1955 will not be fully affected.

Non-contributory retirement pension

Non-contributory retirement pensions were initially payable to men and women who had reached pension age before the National Insurance scheme began on 4 July 1948 and who satisfied certain residence conditions. The wives, widows and former wives of men who qualified could also receive this pension, provided the conditions were met and provided they had no other state pension entitlement. Very few people now receive pensions on these grounds.

Nowadays non-contributory retirement pensions are paid to people who:

- are aged 80 or over; and
- are ordinarily resident in the UK on the day they reach 80 years of age or, if later, the date of claim; and

- have been resident in the UK for ten years in any continuous period of 20 years which includes the day before the age of 80 is attained or any later day.

It is paid at 60 per cent of the full basic state pension currently £38.70 per week, to about 21,800 people.

Uprating

All state pensions in payment – and the earnings limits for National Insurance contributions to which they are linked by statute – are uprated annually by the increase in retail prices. From April 1998 the full rate of basic pension for someone under the age of 80 and without dependants is £64.70 per week. The lower earnings limit for National Insurance contributions is £64 per week, the upper limit £485 per week.

Means-tested benefits

Income Support

Income Support provides cash help for people who are not required to be available for work, whose income is below a certain level and who work less than 16 hours a week (24 hours for partners). Only one person of a couple living together may claim. Income Support is non-contributory and tax free.

The main components of Income Support are personal allowances paid according to age and family status and flat rate premiums for groups recognised as having special needs, such as disabled people, elderly people and families. Together these are known as each person's 'applicable amount'.

For most people, to qualify for Income Support their savings must be below £8,000. A 'tariff income' is assumed at £1 for every £250 of savings between £3,000 and £8,000. Savings below £3,000 and the income from them are ignored. Higher savings limits apply to people in residential care or nursing homes.

The amount of a person's entitlement is calculated by deducting her or his resources (tariff income plus other income and earnings) from the applicable amount. Certain forms of income are partially disregarded. For instance, income from a charitable trust is disregarded up to a maximum of £20 per week.

Assistance with housing costs

For owner-occupiers, Income Support will cover mortgage interest. For tenants, the cost of rent is paid by Housing Benefit. Income Support also acts as a passport to Council Tax Benefit, which will meet Council Tax liability.

Assistance for disability

Any Attendance Allowance or Disability Living Allowance is ignored in the Income Support assessment. Disability premiums can also be paid in addition to pensioner premiums and to Attendance Allowance or Disability Living Allowance.

Uprating of benefit

Unlike state pensions there is no statutory requirement to raise Income Support rates in line with prices. The only requirement is for Ministers to review the rates annually. However, in practice, the benefit has been uprated each year since its introduction in 1988 using the 'Rossi' index, which is the index of retail prices less housing costs. Some rates – including those for pensioners – have been increased faster than the rise in prices.

Housing Benefit and Council Tax Benefit

Housing Benefit and Council Tax Benefit give means-tested help for people on low incomes – both in and out of work – to pay their rent and/or Council Tax.

The personal allowances and premiums used in the calculation of Housing Benefit and Council Tax Benefit are the same as those for Income Support, as are the disregards for certain forms of income including the full disregard of Attendance Allowance and Disability Living Allowance.

The main differences from Income Support are:

- the savings limit above which no benefit is payable is £16,000 rather than £8,000; and
- the way maximum benefit is calculated and the use of 'tapers', both described below.

Both Housing Benefit and Council Tax Benefit have maximum amounts of benefit which may be paid. The maximum rent used to calculate Housing Benefit for private sector tenants is based on rent officers' determinations. If ineligible service charges are included in the rent, then the maximum rent is reduced to take account of those charges. The maximum Housing Benefit is the maximum rent (as reduced where appropriate) less any deductions for non-dependants. Currently, maximum Council Tax Benefit is the full amount of Council Tax due, less any deductions for non-dependants.

People on Income Support receive the maximum amount of Housing Benefit and/or Council Tax Benefit. For people not on Income Support a comparison is made between their 'applicable amount' (the sum of the personal allowances and premiums to which they are entitled) and their income (less any disregards). If their income does not exceed the applicable amount, then they are entitled to maximum Housing Benefit/Council Tax Benefit. Otherwise entitlement is calculated by working out the difference between income and the applicable amount (the 'excess income') and:

- for Housing Benefit, subtracting 65 per cent of the excess income from the maximum amount of Housing Benefit; and
- for Council Tax Benefit, subtracting 20 per cent of excess income from the maximum amount of Council Tax Benefit.

The 65 per cent and 20 per cent reductions are known as tapers.

Annex F – Notes by the Government Actuary's Department

In this annex we reproduce notes prepared for us by the Government Actuary's Department. They cover:

- demographic prospects;
- developments in state pension entitlements;
- prospects for the National Insurance scheme; and
- trends in occupational and personal provision.

These notes were prepared as background material for an early meeting between the Pension Provision Group and the Government Actuary. They were, therefore, aimed at highlighting issues and stimulating discussion.

Demographic prospects

For the purpose of this note, it has been assumed that the focus is on age-retirement provision. Although pension provision is not exclusive to age-retirement, in general the main demographic impact arises from trends in the number of people who actually (or potentially) qualify for income from 'age pensions'.

The demographic prospects are vital for any fundamental review of the national arrangements for pensions. The overall costs of the transfers to the older people under any pension system, however the financing is arranged, depend on:

(a) the number of people who receive income transfers, and that number relative to the number of people creating the resources from which the money is made available to provide the pensions; and

(b) the average amounts of the transfers relative to Gross National Product (GNP) per head. In view of the method of financing almost all state schemes largely by contributions levied on workers, attention often focuses on average earnings per earner, rather than GNP.

Inevitably, demographic considerations focus on the ageing of the population and the commonly expressed concerns over the 'demographic time bomb' caused by an ageing population. But:

- There has already been an enormous increase in the numbers of older people over the past 50 years. In spite of the general increase in the formal pensions transfers over that period, there has not been the economic collapse or social revolution which might have been expected from the scaremongering attached to 'demographic time bombs.
- Any financial strain there might have been, has been met through increasing GNP per head (or average real earnings) so that the increased transfers have been more easily accepted by the workers/contributors/financers.

Nonetheless, from the perspective of pension provision in the future, it is important to take the expected demographic outlook into account. It may reasonably be argued that the level of pension provision in the UK is likely to be too low relative to many pensioners' expectations in the medium and longer term. This is the result of the falling value of state pensions relative to earnings and the reducing proportion of employees covered by good occupational pensions. Thus there will be pressure to increase the general level of pension provision – indeed it can be argued that the function of the Pensions Review is to find acceptable ways of enabling this outcome to arise.

The financial impact of these extra transfers to the elderly will be compounded by the ageing of the population, other things being equal. The precise scale of this demographic change is always subject to uncertainty, increasingly so the further into the future we look. The following discussion is based on provisional estimates from the Government Actuary's Department National Population Projections for Great Britain based on the mid-1996 population projections.

Figure F.1 shows the population of Great Britain by broad age bands for 1997 and selected future dates, together with the projected numbers based on an index of 100 in 1997. In order to focus on the population changes themselves, Figure F.1 shows the projected number of people aged 65 years of age and over, rather than the number over state pension age. (The state pension age for women will rise from 60 to 65 years of age in the period 2010 to 2020.) Although not everyone between the ages of 20 and 64 is in paid work, nor does everyone over 65 years of age receive a pension, the trends in these broad age groups are a reasonable proxy for the expected trends in the number of people who are economically active and the number of pensioners. Whilst trends in early retirement and in economic activity of women and at young ages should not be ignored in any detailed analysis, it is likely that such factors will be of second order relative to the demographic trends.

Figure F.1: The age distribution of Great Britain's population

Year	Age 0–19	Age 20–64	Age 65+	Total
		Millions		
1997	14.5	33.8	9.1	57.3
2000	14.5	34.2	9.1	57.8
2010	14.0	35.4	9.7	59.1
2020	13.5	35.4	11.5	60.4
2030	13.4	33.9	13.8	61.1
2040	13.0	32.7	14.9	60.7
2050	12.7	32.6	14.4	59.6
2060	12.5	31.5	14.2	58.3
		Indexed to 100 in 1997		
1997	100	100	100	100
2000	100	101	100	101
2010	97	105	107	103
2020	93	105	127	105
2030	93	100	152	107
2040	90	97	165	106
2050	88	96	159	104
2060	87	93	157	102

Source: Government Actuary's Department

The projections are based on an assumed total fertility rate of 1.8 in the medium and longer term. As this is significantly below the replacement rate, the numbers of children are projected to fall in future, followed with a lag of about 20 years, by a drop in the numbers at working ages. Eventually, there will be a fall in the number of pensioners, but by that time the structure of the population will have aged considerably. Net inward migration for the UK is assumed to be about 65,000 a year from 1989/9 onwards.

Figure 5.12 in Chapter Five shows the effect of allowing for the lower state pension age for women that will apply in the period up to the equalisation of state pension ages in 2020. As women aged 60 years and over are treated as retired in the early years in Figure 5.12, the increase in the women's state pension age can be seen to offset part of the demographic ageing. However, the relative increase in the numbers of pensioners is still significant.

One common proposal to offset the increasing relative number of pensioners is to increase the pension age after it has been equalized. This is a complex issue, involving much more than simple demographic considerations. In particular, potential labour market effects and the impact on benefits other than retirement pension need to be taken into account. The impact on the worker/pensioner ratio is shown in Figure 5.13 of Chapter Five.

Future state pension entitlement

This note explains further the assumptions used in Figures 5.8 to 5.10 in Chapter Five to provide examples of the likely level of state pensions in the future, assuming a continuation of the current system and policies. In order to avoid obscuring the issues, the illustrations are highly stylised.

Basic state pension is in principle straightforward. Most people resident in the UK for the whole of their working lives are likely to have entitlement either to the full rate or to have entitlement very close to that level.

Although the complexities of basic state pension are ignored for this note, they may be important in specific cases and raise detailed issues. In particular, it will be a further 20 years or so before almost all women retiring will have paid full National Insurance contributions throughout their working lives as a result of the abolition of the 'married women's option' in 1977. Together with the introduction of home responsibilities protection and the generally higher levels of women's economic activity than in earlier years, this will result in most women being entitled to higher levels of basic state pension than is the case for women retiring in the next 20 years.

If the annual uprating of basic state pension continues to be in line with prices, there will inevitably be a gradual decline in value relative to earnings, with the extent of the decline critically dependent on the level of real earnings growth in future. The extent of this is clear in the figures.

SERPS entitlement depends on career earnings since 1978, which obviously differ greatly between individuals. Most (but not all) higher earners generally rely to a lesser extent on state provision for their retirement as they also have some other form of pension provision. For the purpose of illustrating the impact of the future trends in SERPS entitlement, we have therefore used median earnings.

Figures 5.8 and 5.9 show the amounts of state pension as percentages of overall average earnings in the year of retirement respectively for men and for women with age-specific median earnings each year in all but six years of their potential working lives from the age of 16 to pension age.

Figures 5.8 and 5.9 illustrate several aspects of state pensions. Although the general nature of these is now well recognised, the scale of them is worth noting. The features include:

- the continuing decline in basic state pension relative to earnings. Although the change from one year to the next is small, the cumulative effect clearly calls into question the sustainability of policy towards uprating the basic state pension only in line with prices, at least in the medium to longer term. The figures are based on an assumed 1.5 per cent a year real earnings growth. If instead real earnings were to increase by two per cent a year, then, by 2035, basic state pension would have fallen from the current 17 per cent of average earnings to eight per cent, instead of the 9.6 per cent level with the 1.5 per cent earnings assumption;

➢ the importance of SERPS since 1978 in offsetting the decline in basic state pension for employees as they reach state pension age. (SERPS pensions – like the basic state pension – are increased in line with prices once they are in payment.) Inevitably, the extent to which this applied in individual cases depended upon the individual accruing SERPS entitlements, or on the contracted-out equivalent;

➢ the peak of SERPS entitlements around 2000 followed by the decline in future. Initially this is as a result of the reduction in the future SERPS accrual rate and the phasing out of the higher accrual rate for those retiring in the period from 1978 to 1998. In the longer term, provided the earnings limits on which SERPS accrues continue to be revalued in line with prices, SERPS, too, declines as a proportion of average earnings once relevant earnings are cut off by the upper earnings limit. It is worth noting that at present the upper earnings limit is only 14 per cent higher than average male full-time earnings; and

➢ for these examples, by 2035 the level of the total state pension (basic state pension plus SERPS) is about 60 per cent of the current level relative to earnings.

Effect of gaps in contribution record

It is possible to produce numerous variants on these simple examples, although there is a rapid danger of obscuring the main issues, especially in any fundamental review. For this note we have only considered the effect of having complete years without earnings or with earnings below the lower limit. These can occur at any time in an individual's working life, although they are most common at the youngest ages from 16 years of age onwards whilst still in education, and in the years immediately preceding state retirement age. In general, but not always, credited contributions protect basic state pension entitlement.

In addition, many women have significant career breaks in the middle of their working lives. Although the Social Security Contributions and Benefits Act 1992 contains provision which could protect SERPS entitlements if such gaps are due to 'home responsibilities', i.e. looking after children or caring for a disabled person, the relevant regulations have not yet been laid. As these provisions would probably fall within the Citizenship Pension issue, it is useful to illustrate the impact of such gaps without any compensating provisions.

Figures 5.8 and 5.9 show the effects of gaps of three years at the start of working life and three in the years before state pension age. Figure 5.10 shows the effect for married women of an additional gap of 15 years with no earnings from the age of 25 to 39 years. The general effect is obvious, but it is worth noting the scale. As SERPS forms an increasingly important proportion of total state pension entitlement for people with around median earnings, and, as gaps in earnings affect SERPS much more than basic state pension, there is a serious reduction in longer term expectation.

Future prospects for the National Insurance fund

This note gives further information about the estimates on prospects for the finances of the National Insurance fund in the longer term. It is mainly based on the detailed estimates made for the Pensions Bill (December 1994) and the corresponding quinquennial review, with adjustments to update the estimates. We are currently carrying out the analysis which will form the basis for the next quinquennial review of the National Insurance fund, to be completed around the end of the year. Although that will inevitably result in numerous detailed changes to the assumptions, the general conclusions are unlikely to be materially affected.

The National Insurance fund operates on the pay-as-you-go principle, with contributions set to be broadly equal to benefit expenditure each year. Account can be taken of the expected financial prospects for the next few years in order to avoid trivial adjustments to the contribution rates. The fund is small relative to both income and outgoings – currently it is about 16 per cent of these amounts. It merely provides a cushion against the inevitable uncertainties involved in setting the contribution rates in advance of the relevant year as well as a degree of liquidity.

The financial prospects for the National Insurance fund depend critically on:

- demographic changes;
- the level of flat rate pensions relative to earnings, as the latter are the basis on which contributions are levied; and
- changes to average benefit levels. These are projected to arise mainly from higher female entitlement to basic pension and to the effect of the phasing in of SERPS and changes to the SERPS accrual rates. Changes in the level of contracting out also impact on SERPS expenditure.

In addition, labour market changes can produce both short term fluctuations in the financial position (e.g. sharp changes to unemployment and employment) or longer term changes (e.g. trend changes in economic activity or earnings distributions). Finally, legislative changes in reaction to the perceived financial position, or for other reasons, can produce discontinuities to trends.

As the cost of the basic state pension dominates benefit expenditure, the general nature of the effect of demographic changes follows closely on the population changes themselves, which are covered in the earlier note 'Demographic Prospects'. It is therefore not considered further here.

The level of basic pension relative to earnings levels follows the general pattern illustrated by the note 'Future State Pension Entitlement'. There is, of course, considerable uncertainty over the assumption for the long term average rate of real earnings growth. Our projections, and the following comments, are based on an average real earnings increase of 1.5 per cent a year. This is perhaps cautious by historical standards but is not an unreasonable assumption for the long-term future. A higher assumption for real earnings growth would reduce basic state pension faster relative to earnings and, other things being equal, reduce the contribution rates needed in future to balance income and expenditure.

Changes to the underlying basic pension entitlement lead to increases in expenditure at a slightly faster rate than that implied by the demographic changes. A small reduction in the level of male entitlement will be more than offset by increasing female entitlement based on their own contribution record as a result of higher female economic activity, the abolition of the married women's option and the introduction of home responsibilities protection. However, as married women are the group most affected by these changes and they are already entitled to pensions of about 60 per cent of the full rate (and 100 per cent when widowed, as many become) based on their husband's contributions, the financial effect is less than might be expected.

SERPS expenditure is still relatively immature. However, the changes legislated in 1986 and 1995 mean that SERPS expenditure will, at its maximum relative to earnings, be only twice its level in 2000. At that point, SERPS expenditure will be about 30 per cent of that on basic pension. In the long term, the expenditure on SERPS pensions from the National Insurance fund will depend critically on the future level of contracting out, although the 'loss' of contribution income in respect of contracted-out people must also be taken into account.

Figure 5.14 in Chapter Five shows future benefit expenditure in constant earnings terms. Our projections have not been adjusted to take account of the provisional 1996-based population projection. However, the general conclusions likely to be derived from the table remain valid.

As shown in the note 'Demographic Prospects in Great Britain' the numbers in future of people at working ages change much less than those at pension ages. Thus, expressing the figures in real earnings gives a useful indication of the future financial position. The simple conclusion is that the fall in the value of basic pension relative to earnings roughly offsets the demographic and scheme maturity changes up to 2030. Thereafter, as the demographic position is projected to be more stable, the falling value of basic pension predominates and the costs fall relative to earnings. It is important to emphasize that the projections imply that basic pension will be about half its current level (relative to earnings) by about 2040.

Figure 5.15 in Chapter Five shows the contribution rates needed to balance income and outgo in future with price linked and earnings linked upratings of basic state pension and the earnings limits for contributions and SERPS. These figures are based on our projections for the last quinquennial review and so do not allow for the provisional population figures and other minor adjustments to bring them fully up to date.

Trends in occupational and personal pension provision

Although we appear to be at a critical point in the development of pension provision in the UK, it is instructive to start by looking at occupational scheme membership since 1953, taken from successive surveys by the Government Actuary's Department. (Please refer to Figures 6.3 and 6.4 in Chapter Six.)

Pension coverage for male employees reached a plateau in the early 1960s. Since 1983 the coverage has been falling steadily.

Female employees' membership has continued to rise. In recent years, this is likely to be the net effect of an increase due to greater membership of part-time workers offset by the general reduction in occupational pension provision.

Anecdotal evidence suggests that there has been a switch from defined benefit to defined contribution provision. Not only are most small arrangements now defined contribution, but a number of major schemes have switched to defined contribution provision for new members.

Changes in occupational scheme rules since 1991

The 1995 Government Actuary's Department survey asked schemes about changes to scheme rules since the previous 1991 survey, or the date of inception of the scheme, if later. This data has not yet been rated up to cover all schemes or membership for the UK. However, about three per cent of schemes in the sample had either introduced a defined contribution system for some or all its members, or had changed from a defined benefit to a defined contribution scheme by 1995. Very few defined contribution schemes had introduced final salary benefits for some or all members or had converted to a defined benefit scheme. Around six to seven per cent of schemes in the National Association of Pension Funds survey in 1996 had switched from final salary to defined contribution for some or all members, or had added a defined contribution scheme in the previous 12 months. This would suggest that there has been an increase in the numbers of schemes switching from defined benefit to defined contribution provision, although it is difficult to say whether this will continue once the impetus for reviewing scheme provision, because of the regulations introduced by the 1995 Pensions Act, has receded.

Changes in the provision of schemes arise for a variety of reasons: because of changes in legislation, attitudes of employers and employees to pensions, changes in working patterns, and so on. The most common change recorded by schemes since 1991 in the 1995 Survey was an increase in the number of part-timers eligible for membership. This is likely to have arisen because of the increase in the number of people working part-time and because of European Court of Justice judgements stating that excluding part-timers could be discriminatory. The next most common change was in respect of the introduction of better terms for early retirement. Reasons for this may include employers wishing to remove the older workforce by making retirement more attractive and also taking into account the wishes of more employees who want to retire early.

Over ten per cent of the sample registered an improvement in the level of death-in-service lump sum payments. This continues a trend noted in previous surveys. A similar number of defined benefit schemes had given an increase in the level of guaranteed pensions increases. This is likely to have arisen mainly because of the effects of the Pensions Act requiring schemes to provide pensions increases equal to the increase in the RPI (up to a limit of five per cent). The prevalence of scheme surpluses in recent years may also have led to various improvements in benefits, including higher guaranteed pensions increases.

Another feature of the trend in occupational scheme provision is the increasing complexity of arrangements. This includes arrangements such as those which provide money purchase benefits for younger employees with the option to transfer to a final salary arrangement at a later date; final salary schemes with low rates of accrual with the benefits payable topped up through defined contribution arrangements; schemes which provide final salary benefits with defined contribution underpins and vice versa; and cafeteria schemes which offer varying levels of benefits which normally require differing levels of employee contribution according to which benefit level the member chooses.

Trends in personal pension provision

There has been an increase in the number of arrangements of personal pensions for employees over the last five years, especially with regard to arrangements in which contributions are received from the DSS, employees and employers and in free standing voluntary contribution schemes. Other types of arrangements include those where contributions are received from the DSS and schemes not approved for National Insurance contribution rebates.

Annex G – Sensitivity analysis

In this annex we look at the impact of alternative economic assumptions on projections of:

- the future cost of state pensions; and
- future pensioner incomes.

We also show projections for changes in pensioner incomes at five-yearly intervals from 2000 to 2025.

Future cost of state pensions

In Chapter Five we showed estimates for future expenditure on state pensions and other National Insurance benefits and the contribution rates that will be needed to meet their cost. We also noted the effects of expressing those costs as a proportion of all earnings, rather than just those on which National Insurance contributions are paid.

Those estimates were all based on our central economic assumptions. Here we show the effect of varying the main long term economic assumption: the extent to which average earnings grow faster than the rise in prices. We also give an estimate of the future cost of state retirement pensions alone, i.e. excluding the cost of National Insurance benefits paid to people under pension age.

We show in Figure G.1 expenditure on all National Insurance pensions and benefits as a proportion of the earnings of employees and self-employed people, using the following assumptions about the growth of average earnings in excess of prices:

- one per cent a year;
- 1.5 per cent a year; and
- two per cent a year.

These correspond, respectively, to a pessimistic, central and optimistic assumption about the future growth in real earnings.

Figure G.1: Earnings growth and the cost of National Insurance pensions and benefits

	Annual rate by which average earnings grow faster than prices		
Year	**1%**	**1.5%**	**2%**
2000	12	12	12
2010	13	12	11
2020	13	11	10
2030	14	12	10
2040	13	10	9
2050	12	9	7

Source: Government Actuary's Department

Note: The table shows the projected expenditure each year on National Insurance pensions and benefits expressed as a proportion of the total earnings received by employees and self-employed people.

In examining long-term trends, we believe it is sensible to express these costs in relation to total earnings rather than the earnings on which contributions are paid. We have included in Figure G.1, as well as state retirement pensions, the cost of National Insurance benefits that are paid to people under state pension age, such as Incapacity Benefit, the contributory part of Jobseeker's Allowance and widows' benefits.

Figure G.1 shows, not surprisingly, that the more average earnings grow in excess of prices the lower the costs will be expressed in this way. Were earnings increases to exceed price increases by as much as two per cent a year, these costs would fall from about 12 per cent of earnings in 2000 to about seven per cent in 2050. Conversely, if earnings growth were only as little as one per cent a year above prices, these costs would form the same proportion of earnings in 2050 as in 2000 having, in the meantime, risen to about 14 per cent in 2030 and subsequently fallen away again.

If we look only at the cost of spending on state retirement pensions, this will form about nine per cent of earnings in 2000. In 2050 it would comprise about six per cent of earnings if average earnings grow two per cent a year faster than prices, about 7.5 per cent on our central assumption and about 9.5 per cent of earnings if average earnings grow only one per cent a year more than prices.

In comparison to assumptions about earnings, those about other economic factors such as unemployment have a relatively small effect within the ranges that seem likely to apply.

Future pensioner incomes

In Chapter Nine we showed the results of special projections made for us using the PENSIM model on the basis that means-tested benefits and savings limits rise either in line with prices or – which we think more likely – in line with earnings. Those projections were based on our central assumptions about the economy. Here we show the effect of varying those assumptions.

Again, we do this by using both a 'pessimistic' and an 'optimistic' case as well as our central projection. Details of the assumptions are shown in Figure G.2.

Figure G.2: Alternative economic assumptions

Assumptions	***Pessimistic case***	***Central projection***	***Optimistic case***
		Percentages per annum	
Growth of earnings over prices	1	1.5	2
Return on investment over prices	3	4	5
Growth of rents over prices	0	0	2

Notes: (1) Price increases are assumed to average 3.8 per cent a year in all cases.
(2) Unemployment is assumed in all cases to be in the range of one to 1.25 million for most of the period.

General trends

We look first at the projected growth in the average incomes of single and married pensioners on each set of main economic assumptions. As Figure G.3 shows, the different economic assumptions have a major impact on the value of average earnings received by people in work. On the central assumption that earnings grow faster than prices by 1.5 per cent a year, average earnings in 2025 will be about half as high again as they are now.

Figure G.3: Growth in average pensioner incomes and average earnings, 1997–2025

Economic assumptions	***Single pensioners***		***Married pensioners***		***Average earnings***
	prices %	***earnings*** %	***prices*** %	***earnings*** %	%
Optimistic	66	80	57	60	74
Central	58	66	47	48	52
Pessimistic	53	58	41	41	32

Source: Projections for the Pension Provision Group using the PENSIM model

Notes: (1) Figures show the extent to which pensioner incomes and average earnings grow faster than the rise in prices between 1997 and 2025.
(2) 'Prices' and 'earnings' refer to assumptions about the future rates of means-tested benefits and savings limits. They are assumed to rise either in line with prices or in line with earnings.

On our optimistic assumption that earnings grow two per cent faster than prices, average earnings will be about three-quarters as high again in 2025 as they are now. On the pessimistic assumption, the growth will be only about a third.

Average pensioner incomes are also affected by the differences in economic assumptions, but to lesser extent. In the central case, married pensioners' average incomes rise a little less slowly than average earnings, those of single pensioners slightly more. But on our optimistic assumptions, the average incomes of married pensioners grow substantially more slowly than average earnings. For single pensioners the position depends on whether means-tested benefits and savings limits rise in line with prices or earnings. In the pessimistic case, pensioner incomes grow substantially faster than average earnings.

To a large extent this pattern arises because, for many of the people who will be pensioners in 2025, much of their pension provision has already been determined. This applies particularly to people who have already retired or are about to. As far as average pensioner incomes are concerned, therefore, they are to some extent insulated against the full effect of wider trends in the economy over the next 25 years.

The implication is also that much of the impact on pensioner incomes of differences in economic performance in the next 25 years will not be felt until well after 2025.

The distribution of pensioner incomes

We now look at the growth in pensioner incomes at different points in the pensioner income distribution. Figure G.4 shows our results which divide, respectively, single and married pensioners into fifths ranked according to their income level.

The results in Figure G.4 refer to changes between 1997 and 2025 in each fifth of the distribution. They do not refer to the same individuals in each year. Thus, a pensioner in, say, the lowest fifth of the distribution in 2025 may have seen no growth at all in their own income – or indeed a decline – even though the average income of the statistical category in which they appear in 2025 is projected to have increased by around 57 per cent since 1997 (central projection, earnings uprating of means-tested benefits and savings limits).

Differences in economic assumptions have a substantial impact on the projected incomes in 2025 of the lowest fifth of the distribution, if means-tested benefits and savings limits rise in line with earnings, but much less so if they were to rise only in line with prices. Differences in economic assumptions also have a large impact at higher levels of the pensioner income distribution.

Figure G.4: Growth in pensioner incomes by fifths, 1997–2025

Economic assumptions	Lowest fifth		Middle fifth		Highest fifth		Average earnings
	prices %	earnings %	prices %	earnings %	prices %	earnings %	%
Single pensioners							
Optimistic	24	71	39	56	110	110	74
Central	23	57	35	44	93	93	52
Pessimistic	22	43	32	36	84	85	32
Married pensioners							
Optimistic	31	53	54	55	68	68	74
Central	27	40	47	47	54	54	52
Pessimistic	25	30	42	42	46	46	32

Source: Projections for the Pension Provision Group using the PENSIM model

Notes: (1) Figures show the extent to which the average income in each fifth of the single and married pensioner income distributions, and to which average earnings grow faster than the rise in prices between 1997 and 2025.

(2) 'Prices' and 'earnings' refer to assumptions about the future rates of means-tested benefits and savings limits. They are assumed to rise either in line with prices or in line with earnings. Differences in this assumption do not affect the results of projections for the highest fifth.

Pensioner income inequality in 2025

We looked at pensioner income inequality in Chapter Nine in terms of the ratio of the income of the top fifth of pensioners to the income of the lowest fifth, considering single and married pensioners separately.

Figure G.5: Extent of pensioner inequality

Economic assumptions	Income of top fifth as a ratio of income of lowest fifth: 1997	2025 – Means-tested benefits and savings limits rise in line with: prices	earnings
Single pensioners			
Optimistic		5.6	4.0
Central	3.3	5.2	4.0
Pessimistic		5.0	4.2
Married pensioners			
Optimistic		4.6	3.9
Central	3.5	4.3	3.9
Pessimistic		4.1	3.9

Source: Projections for the Pension Provision Group using the PENSIM model

Note: Figures show the ratio of the average income of the top fifth of the single and married pensioner distributions to the average income of the lowest fifth.

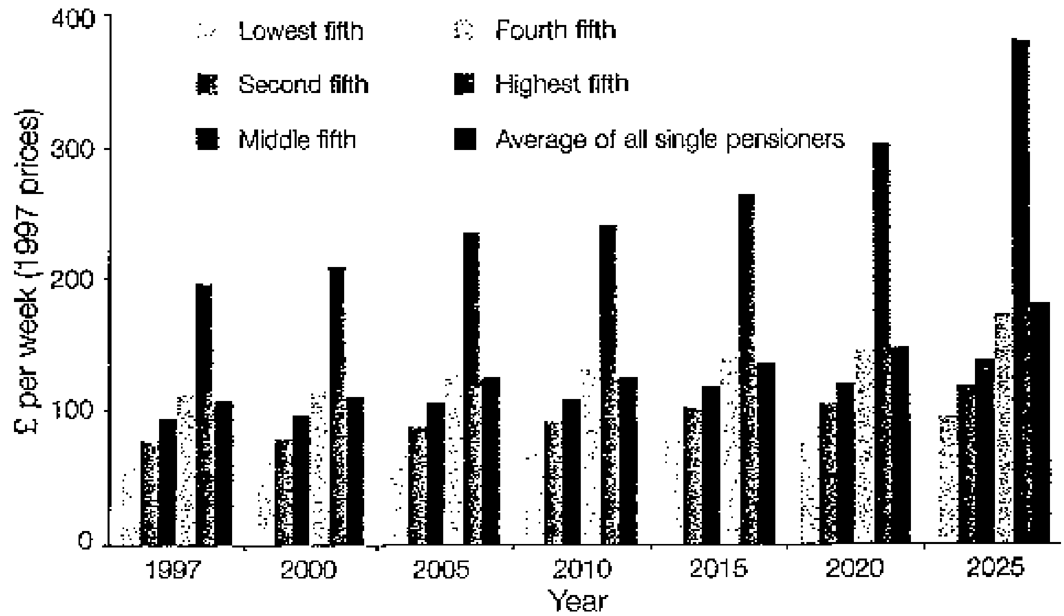
Figure G.5 shows the impact of alternative economic assumptions on the growth in pensioner income inequality that will occur by 2025. The ratio for single pensioners is projected to rise from 3.3 in 1997 to between 4.0 and 5.6 in 2025, depending on assumptions about the economy and the uprating of means-tested benefits and savings limits. For married pensioners, the growth in income inequality in terms of this ratio is from 3.5 to between 3.9 and 4.6 in 2025.

If means-tested benefits and savings limits rise in line with earnings, varying economic assumptions has little impact on the rate of growth inequality in the period to 2025. If those benefits and savings limits were to rise only in line with prices, then the rise in inequality would be greater in the optimistic case, and smaller in the pessimistic case.

Projections for five-yearly intervals

Figures G.6 and G.7 show results at five-yearly intervals between 2000 and 2025 using our central economic assumptions and assuming means-tested benefits and savings limits increase in line with earnings.

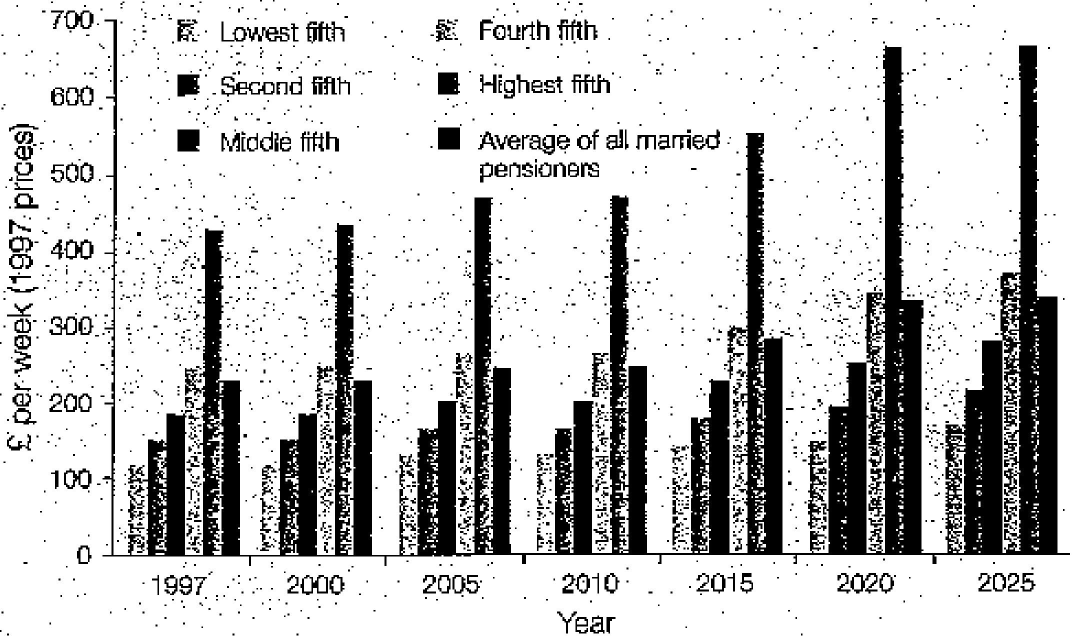
Figure G.6: Projected incomes at five-yearly intervals for single pensioners



Source: Projections for the PPG using the PENSIM model

Note: On central economic assumptions and assuming means-tested benefits rise in line with earnings.

Figure G.7: Projected incomes at five-yearly intervals for married pensioners



Source: Projections for the PPG using the PENSIM model

Note: On central economic assumptions and assuming means-tested benefits rise in line with earnings.

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