PENSIONS POLICY INSTITUTE

PPI

Submission from the
Pensions Policy Institute in response to the
Pensions Commission's First Report
Pensions: Challenges and Choices
("the Report")
January 2005

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Summary

1. The Pensions Policy Institute (PPI) welcomes the success of the Commission's report in raising awareness of the current state of UK pensions.

2. The general conclusions of the Report are in agreement with much other work carried out by the PPI and other organisations.

3. This response focuses on where the PPI can be most helpful to the Commission in producing the Second Report. Rather than discuss the many areas of agreement with the First Report, this submission concentrates on where further consideration is needed to meet the different requirements of the Second Report, and where PPI work can most usefully feed in to the Commission's remit.

4. The first part of the submission highlights significant gaps in the First Report's analysis. These gaps include:
    - **Some assumptions have been overly simplified**. Making assumptions such as individuals are all male, single, working for 44 years until age 65, and saving continuously has probably overestimated the amount of money received from state and private pensions and so *underestimated* the extent of 'undersaving' and the impact of Pension Credit on incentives to save.
    - **Opportunities to do new analysis have not been taken**. For example, more analysis is still required to investigate the affordability of the 'required' savings rate, likely future retirement behaviour, and to estimate the impact of non-pension, non-property saving on 'undersaving'. Not allowing for these factors may have *overestimated* the extent of 'undersaving'.
    - **A number of wider policy issues are not addressed in the Report**. For example, there is little discussion of the future distribution of pensioner incomes, or pensioner poverty. There is no analysis of the impact on individual incomes of longer retirement. The Report does not consider the significant amount of money that government pays to people of working age to support private pension provision, or how uncertainty in private pension provision results in uncertainty in future state spending on Pension Credit.

5. The implications of these gaps are that:
   - The 'savings problem' appears as a stark, accurately quantified issue rather than the reality of a dynamic, unquantifiable situation.
   - The Report, in representing the savings issue, is an incomplete starting point for a resolution of the underlying problems in the state pension system.

6. The second part of this submission focuses on the possible solutions to the pensions problems. For each of the possible ways forward - later retirement, reforming state pensions, enhancing voluntary saving and introducing compulsory private saving - this submission:
   - Makes detailed comments based on PPI analysis, and,
   - Sets out some critical questions to be answered either in the Commission's Second Report or elsewhere.

7. The PPI view – based on a large body of work already completed – is that reform of the state pension system is the necessary first step before tackling issues of the private sector such as voluntary or compulsory pensions.

8. Further, the PPI doubts that a practical system of compulsion into private pension saving can be designed that will achieve the objective of good pensions for all.

9. The PPI is part-way through a major programme of work examining options for state pension reform. A summary of the findings so far, and copies of PPI reports on state pension reform and related topics have been included as part of this submission to enable the Commission to build upon existing and planned work in this area.

Introduction

The role of the Pensions Policy Institute

1. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI does not make policy recommendations, but exists to contribute facts and analysis to help all commentators and policy decision-makers.

2. This submission is written by Alison O'Connell, Director, and Chris Curry, Research Director. Alison trained as an actuary and has over 15 years experience in the financial services industry and pensions policy. Chris has worked in pensions for the government and the private sector for 10 years.

General agreement with the Report and structure of this submission

3. The Commission's First Report concluded that if future pensioners are to have as high living standards in retirement as today's pensioners, then:
   - State pensions must change (which may have a cost, for example, in higher taxes or National Insurance contributions), and/or
   - There must be more private saving by people of working age, on an enhanced voluntary or new compulsory basis, and/or
   - Retirement must start later.

4. The Pensions Policy Institute welcomes the Commission's Report. It has succeeded in raising awareness of the current state of UK pensions.

5. The general conclusions of the Report are in agreement with much other work done by the PPI and other organisations over the last few years, for example: the House of Lords Economic Affairs Committee, the House of Commons Work and Pensions Select Committee, the Institute of Public Policy Research, the National Association of Pension Funds, the Association of British Insurers, Age Concern, the Fawcett Society and Help the Aged[1].

[1] House of Lords Economic Affairs Committee (2004) *Aspects of the Economics of an Ageing Population,* House of Commons Work and Pensions Select Committee (2003) *The Future of UK Pensions*, IPPR (2000) *A New Contract for Retirement* National Association of Pension Funds (2002) *Pensions - Plain and Simple*, Association of British Insurers (2003) *Stakeholder Pensions: Time for Change*, Age Concern and The Fawcett Society (2003) *One in Four*, Help the Aged (2002) *A Future we can trust: Pensions or pin money?*

6. This submission focuses on where the PPI can be most helpful to the Commission in producing the Second Report. Rather than discuss the many areas of agreement with the First Report, this submission concentrates on where further consideration is needed to meet the different requirements of the Second Report, and where PPI work can most usefully feed in to the Commission's remit.

7. The First Report is a good exposition of the challenges facing the UK pension system, from the perspective of voluntary savings. However, partly because of the remit of the Commission, and partly because of methods of analysis chosen, there are gaps in the analysis in the First Report. The first part of this submission focuses on explaining these gaps, because it is important to recognise that:
   - The simplified assumptions made will influence – probably significantly - the context and interpretation of the First Report's conclusions.
   - Some work in the First Report could have been improved upon by taking the opportunity to do new analysis, again perhaps influencing the interpretation of conclusions significantly.
   - One of the potential areas for reform to be examined in the Second Report is the state pension system. Consideration of state pension reform will require a different set of analyses, and assumptions, to those in the First Report.

8. The PPI has already completed a large body of work to come to the view that reform of the state pension system is the necessary first step before policy decisions on private pension saving can be made. The second part of this submission expands on this view.

9. The PPI is part-way through a programme of work examining options for state pension reform. A summary of the findings so far (see the Appendix), and copies of PPI reports on state pension reform and related topics (see List of Enclosures) are included as part of this submission to enable the Commission to build upon existing and planned work in this area.

Part 1: Gaps in the Report

10. The Commission's Report has added to the database for such analysis by presenting detailed data in Chapters 1 to 3 and 5. In particular, the correction to official statistics on pension contributions is very valuable, as is the macro modelling of the potential size of the contribution to pensioners' incomes made by private pension saving.

11. There are, however, a number of significant gaps in the Report's analysis. These include:
    - Overly simplified assumptions, and
    - Opportunities not taken to do new analysis, and
    - Wider policy issues not addressed.

    These gaps have implications for the assessment of 'undersaving' in this First Report and for the analysis of possible policy solutions that will be the focus of the Second Report.

Overly simplified assumptions

12. The Report contains a wide range of model based analysis. As with all models, the analysis is based on simplified assumptions. Although the Report contains some sensitivity analysis – for example looking at the impact of assuming different rates of return – the impact on the analysis of many of the basic assumptions is not illustrated. In some cases, the assumptions made contradict other findings in the report.

13. The simplified basic assumptions, which could have been improved upon, include:
    - Everyone is male, makes 44 years of continuous contributions to the state pension scheme, and takes state pension at age 65.
    - Pension saving, once started, continues without any breaks.
    - Working and saving continues until age 65.
    - Everyone of pensionable age is in a household of one individual.
    - In some (but not all) analysis, Pension Credit operates in future at the same level as today.

    The choice of these simplified assumptions is likely to be significant in the interpretation of the results, probably underestimating the extent of 'undersaving'.

14. All of the modelling of 'undersaving'[2] assumes that individuals are male, and have **44 years of continuous contributions** to the state pension scheme, while being continuously employed at gradually increasing average earnings. But most women (the majority of pensioners) do not fit this profile[3], and many men will not.

15. This assumption means every individual modelled has a full Basic State Pension, and high levels of State Second Pension. This is unrealistic. 5 million people (out of a total of 35 million people of working age) do not accrue any entitlement to the Basic State Pension each year[4], and a further 7 million do not accrue any State Second Pension[5].

16. No analysis is undertaken assuming that fewer state pension contributions are made, or different work patterns followed. A lower state pension entitlement would increase the amount needed to be saved to achieve a target replacement rate, and so increase the number of people 'undersaving'.

17. Similarly, modelling in the Report assumes that **private pension[6] saving, once started, continues without any breaks**. This is another strong assumption, not borne out by evidence. Only 44% of men and 26% of women in work in 2001/2 aged between 25 and 59 had made private pension contributions in each of the last 10 years[7].

18. Making irregular pension contributions, or stopping contributions altogether, would reduce the amount received from pension saving and increase the amount that needs to be saved during periods when savings are being made to achieve a target replacement income. Assuming plausible different patterns of saving across the lifecourse could lead to significantly higher numbers of people 'undersaving'.

19. The illustrative individuals used in the Report all **work and save until the age of 65.** However, the Report states that the average age of retirement is 63.8 for men and 61.6 for women, and that only 42% of men and 53% of women are still in work at ages 64 and 59 respectively[8].

[2] Chapter 4 of the Report
[3] As the Report acknowledges in Chapter 8
[4] PPI Briefing Note Number 10 *The balance between state and private pension provision*, enclosed
[5] Or contracted-out equivalent
[6] Private pensions refers to personal or occupational pension savings
[7] Curry (2003) *The Under-pensioned* PPI, enclosed
[8] Page 34

20. This implies that most people will stop making contributions to private pensions earlier than assumed, and will earn a lower state pension entitlement than assumed[9]. Using more realistic assumptions concerning retirement ages could lead to significantly higher numbers of people 'undersaving'.

21. The Report also concentrates on modelling **individual entitlements**, as if everyone of pensionable age lives in a single household. Although Chapter 8 makes the case for each individual to be considered in their own right, almost 60% of pensioners live as couples[10] and means-tested benefits are paid on a joint household basis to couples. This will become even more important as the Pension Credit is projected to play an increasingly large role in pensioners' incomes in future. In particular, the disincentive effects of the Pension Credit identified in the report could impact less on someone who has a low individual pension income, but access to a partner's income.

22. The modelling of incentives to save in Chapter 6 is based on similar simplified assumptions as the modelling of 'undersaving' in Chapter 4. As continuous private pension saving and working and saving to age 65 are likely to overestimate the state and private pension income that individuals receive, the same assumptions will tend to overestimate the effective real rate of return on saving estimated in Chapter 6.

23. In addition, the real rate of return is calculated using the **state pension system in place today, including the current levels of Pension Credit**. But people currently of working age will be affected by the parameters of the state pension system <u>in future</u>, which can be modelled.

24. For someone aged 35 today, Pension Credit will be much more significant relative to the Basic State Pension and State Second Pension[11], and a much larger proportion of the income generated by private pension saving is likely to be affected by the Pension Credit. Therefore, using today's parameters will significantly underestimate the impact of the Pension Credit on the effective real rate of return, and the incentive to save.

[9] Though people may receive credits for the Basic State Pension while they are not in work, they will not accrue any rights to the State Second Pension
[10] PPI calculations based on the 2002/3 Pensioners' Incomes Series
[11] Figure 3.20 on page 77 in the Report

Opportunities not taken to do new analysis

25. The Report improves on some pre-existing work, and contains a number of new areas of analysis. But there are several important areas where new analysis is still required, which would have been welcome from the Commission in this Report[12]. These areas include:
    - Affordability of the 'required' savings rate
    - Likely future retirement behaviour
    - Non-pension, non-property saving

    Not allowing for these factors may have overestimated the extent of 'undersaving'.

26. The Report's analysis of the number of people 'undersaving' is based on different types of individuals achieving replacement rates relative to final earnings. Implicit in this is a calculation of the required savings rate - how much each type of individual needs to save to receive a combined state and private pension income at this replacement level.

27. What is not covered in the Report is **how affordable the required savings rate is** for different types of individual, how affordability may change at different stages of the lifecourse and with different opportunities for employer pension provision. Is it reasonable for someone aged 35, without access to an employers pension contribution and earning £13,500 a year to contribute 11% of his salary to a private pension? How many people at this income level have debts? What is the average mortgage payment? How many people in this position are married, or have families? What are the implications for future entitlement to Pension Credit, and the implicit rate of return on this saving? Would this individual be better off not saving now but saving more later? What behaviour drives decisions not to save when it is economically rational to do so?

28. These factors would provide very important information that would put the modelling results in context. For example, some individuals will be modelled as 'undersaving', meaning they are not projected to reach a target replacement rate, when they would be unable to save more at younger ages, though quite able to make up the deficit in later life. Without this contextual information, it is difficult to identify relevant policy solutions.

[12] See comments on Pension Commission Workplan, PPI letter to Adair Turner July 2003 for more details, enclosed

29. The Report looks at the impact on aggregate pensioners' incomes of increases in retirement ages, but contains little analysis as to how **retirement behaviour, and by implication employment levels at older ages, are likely to change in future**. The higher participation scenario[13] used assumes that employment rates increase, but does not quantify how likely this is to happen.

30. Retirement behaviour is complex, depending on a mix of individual characteristics, for example:
    - Personal preference and individual/spouse circumstance
    - Savings levels and type of pension arrangement (Defined Contribution or Defined Benefit)
    - Labour market factors, including employer attitudes and policies, the availability of younger workers and legislation against age discrimination.

31. In particular, further research into how the changing age structure of the population may affect demand for older workers, and consideration of how the shift from Defined Benefit to Defined Contribution pension provision might affect retirement behaviour would help quantify how retirement ages could change without any further policy intervention. This would give a more realistic baseline for future projections, and add to the existing knowledge on the subject.

32. Chapter 5 of the report looks at non-pension saving, including non-pension financial wealth and housing assets. Within this analysis, different asset holdings are identified (cash deposits, securities (equities and bonds) and insurance policies), but **the investment vehicles containing these assets are not identified** e.g., ISAs. More analysis of the purchasing patterns of ISAs and other vehicles may help to build up a better picture of how individuals are planning retirement saving, and give some new insights into individual preferences for the factors that government can affect, such as tax incentives and design of savings vehicles.

[13] Page 41

33. ISAs (along with other non-pension savings) and property have been excluded from the analysis of 'undersaving' in Chapter 4. PPI analysis came to the same conclusion as that in Chapter 5 of the Report: that non-pension financial wealth is unevenly distributed, that while housing wealth is more evenly distributed it is correlated with pension wealth, and that both non-pension financial wealth and housing wealth are likely to be used for other purposes[14]). These conclusions should be confirmed as soon as non-pension asset data becomes available, and should be taken into account for any further analysis of 'undersaving'.

34. The Report suggests that 12% of retirement income could come from non-pension savings based on median wealth[15], and in some (but not all) cases housing wealth could provide more. These levels will be much higher for some individuals and much lower for others.

Wider policy issues not addressed

35. Partly as a consequence of the Commission's remit being limited to private pensions and long-term savings, and partly because of gaps in the analysis, some issues that are critical to the wider question of pension (and retirement) policy were not addressed in the Report. These include:
    - The distribution of pensioner incomes
    - Pensioner poverty
    - The impact on individual incomes of longer retirement
    - The totality of state expenditure on pensions
    - The uncertainty in future projections of state expenditure on pensions

36. The Report's analysis of the shortfall in pensioner incomes relative to the amount needed to ensure that pensioners do not become poorer relative to the rest of society concentrates on the <u>total</u> income across all pensioners, measured as a percentage of GDP. This is a useful measure, as it highlights the size of the hole left by the planned reduction in future state pensions and current savings behaviour, and the scale of change that any policy intervention would need to achieve.

[14] As outlined in Curry (2004) *Property or Pensions?* PPI, enclosed
[15] Figure 5.9, page 183

37. However, this aggregate measure does not capture the **distribution of pensioner incomes**, that is, whether poorer pensioners will get richer or poorer relative to richer pensioners. Therefore, there is insufficient analysis to examine the distributional consequences of current policy, or alternatives. This limits the usefulness of the Report's analysis to cover the policy issues beyond 'undersaving', including the impact of potential policy responses.

38. By not looking at the distribution of retirement incomes, the Report has not been able to address perhaps the most important aspect of the consequences of current policy and savings behaviour – the impact on **pensioner poverty**. Although the aggregate level analysis suggests that the amount of resources reaching pensioners as a whole will not keep pace with the increasing pensioner population, it cannot say if this will fall more heavily on pensioners with low incomes or relatively high incomes.

39. Pensioner poverty is one of the most important indicators of the effectiveness of pensions policy, and any analysis of policy alternatives will need to consider the potential impact on levels of pensioner poverty.

40. Estimates of the differences in pensioner poverty under alternative scenarios should ideally be covered in the Second Report, using PENSIM 2. If PENSIM 2 is not available for the Second Report, an alternative high level analysis of the potential impact on pensioner poverty is essential.

41. The Report correctly identifies the issues for funding retirement caused by increasing life expectancy. But the Report does not then consider **the implications of increasing life expectancy for the individual, most importantly what happens to income in the 20 or more years after retirement**[16]. One of the major causes of pensioner poverty is the age effect: the longer an individual lives after leaving the labour market, the more his or her income falls further behind the incomes of the rest of the population. Although some of this income reduction can be offset by increasing Pension Credit entitlement (the oldest pensioners are those most likely to be entitled to Pension Credit), Pension Credit needs to be claimed.

[16] Further, the Report assumes only that retirement happens at age 65: the only metric of analysis is income in terms of replacement rate at age 65

42. The dynamics of income after retirement are important to the analysis of 'undersaving'. Target replacement income levels should arguably be higher in the future if income reduces relative to earnings during retirement, to ensure that they do not become unacceptably low at older ages. Ignoring life after age 65 could lead to an underestimate of the number of people 'undersaving'.

43. Income dynamics are also vital in considering alternative policy options. The level of, and ease of access[17] to, pension entitlement at older ages is likely to be important in determining levels of pensioner poverty.

44. In looking at state expenditure on pensions, the Report concentrates on payments made to pensioners. The inclusion of the payment of unfunded public service occupational pensions is justified, and welcome. However, **the Report does not consider the significant amount of money that government pays to people of working age to support private pension provision**. The main mechanisms for this are **contracted-out rebates** and **tax relief** on pension contributions and pension fund growth.

45. The amount paid to current workers has a direct impact on the amount received in private pensions in the future, and reduces entitlement to state pensions (directly in State Second Pension (S2P) through contracting-out, and indirectly in Pension Credit through tax relief). A large proportion of the money paid out to pensioners in private pensions in the future is funded by government contributions[18].

[17] For example, does entitlement need to be claimed or is it paid automatically?
[18] As demonstrated in the analysis of savings incentives in Chapter 6

46. Both contracted-out rebates and tax relief should be considered as part of overall government support for pensioners. In the case of contracting-out, counting the reduction in S2P payments in future from contracting-out, but not the £12bn paid up-front in rebates in the current year, is inconsistent and misses out a large part of the cost of the state scheme[19].

47. Pension contributions are *tax deferred* relative to pay[20], but *tax advantaged* relative to most other forms of saving. Compared to a system in which pensions have no tax advantage, the cost of tax relief was around £20 billion in 2003/4[21]. This cost is the difference between the tax relief on contributions made today, and the amount of tax paid on pensions paid out today[22].

48. Over the lifetime of an individual, the amount of tax relief paid on contributions and the amount of tax collected when the pension comes into payment may be expected to be roughly the same[23]. But in the context of government expenditure, the annual cash flow from aggregate relief on contributions net of aggregate tax collected from private pensions in payment is important. The tax treatment of pensions should be considered as a real cost, as it reduces the revenue collected by government. This cash flow cost is expected to remain at or above current levels over the next 50 years[24]. Different patterns of pension saving could change this future cost, which could significantly change the share of GDP allocated to pensions.

[19] PPI Briefing Note Number 14 *State spending on pensions: An update*, enclosed. Page 146 of the Report highlights that more than one-quarter of all private funded pension contributions are products of the UK's compulsory earnings related pension system.
[20] There is some tax advantage, through the tax-free lump sum and paying lower marginal tax rates on pensions in payment than on pension contributions
[21] Curry and O'Connell (2004) *Tax Relief and Incentives for Pension Saving*
[22] The cost also includes other tax advantages for pensions, such as relief from National Insurance on employer pension contributions, and relief on the investment returns of pension funds. See Curry and O'Connell (2004)
[23] Although the tax-free lump sum and different tax rates applying when contributions are made and pensions come into payment are likely to mean that there are still tax advantages to pension saving
[24] OECD (2004) *Long-term budgetary implications of tax-favoured retirement plans*

49. PPI research has highlighted that the sustainability of the current state pension system is in some doubt, but the Report does not analyse the **uncertainty in future state expenditure on pensions**.

50. Any projection of the long-term costs of pensions will be surrounded by a large degree of uncertainty. The demographic projections that underpin cost calculations are themselves uncertain, and the cost of contributory-based schemes will depend on patterns of work and levels of earnings.

51. However, there are additional uncertainties surrounding the cost of Pension Credit. The funnel of doubt in the state expenditure on Pension Credit could be as much as 2.5% of GDP (half of the current spend on pension benefits)[25].

52. This is because the future cost of Pension Credit will depend on the level and distribution of private pension saving, as well as the level and distribution of other state pension income, earnings above state pension age (SPA) and other non-pension saving.

53. The transfer from the state system to pensioners should therefore be viewed as variable rather than fixed[26]. The amount transferred will increase as savings fall, and fall as savings rise.

54. Government projections of the future cost of Pension Credit assume that **the amount received from all types of income grows in line with average earnings growth, at all points of the income distribution**. If income grows by less than average earnings, particularly at the bottom of the pensioners' incomes distribution, the cost of Pension Credit will be higher than the official projection.

55. This uncertainty is inherent in all means-tested benefits, but becomes more important as Pension Credit becomes an increasing source of pensioners' incomes in future.

[25] NAPF (2004) *Towards a Citizen's Pension* and *Appendices,* enclosed
[26] It is assumed to be fixed in the Report – see for example Figure 1.12

56. The significance of the uncertainty in the state expenditure on pensions is highlighted in an apparent inconsistency in the Report. Although the official projection of the cost of the Pension Credit is used in the Report's analysis of future pensioners' resources[27], the assumptions underlying the projection appear to be inconsistent with other parts of the Report.

57. The Report highlights that pension resources – from state and private pensions - will not increase significantly as a proportion of GDP[28]. At the same time, the number of pensioners is projected to increase by more than 50%[29]. This implies that the average amount received per pensioner will be much less as a proportion of GDP than today.

58. State spending per pensioner is projected to fall by 27% by 2053/4[30], even including the large expansion of the Pension Credit (which by 2053 is 1.5% of GDP compared to 0.5% of GDP today[31]). The central estimate of the total amount of private pension received by pensioners[32] suggests a fall in the amount received per pensioner of around 15%[33].

59. Assuming that average earnings growth is the same as GDP growth[34], the Report projects that both state pension income and private pension income will <u>fall</u> significantly relative to average earnings. These are the largest components of pensioners' incomes[35].

60. Government projections of the cost of Pension Credit assume that all income will <u>increase</u> in line with earnings growth. If income from state and private pensions grows by less than earnings, the future cost of Pension Credit will be higher than projected, <u>or</u> there will need to be significant growth in other sources of income (such as income from other saving, or earnings) throughout the pensioner income distribution[36].

[27] In Chapter 1, and repeated in Chapter 4
[28] Figure 1.12 shows resources from state pensions
[29] Figure 3.19
[30] Figure 3.19
[31] DWP long-term benefit projections, as used in the Report
[32] Based on a total transfer of 10.85% of state and private pensions, as shown in Figure 1.12
[33] PPI calculation based on Figures 1.12 and 3.19
[34] As implied on page 74 of the Report
[35] DWP (2004) *The Pensioners' Incomes Series 2002/3*
[36] See PPI Briefing Note Number 14 *State spending on pensions: An update*

61. The Report suggests that there is only limited scope for increasing the use of housing and other non-pension assets[37], and for increasing work above state pension age[38]. Higher income from other savings and earnings are therefore unlikely to offset the fall in state and private pension income, particularly for lower income people.

62. This suggests that the estimated future cost of Pension Credit is higher than the projection used in Figure 1.12, and the Report has underestimated the contribution that Pension Credit (and therefore the state) could make to future pensioners' incomes under current policy.

63. The Report looks briefly at some of the trade-offs involved in changing state pension policy, and estimates that a non-contributory basic state pension set at the current level of the Guarantee Credit and an increase in state pension age to 72 would cost the same as the current system in 2043[39]. But if the cost of the current system is underestimated, then that higher basic state pension would be cost neutral at an SPA lower than 72.

64. Chapter 7 also looks at the trade-offs needed for alternative pension policy if the level of spending on state pensions is constrained to 5% of GDP. For example, with a non-contributory basic state pension set at the current level of the Guarantee Credit, state pension age would need to increase to 74. However, no estimate is made of what state pension age would need to be to keep spending at 5% of GDP under the current system.

65. The Second Report should:
    - Include estimates of the cost of the current system consistent with assumptions made on future income trends contained in the First Report.
    - Reflect the fact that the current system – even in official projections - is projected to cost more in future than it does today.
    - Reflect the uncertainty in the future cost of Pension Credit.
    - Illustrate the future trade-offs likely under current policy alongside the trade-offs required in alternative policies.

[37] Chapter 5
[38] Chapter 2
[39] Chapter 7, page 246

Implications of gaps in the Report

66. The analysis of 'undersaving' extends the methodology used in other pensions situation analyses[40], more appropriate data has been used, and the level of uncertainty appears to have been reduced. For example, the Report suggests between 9.6 million and 12.1 million people are 'undersaving' for retirement. This range has narrowed down the government's own estimate of between 3 and 13 million.

67. The improvements made by the Commission's analysis are welcome, but readers should not assume the findings are 'correct'. The estimates still contain huge uncertainties, as is acknowledged in the Report.

68. Some of these uncertainties are addressed through sensitivity analysis, including the impact of starting saving at younger ages, and for lower target replacement rates. But many other important simplifications have not been sensitivity tested. The important gaps, as highlighted earlier, include assumptions on continuous employment at increasing wage levels, continuous saving at increasing real amounts and continuing working and saving until state pension age. The gaps are all likely to have a material impact on the estimated number of undersavers – some to increase the number said to be 'undersaving'; some likely to decrease that number. There is no indication in the Report as to how realistic is each of the assumptions made or by how much the outcomes might change if these assumptions were incorrect.

69. In addition, the Report does not give any context as to what an acceptable level of 'undersaving' might be. It is very unlikely there would ever be zero 'undersaving', as even people acting rationally may choose to 'undersave' at a point in time (for example, if they value immediate consumption more than retirement incomes at the level assumed by the analysis, or if they are expecting to be better able to make up saving later in life).

70. It may be that the seemingly improved accuracy in response to the question of *How much avoidable 'undersaving' is there?* is spurious, and/or that the question itself cannot be answered to a practically useful level of accuracy.

[40] For example Oliver Wyman & Co (2000) *The future regulation of UK savings and Investment: Targeting the savings ga*p and DWP (2002) *Simplicity, Security and Choice: Working and saving for retirement* both used a similar methodology (but different or less extensive data) to estimate the size of the 'savings gap' and the number of people 'under-saving' respectively

71. In practical terms, this may not matter, as there is general agreement that the answer to the question is *there is probably more than enough 'undersaving', and other problems with the state pension system, to justify doing something about it*. From the point of view of sharpening this message, the Commission's analysis has proved extremely valuable. However, **the 'savings problem' appears as a stark, accurately quantified issue rather than the dynamic, unquantifiable situation it really is**.

72. This First Report forms the baseline for the Commission's Second Report, which will look at the changes necessary to the state system to make the private system work[41]. But the First Report – and in particular the modelling within it – necessarily concentrates largely on the narrow focus of savings, rather than considering the pension system as a whole. Where the state system is considered, it is only in relation to its impact on saving.

73. A large number of issues not covered in the Report are critical to the effectiveness of the whole pension system, in particular:
    - The inequality in outcomes from the state pension system, which is underplayed in the Report by concentrating on individuals with full work histories and continuous saving.
    - The uncertainty in the future cost of the state pension system, which is not analysed to the same degree as the uncertainty in private saving.
    - The dynamics of state and private incomes during retirement as life expectancy increases.
    - Future trends in pensioner poverty.

74. Assessment of these issues is essential to any consideration of reforming the state pension system. Changing the state system should not be done only in order to make the private pension savings system work better. **The Report, in representing the savings issue, is an incomplete starting point for a resolution of the underlying problems in the state pension system**.

[41] Adair Turner interview BBC Radio 4 *Money Box*, October 2004

Part 2: Possible solutions to the pensions problems

75. Chapter 7 of the Report suggests that, to achieve 'adequacy', there are three ways forward:
    - A major revitalisation of the voluntary system; and/or
    - Significant changes to the state system; and/or
    - An increased level of compulsory private pension saving beyond that already implicit in the UK system.

76. The PPI agrees that these options should be considered further, alongside the option of retiring later. Retiring later is recognised as a choice earlier in the Report. There seems to be no obvious reason why encouraging later retirement is not as feasible a policy option as encouraging saving. While not initially included in the Commission's remit, later retirement surely has to be considered: if adequacy at a later retirement age than 65 were the benchmark, the amount required to be saved would be significantly less than using age 65 in the benchmark[42].

77. The remainder of this submission makes detailed comments where the PPI has analysed the issues in detail, and sets out some critical remaining questions to be answered either in the Commission's Second Report or elsewhere.

[42] As illustrated in Table 4.7 of the Report

Later retirement: a labour market and pension policy issue

78. Many of the issues to do with later retirement have to be led by labour market policy analysis, incorporating pensions policy analysis. The relevant questions to be asked on the subject of later retirement, which we suggest are considered, if not by the Pensions Commission then elsewhere, include:
    - What changes in retirement behaviour are possible in future given planned initiatives such as legislation against unfair age discrimination, and likely employer/ee response, over what timescale?
    - How much of a difference could later retirement feasibly make to the adequacy issue, by gender and income group?
    - What further labour market policies could be effective?
    - What pension policy initiatives could additionally encourage later retirement? How much impact could they be expected to have on future retirement behaviour?

79. Regarding the last question on pension policy, the PPI has analysed the government's planned response of a higher incentive to defer state pension, and, raising state pension age (SPA)[43]. The conclusions reached are set out below. In summary: raising state pension age, if done in an appropriate way, is far more likely to influence later retirement than the deferral incentive.

80. The deferral option is not generous enough to make it likely that many more people will defer compared to the current 2% of pensioners each year. Taking the money and investing it will be as good as or better for many people. The lump sum option is slightly more generous than the enhanced pension; and deferral is most generous for higher rate tax payers.

81. Any impact on actual retirement behaviour from the deferral option is unknown: are the people who defer those that will carry on working anyway?

[43] PPI Briefing Note Number 4, *Deferring State Pension*; O'Connell (2002) *Raising State Pension Age Are We Ready?*; O'Connell (2003) *Raising State Pension Age: An Update*. All are enclosed.

82. The deferral option is actuarially neutral, so that it is not a method to allow a better state pension payable from a later age for everyone[44]. Any improvement in cash flow arising from people deferring taking state pensions after the current SPA would be temporary.

83. Raising state pension age would be an option that releases money so that a better state pension could be paid for everyone from a later age (after taking account of increased costs in Incapacity Benefit etc.). The Report did not consider this as a reason for considering a later SPA[45], concentrating instead on the macro-economic effects of raising SPA only. But raising SPA in order to improve the state pension seems the important social policy rationale.

84. Allowing any kind of choice in age of taking state pension only allows state pensions to be improved if the central age - from which actuarially neutral early- or late- factors are calculated - is raised.

85. Raising state pension age is not of itself a direct lever to later retirement, but it would be of immense significance as an indicator that the government expects people to work longer.

86. Raising state pension age can only be done with a long lead-in time to allow individual work/retirement and financial plans to adjust. For example, legislation in 2005 could mean a phased transition of SPA from 65 to 70 between 2020 and 2030 or later. Such a change would only affect people currently younger than age 45.

87. This timetable means that the modelling work shown in the Report[46] is of limited use: current 65-69 year olds would not be affected by an increase in SPA. The conclusion the Report draws (that lower income people would be more likely to work longer than higher income people) cannot be inferred from this analysis.

[44] As the Report recognises, p. 42
[45] Chapter 2
[46] Fig. 2.28

88. The strongest objection to raising state pension age is that it could disadvantage people in lower socio-economic groups who tend to have lower life expectancy. While it is true a gap in life expectancy exists between socio-economic groups, the actual impact of the gap can be overstated. The Report shows the latest available ONS statistics[47] from which comes the often quoted life expectancy at birth for people in Class V of 71 years. But because life expectancies have improved for all groups since this data was taken – and the data is on a period rather than a cohort basis as well as being flawed in other respects - the likelihood is that the more correct and up to date figure is something nearer 80[48].

89. Raising state pension age should not be done without policies in place to protect those worst affected. Contrary to suggestions in the Report[49], there are feasible ways to raise SPA equitably. For example, Guarantee Credit (GC) is currently available from age 60 for those people with no other income (therefore not working). Continuing to make GC available in the five years before a higher SPA would offer some protection for those likely to be worst affected by a rise in SPA. However, the government intends to increase the age for availability of GC to 65, coincident with raising SPA for women from 60 to 65.

90. On the timetable suggested, an increase in SPA to 70 and even beyond is justified by the life expectancy improvements that have already happened[50]. However, this is unlikely to be the only consideration, and a jump to age 70 in one go is unlikely to be politically acceptable.

91. A schedule of planned future rises could be set out, conditional on expected improvements in longevity (and/or health inequality improvements), with a plan to cancel the increase in SPA if longevity does not improve as expected[51].

[47] Fig. 2.2. Cohort data for 1997-99, based on occupational classification of 1977.
[48] This is even assuming some further widening of the gap in life expectancy between manual and non-manual groups, as we understand further analysis requested from the ONS by the Commission suggested. See PPI Briefing Note Number 17 (forthcoming).
[49] p. 28
[50] See O'Connell (2002). This conclusion is also apparent from the Report, Fig 1.1.
[51] This approach would give more certainty to individuals than the method used in Sweden which calculates the appropriate pension according to the life expectancy of each cohort when they reach age 65

Reform of the state pension system should be the first step

92. The PPI's assessment of *The Pensions Landscape* in February 2003 concluded that reform of the state pension system should be the necessary first step before tackling issues of the private sector such as voluntary or compulsory pensions.

93. This conclusion is reinforced by the array of state pension reform proposals currently active. The PPI recently analysed[52] 16 proposals, as well as government policy, and found:
    - Exceptional dissatisfaction with the current state system, with some proposals representing a significant change from the status quo.
    - A strong consensus for the state pension system to aim at getting everyone above the means-testing level and so drastically reduce the extent of means-testing.
    - A strong consensus for simplicity.

94. The appendix gives a summary of the conclusions of PPI reports on the state pension reform theme[53].

95. Roles for a state pension can be ranked from the minimal to the generous (with obvious consequences for cost)[54]:
    1. Alleviation of poverty
    2. Prevention of poverty
    3. Belonging and participation so that retired people feel part of the community
    4. Continuance of economic status so that the standard of living relates to pre-retirement levels.

[52] PPI Briefing Note Number 16 *Pension reform: who is proposing what?*, enclosed. See also O'Connell (2004) *State Pension Reform: The Consultation Response*, PPI, enclosed
[53] The full reports are also enclosed
[54] St. John and Ashton (1993) discussed in Littlewood (1998) and Blackburn (2002)

96. In the UK, the problem is that the ill-defined system achieves different levels for different groups of people. Poverty is not prevented because of the c. 75% take up of Pension Credit, so for lower income people the state system operates only at Level 1. Yet for people at the other end of the income scale it has been operating at Level 4, because of the generous state benefits through SERPS[55]. Even with the flatter State Second Pension benefit, as private savings are generously tax incentivised, the state is still at a (less generous) Level 4 for higher income people.

97. The choice of state model has consequences for the private sector, or more likely there is an iterative process to find the right balance. For example, if the UK system changed to a better poverty prevention model, and provided a higher level of state pension, so, private saving would be focused more strongly on its natural target market of higher income people, and there would be less of a case for compulsory private savings.

98. Therefore, both of the Commission's 'savings' options (enhance voluntary or move to compulsion) depend upon resolving the state pension issue.

99. The Commission's First Report posed changes to the state system as potentially part of the way forward to solve the adequacy problem by looking at whether savings are enough for an 'ideal' replacement rate at age 65. As the PPI reports show, there are other reasons for reforming state pensions. **The importance of this for the Commission is that any attempt to redesign the state pension system in order to help resolve the savings issue has to consider also a wide variety of other issues that were not considered in the Commission's First Report**.

100. The questions that any proposal for a state pension system should be tested against are in Table 1.

[55] State Earnings Related Pension, the predecessor of State Second Pension

Table 1[56]

Tests for a reformed state pension system	
1.	Is the reformed policy capable of being sustained for at least 30 years, and preferably 40 years?
2.	How would the number of pensioners at risk of poverty in the UK change? How would pensioner poverty compare with that in other countries and with that in other age groups in the UK?
3.	How much would the total 'economic cost' to the state – including state pension benefits, contracting-out rebates and tax relief – be in the short term?
4.	By how much would the total 'economic cost' to the state increase in the long term?
5.	Does the reformed UK state pension system recognise past and likely future improvements in health and longevity and is it flexible for different working arrangements and retirement choices?
6.	Is the reformed UK state pension system fair to all groups?
7.	Is the reformed UK state pension system simple? Does it help people to understand what income they will receive from the state during later life?
8.	Does access to the reformed UK state pension system become easier (or at least not harder) for people as they grow old?
9.	Does the reformed UK state pension system enable individuals to meet their personal objectives for additional retirement income through occupational and personal private pensions?

[56] From O'Connell (2003) *A Guide to State Pension Reform*, PPI, enclosed

101. The PPI is part-way through a programme of work to examine possible reform options against these tests. The most detailed work has been carried out so far on a universal or 'Citizen's Pension'[57]. The transition to a universal pension has been compared to the other main reform alternative of increasing the Basic State Pension (BSP). Both appear possible, affordable and sustainable; the universal pension would be more effective at reducing poverty, inequality and complexity.

102. The universal pension and increasing the BSP have most support among current policy reform proposals[58]. The status quo, which is evolving to a flat-rate multi-component pension with significant targeting through means-testing has much less support, as do the other options mooted: reforming the State Second Pension and stepping up state pension by age.

103. The Commission's Report specifically asks about the additional future cost of changing the state pension system, and quotes some ballpark figures[59]. The future additional cost is often quoted as that additional to the government's own projection of the future cost of paying state pension benefits. But this baseline is likely to be incorrect as:

- It excludes significant costs such as contracting-out rebates and tax incentives, and,
- It may be significantly underestimating the future cost of Pension Credit, which is highly uncertain, and,
- The status quo may well not be politically sustainable anyway, as increasing numbers of pensioners demand a better system, and,
- Although government projects cost for 50 years, it makes no action plans for that period, and many decisions can be made to change parameters in the system in the very short-term (e.g., Pension Credit and state pension increases within a few months).

[57] See O'Connell (2004) *Citizen's Pension: Lessons from New Zealand*, PPI and NAPF (2004) *Towards a Citizen's Pension Interim Report*, both enclosed
[58] PPI Briefing Note Number 16 *Pension reform: who is proposing what?*, enclosed
[59] p. 246 and p. 285

104. Further, the choice of how to transition to another state pension model can have significant implications for cost. As an example, the 'offset' as opposed to 'addition' method could cost £5bn less during the first years of transition, as well as having different distributional consequences[60].

105. Specifically therefore, appropriate questions are:

- How much should be spent in order to provide an appropriate state pension system, now, during transition, and over the next 50 years on best estimate demographic and social trend assumptions?
- How could that be paid for in addition to the current cost, and the likely future whole state system cost of the likely evolution of the status quo, taking into account likely changes in taxes/NI contributions or state pension age?
- How important should certainty of cost be over the long-term: is a certain higher cost preferable to one which may appear lower, but is uncertain?

106. The long-term shape and level of state pension is the philosophical, financial and practical underpin to the decision on whether government should have a role beyond poverty prevention in compelling or encouraging saving, and how much the state should spend on that.

107. The PPI has a programme of work through 2005, sponsored by the Nuffield Foundation, which will examine these overarching issues on the interface between state and private pensions. The PPI believes that any way forward on state pension reform will best work if a consensus on these issues is developed and maintained as far as possible. The PPI/Nuffield project will involve pensions experts and representatives of pensions interest groups to identify where the consensus lies and where and why disagreements remain.

108. The PPI/Nuffield project has been designed so that the first half can integrate with the timing of the Commission's work for the Second Report. Pensions Commissioners are invited to participate in this work. The key issues to be examined are in Table 2.

[60] In the context of changing to a Citizen's Pension (NAPF (2004) *Towards a Citizen's Pension*) or increasing the Basic State Pension (PPI (2004) *State Pension Reform: Managing Transition*)

Table 2: Issues to be examined in *Shaping a Stable Pensions Solution*

	Title	Issues
1	What should be the balance between state and private pensions?	Is the shift to 40% state provision : 60% private provision possible? Is it desirable? How much can the private sector be expected to provide? How does the balance depend on retirement and/or pension ages? How does the balance affect individual households? What are the risks to the economy, and to individuals? What is the balance in other countries?
2	How does the interaction of state and private pensions affect incentives to work and save?	What are the incentives for saving, and working at older ages? Should the government promote pension saving above other forms of saving? What would be the implications if they didn't? What are the roles of non-pension saving and property?
3	Should state pensions be universal or contributory?	What are the philosophical and practical differences? What are the implications for means-testing, and private pension saving? How do the principles fit with 21st century society, with increased labour mobility and flexibility?
4	Should earnings-linked pensions be voluntary or compulsory?	Should the government provide more than a basic guarantee? Alternatively, should there be compulsory private saving? How would this fit with state pensions? Or should all saving be voluntary? What happens in other countries? Who would have ultimate liability if compulsory pensions give poor returns?
5	What should be the role of means-testing in state pensions?	Advantages and disadvantages of current policy. Will there always be a need for means-testing? Are HB and CTB different to PC? What are the implications for private saving? Are there any lessons from international experience (e.g. Australia?)
6	How can pension policy consensus be achieved and maintained?	What are the possible mechanisms for securing consensus? Is there relevant experience from other countries? Which state pension models tend to be the most stable?

The issues around compulsory private pension saving

109. As the Commission's First Report explained, in macro-economic terms there is very little difference between Pay As You Go and funding as methods of providing pensions[61]. Therefore, a compulsory private pension savings approach would be adopted more for social policy reasons (income adequacy, savings behaviour) than for purely macro-economic reasons.

110. While understanding why compulsion seems like a panacea[62], there are doubts, which the PPI share, that a practical system of compulsion can be designed that will achieve the objective of good pensions for all.

111. These doubts arise from considering the difficulty in answering the key questions that need to be resolved to identify whether compulsion is feasible and likely to be effective:

- What will be done for those people who cannot be compelled to save?
- How can compulsion be defined to be right for all?
- How can a compulsory system be efficient?
- How will protection of compelled saving be secured?
- What is the future for tax incentives on compulsory saving?
- What future stability in the policy of compulsion can be secured?

These questions, suggested as those the Commission should address in their Second Report, are now discussed in more detail.

[61] p. 250 et seq. of the Report

[62] Recent reports by the ABI (ABI (2004) *Compulsory pensions – an analysis of public attitudes*) and the Engineering Employers' Federation/Aon Consulting (EEF / AON (2004) *The EEF/Aon Consulting 2004 Pensions Survey*) both show that while compulsion seems attractive, closer examination reveals that it is those who are already saving or providing a pension who believe that others should be doing the same

Who cannot be compelled to save?

112. In the current UK environment, around 20 million people of working age are accruing rights to a personal or occupational pension; 15 million are not[63]. Those who are not could be in one of a number of different circumstances: not working, working in an organisation without a pension scheme, working in an organisation with a pension scheme but choosing not to contribute and with no employer contribution, self-employed and choosing not to save in a personal pension.

113. For some people, especially if the current means-testing regime continues, it may not be appropriate to be compelled to save. Creating a set of rules so that the 'right' people to be compelled to save more are identified, and those for whom compulsion is inappropriate are supported in other ways, will be complicated and it may not be possible to get it 'right'.

114. Countries with compulsory pensions do seem to have incomplete coverage. In the Latin American countries who have reformed their pension systems[64], the percentage of the working age population who are contributing ranges from 9% (Bolivia) to 47% (Uruguay) with Chile at 34%. The self-employed and very low income workers are excluded from the Australian compulsory superannuation scheme[65].

How can compulsion be defined to be right for all?

115. Many people would assume that the best retirement situation comes from each individual:

- Having saved regularly throughout working life,
- Probably in an employer's scheme,
- With a fair amount invested in long-term equities,
- To build up a pension income…
- … that is enough to achieve a benchmark standard of living, say, starting at retirement age with two-thirds of previous salary increasing at least with prices.

A compulsory scheme would presumably try to mirror this ideal, by mandating parameters such as % of salary to be saved each year.

[63] PPI Briefing Note Number 10 *The balance between state and private pension provision*
[64] See Palacios (2004) *Pension Reform in Latin America: Design and Experience* in *Pension Reforms: Results and Challenges*, International Federation of Pension Fund Administrators
[65] Disney and Johnson (eds) (2001) *Pension Systems and Retirement Incomes across OECD Countries* Edward Elgar: Cheltenham

116. But other strategies are possible, for example:

- Saving in a different pattern: less when bearing the costs of bringing up children and more later in life; or more in a high-powered job early in working life and less later after down-shifting; or in irregular phases depending on spasmodic or cyclical work.
- Rather than in an employer scheme, saving 'enough' in a personal pension, or an ISA, or property, or a mixture of different vehicles.
- Having a risk-return profile that is more risky, or more secure, than that from typical occupational or private pension investment.
- Being in control of generating personal income from capital assets, rather than having a stream of income guaranteed throughout life from an annuity or a Defined Benefit pension.
- Aiming for a lower standard of living throughout retirement; or more during early retirement and less during later retirement.
- Sharing saving unequally between partners at different periods of the lifecourse, rather than each saving in the same way individually.

117. It cannot be proved that these strategies would be better or worse than the 'ideal' encapsulated by a new compulsory system. So, either the compulsory system would have to be introduced knowing that it was not necessarily the best for everyone, or, it has to be designed to allow choices on some of these parameters. But then, either the objective of good pensions for all could be lost, or, the system will be extremely complex. So, where, and how, can a practical line be drawn between choice and simplicity?

118. This issue is particularly relevant given the current and expected future extent of means-tested state benefits. Should people be compelled to save at all when that would reduce their future state entitlements, in ways that cannot be predicted at the point of saving?

How can a compulsory system be efficient?

119. However the compulsory system is designed, there will be additional administration, investment management, regulation and enforcement costs that will ultimately have to be borne by the individual saver. For example, in Australia, expenses account for 1.28% of assets annually[66]. What level of cost (additional to the state system) is appropriate for a compulsory savings vehicle, and could the compulsory system be feasibly delivered within that range?

How will protection of compelled saving be secured?

120. There is a moral case for making anything that the government compels people into as secure as possible, but by the nature of long-term pension saving, there are significant risks involved for individuals in Defined Benefit and Defined Contribution private pension provision.

- Scheme provider risk in Defined Benefit schemes (the 'ASW scenario'): The Pension Protection Fund offers partial protection from underfunded schemes where the employer becomes insolvent. Would this need to be enhanced to give full protection if membership were made compulsory?
- Personal pension provider risk (the 'Equitable Life scenario'): Again, would enhanced protection be necessary?
- Investment return risk in Defined Contribution arrangements: It seems infeasible that a government could protect against investment return risk since one of the attractions of compulsory savings is seen as the opportunity to participate in higher return/higher risk vehicles. Making available the choice of lower risk vehicles may not be adequate protection, as people need to exercise choice wisely. Evidence from Sweden suggests that after initial enthusiasm to make choices, most people then settle into inertia and do not change their investment choices even when the investment environment is changing[67].

121. Designing a compulsory system will require judgements to be made on the level of security thought appropriate, and may require additional protections which will have to be paid for by the taxpayer.

[66] Coleman, Esho and Wong (2003) *The Investment Performance of Australian Superannuation Funds*
[67] Sunden (2004) *How do Individual Accounts work in the Swedish System?*

What is the future for tax incentives on compulsory saving?

122. Currently saving for private pensions is tax-advantaged through the EtT system[68] which defers tax payment, sometimes to a period where the individual's tax rate may be lower, and allows a lump sum to be taken tax free. This is intended to act as an encouragement to save in occupational or personal pensions where the money is 'locked away' for long periods of time.

123. If compulsion were introduced, there would not need to be any tax incentive. Would the tax regime for occupational or personal pensions change to TTE, as other forms of saving?

What future stability in the policy of compulsion can be secured?

124. By adopting a policy of compulsion, government has to make choices on many parameters to apply to everyone of working age. As the previous questions show, the choices require difficult judgements to be made. Yet people want pensions policy to be stable over many years: an individual's pension planning horizon is at least ten parliaments.

125. There seems to be no consensus for compulsion. In the PPI's recent stocktake of pension reform proposals[69], only two organisations positively argued for it. It will be an uphill and long battle to develop a policy requiring so many detailed judgements when most organisations involved with pensions are either sceptical about or reject the basic principle.

126. It would be easier if there were an unequivocally successful model of compulsion elsewhere, but there is not. The Australian model was brought in under specific trade-offs on wage inflation that are unlikely to be agreed here, and there are questions over how much has actually been achieved in net pension saving because of substitution and increasing debt[70].

[68] See Curry & O'Connell (2004)
[69] PPI Briefing Note Number 16 *Pension reform: who is proposing what?*, enclosed
[70] As the Report acknowledges, p. 254

The issues around enhancing the voluntary system

127. As stated earlier, PPI analysis points to reforming the state pension system as the necessary first step before tackling the 'voluntary or compulsory' question for the private pensions sector. In practice, the issues are somewhat iterative: if voluntary savings could be more certain to deliver more people a higher pension then the need for a change to the state system is lessened. However, there are non-savings reasons to change the state system, which affects more people to a greater extent than the private sector does. It is conceptually easier and practically more relevant to consider changes to the state system first.

128. Changing the state system, while necessary, may not be sufficient. Questions suggested as ones the Commission should address in their Second Report for enhancing the voluntary long-term savings sector are now discussed in more detail:

- How much could be achieved by simplifying and improving the state pension system?
- What remaining role is there for the state in private provision?
- What role should be expected from non-pension saving?

Simplifying and improving the state pension system

129. As noted earlier, most reform proposals suggest boosting the state pension of most pensioners to above the level of the Guarantee Credit (to avoid disincentive effects for working age people and poverty for non-claimants over state pension age) and simplifying the state pension system. Sources of complexity include Pension Credit, contracting-out, and the National Insurance contribution and credit system. Various proposals deal with these in different ways.

130. While there are many reasons for the proposed changes, the saving implication is that complexity and uncertainty for an individual considering a savings decision would be reduced. For example, under the current system, the state pension benefit an individual will receive in future depends on what happens to at least 8 factors over the lifecourse: his or her employment status, earnings, contracted-out status, savings amount and return, work after state pension age, marital status (and which spouse), and residence. With a universal pension at the Guarantee Credit level, only residence may alter entitlement and marital status may do depending on the benefit definition chosen[71].

[71] See NAPF (2004)

131. The critical question is how many people currently thought to be 'undersaving' would not be under different models of state pension: not only because the amount of entitlement to state pension would change (probably increase) but also because of the impact on savings behaviour. Research on likely changes in behaviour in different scenarios would be extremely valuable. Specifically for the example above: would an easily understandable universal pension lead people who 'need' to save more and could do so, actually to increase their personal saving? Would being better able to rely on full value being obtained from saving even small irregular amounts make potential savers more likely to save?

132. Government policy to date has been, through the Informed Choice agenda, to offer more information to individuals so that they can make their own savings decisions. Central to this is a web-based planner with forecast future state pension entitlement as the underpin to the savings decision. But the forecast of state pension entitlement excludes the increasingly important contribution Pension Credit will make in future, so it is incomplete, and it has to be hedged with caveats because of the uncertainties outlined above.

133. If the premise of the Informed Choice agenda is correct, and better information would encourage people to save more (and employers to provide more), then simplifying the state pension system and removing the extent of uncertainty of outcome, should be beneficial[72].

Remaining role for the state in private provision

134. As the earlier section on state pension reform noted, there are various levels to which the state can provide pension benefits, and similarly various degrees to which the state can enable, encourage or incentivise voluntary provision.

[72] As the Commission suggests, p. 212 et seq. and p. 246 of the Report

135. Currently, beyond providing benefits, the state intervenes in the private pensions sector fairly heavily and in some detail, as it:

- Tries to make private saving easier through the Informed Choice agenda.
- Protects personal and occupational saving by regulation through the Financial Services Authority and The Pension Regulator.
- Aims to allay fears on the insecurity of Defined Benefit schemes by facilitating the Pension Protection Fund and Financial Assistance Scheme.
- Offers tax incentives for employers and employees.
- Allows contracting-out of the State Second Pension (although the extent to which this is now, or should be, a financial as well as a structural incentive is a controversial point).

136. In considering enhancing the voluntary system, the effectiveness and efficiency of each of these government interventions should be considered. Such an assessment should take into account the costs, risks and distributional impacts. For example, tax incentives are thought to be costly, have unproven effectiveness, and tend to be disproportionately received by higher income people who are likely to save anyway[73].

137. The same analysis could be extended to different models of reforming the state system. For example, there is a conceptual case for the state to pull back from intervention in personal or employer savings, the more the state provides. As state benefits become more generous beyond guaranteed poverty prevention, so the private savings sector would be expected to focus more on higher income people, who should be better able to bear the risks and costs and make the choices involved.

[73] See Curry and O'Connell (2004) for a review of the issues

What role should be expected from non-pension saving?

138. Without more evidence on the behavioural, lifecourse and distributional aspects of private pension and long-term saving, it is very difficult to evaluate how much saving, by what income groups, at what points in their life is possible.

139. But it should be feasible to model individual lifecourses to understand what patterns of saving would deliver target replacement rates for different types of people, and then these patterns can be compared with the evidence that exists on actual patterns. This would establish a very valuable baseline, and the analysis could be extended as new survey evidence develops, according to the Commission's recommendations[74].

[74] Annex to the Report

Appendix: Summary of the conclusions of PPI reports on the state pension reform theme

The following summarises the PPI's current view on pension reform and presents the summary conclusions from PPI work on the subject.

Summary of PPI view on pension reform

1. The problems with the current pension system are:
   - **Inadequacy**: Around 20% of pensioners are in poverty, exacerbated by low Pension Credit take-up (75%).
   - **Inequalities**: The system accumulates disadvantage for many people, in particular women (eligibility by national insurance) and older pensioners (indexation).
   - **Sustainability**: Future state expenditure on pensions has a wide funnel of doubt; and makes assumptions that may be impossible to sustain as the number of pensioner voters increases (low take-up of benefits; decreasing state pension per pensioner).
   - **Complexity**: The system is highly complex for no good purpose, and the Pension Credit means-testing trap presents real barriers to private pension saving.
   - **Problems getting worse**: Private saving is flat but it needs to grow because state pensions are declining and pensions cost more as we live longer.

2. There is a **strong consensus** that the <u>state</u> pensions system should be modernised to prevent future generations retiring with lower retirement income than is seen today.

3. The consensus for reform is that **the foundation state pension should be above the means-testing level**. There are 2 ways of achieving this: increase the Basic State Pension or move to a Citizen's Pension.

4. The latter would be more effective at reducing poverty, inequality and complexity. Both are possible, affordable and sustainable, provided transition is managed in certain ways.

5. **Reform of the state pension system should happen first**, before further policy decisions are made on the private pension system. Whether compulsory private saving makes sense or not depends on what state pension system we have in future.

6. Crisis is not imminent, so we should **take some time** to find the right solution. All political parties and pension interest groups should be involved in an **open process to get some consensus and stability for the long-term**.

Summary of conclusions from PPI state pension reform research

***The Pensions Landscape* (14 February 2003)**
This paper reviewed the then current pensions situation and looked where state and private pension prospects were heading.

It concluded that:
Today's pensions landscape looks better than yesterday's – on average. But pensioner poverty remains, and there are no signs that tomorrow's landscape will look any brighter. To avoid the risk that tomorrow's pensioners are worse off than today's, reform of state pension policy has to be debated.

Pensioners' incomes have risen, but so has the gap between the richest and the poorest:
- Today's average pensioner is better off than yesterday's. The average income for a single pensioner is £9,500 a year, or 44% of National Average Earnings (NAE). Most income comes from the state. Pensioners' incomes have grown faster than earnings on average, and so have improved relative to those of working age.

- Private pension income makes the difference between rich and poor pensioners. Occupational pension income is important for many pensioners; personal pensions and investments for fewer. Recent growth in private pensions has widened the gap between the richest and the poorest. The richest fifth of single pensioners now have annual incomes of £19,000 a year (87% of NAE), and the poorest fifth £4,600 a year (21% of NAE).

- A quarter of pensioners are in relative poverty. Typically, older pensioners are poorer, as are women, people from ethnic minorities and those who have been self-employed.

The make-up of pensioners' incomes will change but there are no signs that future pensioners will be relatively better off than the pensioners of today:

- Both the state and employers are reducing their long-term pension commitment. More people will receive state pensions in future. But state pension income per pensioner will fall relative to earnings, despite the earnings-linking of means-tested benefits. Employers are changing the type of provision offered, and reducing the amount contributed.

- Today's pension saving behaviour seems unlikely to deliver more private pension income in future. Total contributions to private pensions have stalled. Only a minority save in personal pensions. Pension saving is starting at later ages and tends to be irregular.

- Pension alternatives are not widespread. Most people do not have significant amounts of non-pension saving or investments. Those without pensions are less likely to have other assets. Housing is a significant asset for many, but is rarely converted into retirement income.

To avoid the risk that tomorrow's pensioners are worse off than today's, reform of state pensions policy should be debated now:

- Problems of lower pension income will only become apparent in the long-term. The average pensioner income will continue to grow in the short-term. But inequalities will increase if means-tested benefits are not taken up and if private pensions remain focused on higher earners - as is likely. More than one-third of future pensioners face being disappointed with their future retirement income.

- The long-term problems are due to unclear responsibilities now. Current policy assumes individuals will take more responsibility for pension provision. But the responsibilities of the state, employers and individuals remain largely undefined. Current initiatives address only some of these issues. Many people are unable – or unsure of how – to act.

- The future cost to the state of current pension policy is not clear. Current UK pensions policy constrains the cost of state pensions, meaning relatively less per pensioner. The *total* state budget for pensions in the UK will rise in future, although by how much is not clear. The right balance between the cost to the state of paying state pensions and the cost to the state of encouraging private pensions should be debated.

- Reform of state pensions policy should be debated now. Even though the average pensioner income may not worsen in the short-term, the long-term issues require a new solution to be debated now. The debate should start where the problems lie – with the structure of state pensions. In an ageing society, what state pension do we want and how much are we prepared to pay for it?

A Guide to State Pension Reform **(10 July 2003)**
Following the suggestion in *The Pensions Landscape* that the first step should be reforming state pensions, this paper focused on the UK's state pension system. It confirmed the case for reform by comparing the UK system to a minimum objective standard and to state pension systems in other countries, and by considering how state pensions are interacting with private pensions.

It confirmed that a review of UK state pensions is needed because there are serious pressure points in the current system.

Summary of current pressure points in the UK state pension system

1. The UK has an uncomfortably high number of pensioners in poverty.

2. With no change, UK state pensions will become less adequate.

3. The UK currently spends less than most other countries on state pensions.

4. The forecast of future UK spend on state pensions is likely to prove unrealistically low and socially unacceptable.

5. The UK state pension system has become separated from the significantly improved capacity for longer working lives.

6. The UK state pension system works particularly badly for some groups, especially women.

7. The complexity of the UK state pension system makes it harder than it need be for people to understand what they are likely to receive from the state during later life.

8. The combination of low price-indexed state pensions and extensive means-tested benefits means that the UK state pension system disadvantages people as they grow old.

9. Private pensions are not filling the gap left by low state pensions, and many of the causes of this can only be resolved once state pensions have been reformed.

The paper suggested a major programme of work is required to move state pensions policy forward in the most positive way. A clear sense of where the reform is heading (the long-term objective) needs to be balanced with ideas for how to get there (the transition practicalities). There are no 'off the shelf' solutions available from other countries.

A Guide to State Pension Reform proposed those questions by which possible models for state pension reform should be tested. It is unlikely that any solution will score a clear 'yes' on all tests. Choosing future pension policy is about making tradeoffs to find the best balanced solution.

Tests for a reformed state pension system

1. Is the reformed policy capable of being sustained for at least 30 years, and preferably 40 years?

2. How would the number of pensioners at risk of poverty in the UK change? How would pensioner poverty compare with that in other countries and with that in other age groups in the UK?

3. How much would the total 'economic cost' to the state – including state pension benefits, contracting-out rebates and tax relief - be in the short term?

4. By how much would the total 'economic cost' to the state increase in the long term?

5. Does the reformed UK state pension system recognise past and likely future improvements in health and longevity and is it flexible for different working arrangements and retirement choices?

6. Is the reformed UK state pension system fair to all groups?

7. Is the reformed UK state pension system simple? Does it help people to understand what income they will receive from the state during later life?

8. Does access to the reformed UK state pension system become easier (or at least not harder) for people as they grow old?

9. Does the reformed UK state pension system enable individuals to meet their personal objectives for additional retirement income through occupational and personal private pensions?

By making international comparisons and building on proposals made by other UK organisations, the paper proposed five models of state pension reform to be evaluated against the proposed tests.

State pension reform models to be tested in the PPI review

1. **Status quo**: A multi-component system with extensive means-testing. The current system with minor changes should be compared with other possible reform models.

2. **Reform S2P**: Make the State Second Pension flat-rate and/or increase accruals to it for lower earners. This would keep the overall system structure, but increase redistribution to the poorest during their period of working age.

3. **Much higher BSP, scrap S2P**: Keep the contributory link and the structure of the Basic State Pension, but at a much higher rate, so that there is less means-testing. Stop accruals to the State Second Pension, so that the system is simplified to one main component.

4. **Citizen's Pension**: As the previous option, but instead of eligibility being built up by contributions during working life, eligibility is based on citizenship or residency criteria. This would be particularly beneficial to women, and others who spend time out of the labour market, or working at low levels of earnings.

5. **Age additions**: Increase Basic State Pension to the means-tested level (Model 3 or 4 above) but only for the oldest pensioners, say, age 80 and over. This reflects that people get poorer as they get older.

State Pension Reform: Consultation Response **(10 March 2004)**
Following on from *A Guide to State Pension Reform*, the PPI held a number of seminars with industry experts. *State Pension Reform: The Consultation Response* reported on the feedback collected and what it means for state pension reform. The findings are helping to shape the PPI's program of work on state pension reform.

The main conclusions were:

- There is widespread agreement on the problems with the current UK pension system. The issues on which there is most consensus are:
  - That the system is too complex, and
  - That state pensions are getting worse, because of the increasing extent of means-testing.

- The most important features of a future state pension model are:
  - **Sustainability**, as people wish there were political consensus to sustain a stable environment for pension planning and provision, and
  - **Simplicity**, as people want pension provision to be understood and pension planning able to be done with confidence.

- There was no widespread support for continuing with some form of the current pensions system. The most widespread support was for a Citizen's Pension or for scrapping the State Second Pension and increasing the Basic State Pension

- Policy reform should of course be based on the facts, and will have to challenge some common myths about the current system. The pension myths evident from the consultation include:
  - Everyone gets more or less the same state pension.
  - The state pension will be minimal in future.
  - Everyone has some private pension.

Citizen's Pension: Lessons from New Zealand **(10 March 2004)**
This paper was the next in the PPI series on state pension reform. Drawing on the long experience of a Citizen's Pension in New Zealand, this paper tested whether a Citizen's Pension could be advantageous in the UK. The main conclusions were:

- A Citizen's Pension of around 22-25% of national average earnings (£105-£115 pw) is a possible model for the UK. This level of benefit is not generous, but it would mean that hardly any pensioners need to be means-tested for their basic income.

- The Citizen's Pension passes the PPI tests for pension reform (as outlined in *A Guide to State Pension Reform*).

- The trade-off inherent in the Citizen's Pension is that it dampens the way the current state system favours high, consistent earners and instead simply gives senior citizens a basic income just above the poverty level. It suggests that the role of the state is to ensure that people have enough to live on in old age, leaving personal and occupational pensions to meet individuals' own ambitions for total retirement income.

- There appears to be no 'show-stopper' against the Citizen's Pension, so it should not be discarded as an option. Indeed, there could be significant advantages compared to the current pension system from adopting a Citizen's Pension in the UK, and it appears practically and economically feasible. It should be investigated further.

The PPI was subsequently commissioned by the National Association of Pension Funds to work on a major project *Towards a Citizen's Pension*, examining the practical and economic aspects of this policy. An interim report was published in December 2004 (NAPF (2004) *Towards a Citizen's Pension*), and a final report will be published in 2005.

State Pension Reform: Managing Transition **(September 2004)**
Managing Transition looked at the impact of the policy reform options identified in *A Guide to State Pension Reform* on pensioners in different financial circumstances, who retired before transition begins. The report drew heavily on analysis using the pension policy model developed by the PPI and funded by the Nuffield Foundation.

The main conclusions were:

- Transition to any new pension policy has been made more complex by the Pension Credit, specifically the Savings Credit element. This means that:
  - What to do with Savings Credit will be an important part of any transition plan.
  - As Savings Credit awards are increasing fast, reform will be easier to do sooner rather than later.

- The choice between increasing the Basic State Pension or moving to a Citizen's Pension depends in part on the decision on whether the new state pension should be paid in **addition** to accrued state pension entitlement or should be **offset**.
  - The addition method will be more regressive, giving windfall gains to richer pensioners.
  - The offset method will be more progressive, improving income immediately for poorer pensioners.

  The logic of this choice is consistent with the choice between **contributory** or **citizenship** as the appropriate criterion for state pension entitlement: the former tends to favour people who do well at work, the latter protects people who are under-pensioned in the current system.

- Policy reform options that change the rate of accrual of the existing pensions - for example, to make State Second Pension more generous - avoid transition issues but will not improve pensioner incomes in the short-term.

- In practice, the choice of a new pension system, and the transition path, will be about making trade-offs between the potential 'winners and losers'. Given the complexity and range of outcomes possible from the current system, it is important to identify the real effects of reform.

List of enclosures

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Curry C (2004) *Property or Pensions?*, Pensions Policy Institute

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O'Connell A (2002) *Raising State Pension Age: Are We Ready?* Pensions Policy Institute

O'Connell A (2003) *Raising State Pension Age: An update*, Pensions Policy Institute

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PPI letter to Adair Turner (July 2003) Comments on the Pensions Commission Workplan

PPI (2004) *State Pension Reform: Managing Transition*, Pensions Policy Institute

PPI Briefing Note Number 4 *Deferring State Pension*

PPI Briefing Note Number 10 *The balance between state and private pension provision*

PPI Briefing Note Number 14 *State spending on pensions: An update*

PPI Briefing Note Number 16 *Pension Reform: Who is proposing what?*