A new pension settlement for the twenty-first century? The UK Pensions Commission's analysis and proposals

A NEW PENSION SETTLEMENT FOR THE TWENTY-FIRST CENTURY? THE UK PENSIONS COMMISSION'S ANALYSIS AND PROPOSALS

John Hills, Centre for Analysis of Social Exclusion, London School of Economics and member of the Pensions Commission[1]

I. INTRODUCTION: THE DEMOGRAPHIC CHALLENGE

At the end of November 2005, the Pensions Commission (PC) produced its second report, putting forward proposals for long-term reform of both public and private pension systems in the UK. These include establishment of a new funded National Pension Savings Scheme (NPSS), into which employees would be automatically enrolled unless they opted out (or their employer ran a high quality alternative), and changes to the evolution of the state system to make it more generous and less means-tested than it would otherwise become, but with a gradual increase in the State Pension Age after 2020.

Our recommendations, set out in more detail in Section VI, respond both to challenges that are shared by other countries (see Whiteford in this volume) and to particular problems and features of the UK system as it has developed in recent years and would develop in future in the absence of policy change. The UK has been unusual in the scale of its funded occupational pension provision, combined with a state system which has simultaneously been one of the least generous in the industrialised world, but also the most complex. However, as described in the next section, the generosity of funded occupational pensions is in decline for younger employees, and the state system is set to become much less generous for those with median earnings levels but some level of private pension provision. This combination would leave many of those reaching retirement after 2020 with pensions that would fall well short of the amounts most say they would regard as a minimum.

At the heart of the long-term challenge to the pension system is, of course, demographic change, and the rising proportion of the population likely to be above any particular age in future. In common with other European countries – although, it might be noted, to a lesser degree than many – this reflects both increasing longevity and past declines in fertility.

One of the striking features of the period over which the Commission worked was the very rapid change in official projections of life expectancy. Figure 1 shows the Government Actuary's Department (GAD) projections of cohort life expectancy[2] for women reaching the age of 65 at different dates. In the most recent, 2004-based principal projection, women reaching 65 in 2050 would have an average future life expectancy of 25.9 years. This is four years greater than the equivalent figure generated by the 2001-based projections available to us when we started our work as a

[1] This article summarises the findings of the Pensions Commission's second report (2005) and therefore draws heavily on the work of the author's fellow commissioners, Jeannie Drake and Adair Turner, and of the Commission's secretariat, to all of whom the author is greatly indebted. He is also grateful to Nick Barr and members of the Commission's secretariat for helpful comments on an earlier version of the paper.

[2] That is, allowing for future improvements in age-specific mortality as each cohort ages.

Commission in 2003. For men the equivalent increase has been even larger, by 4.5 years to 23.6 years' future life expectancy at 65 in 2050.

[Figure 1 about here]

This is, of course, good news for those of us affected by such potential improvements. But such figures imply that the prospective proportion of life in retirement would rise still further, if retirement ages do not adjust in proportion. They also illustrate the inherent uncertainty in such projections. There is no way of saying definitely in advance which assumptions about future improvements in age-specific mortality underlying the different projections will be correct. Some might still support the cautious assumptions of a tendency towards a limit to life embodied in the earlier projections. Others would point to the way in which even the most recent projections imply a substantial slow-down in the improvements enjoyed in the UK in the last three decades, and so could end up substantially *under*-stating future longevity if such trends continued. One of the major challenges to policy looking forward is to make it robust to such uncertainties.

If gradually (and correctly anticipated) rising longevity was the only issue, proportionate increases in retirement ages could allow the system to adjust without the need for changes in contribution and tax rates or the relative generosity of pensions. But it is not. As in other countries, the UK has benefited from a comparatively large working-age population in the last three decades as a result of the post-war baby boom, but now faces the retirement of a generation much larger in number than its predecessor. The impact of this is illustrated in Figure 2. This shows the size of the population over 65 in England and Wales in this case as a percentage of those aged 18-64 implied by recent projections by comparison with a synthetic model of what *would* have happened had there been no baby boom, and fertility rates had remained at their level in the 1930s, rather than rising beyond them until the mid-1970s.

[Figure 2 about here]

What the figure dramatises is the way in which the baby boom meant that the UK avoided a significant increase in the old age dependency ratio over the last thirty years, but will now face what is effectively a rapid period of catch-up between 2011 and 2041 to where the ratio would have been without the baby boom. Looking at the UK as a whole, the GAD's principal 2004-based projection implies an increase in the ratio of those over 65 to those aged 20-64 from 27 per cent today to 47 per cent in 2050.

As we set out in our first report (PC, 2004), coping with such changes means that one or more of four adjustments has to occur:

- Private savings for retirement have to rise;
- Taxes and/or national insurance contributions devoted to pensions have to rise;
- Average retirement ages have to rise; or
- Pensioners have to become poorer relative to the rest of the population.

Our second report sets out the combination of these responses that we believe would be feasible and equitable, given where the UK pension system starts from and the current outlook for each of these four outcomes, as outlined in the following section.

II. THE CURRENT OUTLOOK FOR PENSIONS IN THE UK

(a) Private pension income and contributions

Income from private pensions (including from public sector occupational schemes) is currently around 5.5 per cent of UK GDP, but of this only about 3.2 per cent of GDP flows to those above State Pension Age (currently 60 for women and 65 for men). One major uncertainty looking forward is the extent to which this flow of 40 per cent of private pension output to "early" retirees will diminish.

A second uncertainty is the extent of the overall flow. Here the indications are that in the long run the flow coming from funded pensions will diminish as a result of the decline in the value of rights being earned by more recent recruits to private sector companies that have closed their Defined Benefit (DB) schemes to new entrants, switching to Defined Contribution (DC) schemes[3], often with much lower employer contributions being made into them. Over the last decade the value of normal contributions to funded pensions has remained constant, close to its current value of 3.7 per cent of GDP (PC, 2005, figure 1.14). In the last few years this has been boosted by special additional contributions, equivalent to 0.7 per cent of GDP in 2004, as employers have tried to remove the deficits which had emerged in their schemes as a result of the combination of lower stock market values after 2000 and increased longevity projections for their existing members. Such catch-up contributions do not create new rights, however, but rather try to secure promises that have already been made. In the long run, the Commission's calculations suggest that the flow into funded pensions could diminish to around 3.1 per cent of GDP as the DB-DC shift works its way through. Rather than rising to meet demographic pressures, contributions would fall.

These developments suggest that total private pension income could peak at just over 7 per cent of GDP in 2036, with a rapid fall in the proportion coming from funded defined benefit pensions, as illustrated in Figure 3. Two features of such a projection should be noted. First, it takes a very long time for recent changes in accrual of rights to work their way though. Second, the aggregate figures shown disguise large differences between cohorts – the total remains high as those who have recently reached retirement or are near to it now continue to benefit from their pension promises through retirement; it takes a long time before the younger cohorts now accruing less generous rights make up the majority of the pensioner population.

[Figure 3 about here]

The aggregates disguise other differences as well. As the figure suggests, a much larger proportion of "private" pension income would be coming from unfunded public

[3] Defined Benefit schemes promise a pension related, for instance, to someone's final salary. In Defined Contribution schemes, the amounts paid out depend on investment returns and annuity rates when someone retires. See Barr and Diamond in this volume for further discussion.

sector pensions, even allowing for recent proposed changes that would raise normal pension age for new entrants to the sector to 65: public sector employees are 18 per cent of all employees, but account for 36 per cent of accrued pension rights. Meanwhile private sector membership of pension schemes has been falling since the early 1980s – from just under 40 per cent in 1983 to 26 per cent by 2000 (PC, 2004, figure 3.26). Within this women, younger people, those working for smaller organisations, and those with lower earnings are less likely to be members of such schemes, and hence more likely to be dependent on the state or other sources for a larger share of their incomes in retirement. Overall, by 2003-04 46 per cent of those in work were not contributing to a private pension, an increase of about 400,000 just from the previous year (PC, 2005, figures 1.8 and 1.9).

(b) State pensions and spending

The state system in the UK is a complex mix of several components, paid for on a pay as you go basis though a mixture of national insurance contributions and general taxation:

1. The flat rate *basic state pension* (BSP), currently worth about 18 per cent of median earnings, but whose value has been linked to prices since 1981, and so by default will steadily fall in relative value. Entitlement depends on a combination of number of years with earnings above a certain level and years with credits for various caring or other activities. While recently retired men are entitled to an average of 95 per cent of the full BSP, for women the figure is only around 70 per cent (although this will rise towards the male level for those reaching retirement in 20 years time) (PC, 2005, figure 5.29).
2. The *state second pension* (S2P), previously known as the state earnings related pension (SERPS), whose value is partly related to past earnings, but in a way which has changed substantially since it was first introduced in 1978. For those who have recently retired, its value is largely proportional to lifetime earnings (between lower and upper limits) and at a level that could equal that of the BSP for someone who had received average earnings through their working life. Accruals to S2P have become less generous to those with average earnings or above, but are now much more generous to those with low earnings. Significantly in thinking about reform, in the very long run, the system will effectively become flat rate, with the value of the pension linked to earnings growth up to the SPA but to prices in retirement.
3. The *Guarantee Credit* part of Pension Credit which, like its predecessors[4] ensures – if it is claimed – that someone's income does not fall below a certain level. This is currently about 25 per cent of median earnings, significantly higher than in the mid-1990s. The government has said that its value will be linked to earnings until 2008. Beyond that date there is no commitment to maintain its relative value, although the government's long-term public finance projections continue to assume that it remains linked to earnings.
4. The *Savings Credit* element of Pension Credit, paid to those with incomes just above the level of the Guarantee Credit, and with a less sharp rate of means-

[4] Known in turn as National Assistance, Supplementary Benefit, Income Support, and the Minimum Income Guarantee.

testing than was embodied in the old systems of means-tested support, as a way of reducing the sharpest disincentives to save. The amount of Savings Credit depends on pension income (including from S2P) in excess of the basic pension. One side-effect of the way it is calculated is that over time, as the basic pension loses relative value, but S2P rises for younger cohorts who have been on low earnings, the value of Savings Credit and the proportion of pensioners affected by it would rise.

Figure 4 shows the Commission's projections of what would happen to public spending on pensioners (including other benefits such as for disability and Housing Benefit) if current indexation arrangements continued indefinitely, and allowing for the increase in women's SPA from 60 to 65 between 2010 and 2020. Despite the increasing number of pensioners, spending on the BSP would fall as a share of GDP, but the total of the BSP and S2P would remain just around 4 per cent of GDP as the latter became more mature. However the cost of Pension Credit (both elements combined) would increase rapidly. As a result the total, currently around 6.2 per cent of GDP, would reach about 7.6 per cent of GDP by 2050.

[Figure 4 about here]

This increase is substantially more than official projections suggested under similar assumptions just a few years ago, partly because of improved life expectancy projections, but also because of more realistic projections about future private pension income, taking account of the trends described above (which increase the prospective costs of means-tested benefits). But it is still much less rapid than the increase in the number of people over the State Pension Age over the period. This implies that relative to current incomes, spending per pensioner would fall. But the calculations assume that the poorest pensioners are protected, and increasing pensioner poverty avoided, through earnings-indexation of the guarantee credit level. Combined with increases in the generosity of S2P accrual for lower earners, the effect of this is that the state would be doing more for those with low lifetime earnings, but less for those with middle or high earnings, particularly if they have even modest private pension income.

Figure 5 shows the end result of this – illustrated for cases where people retiring in 2050 had saved 10 per cent of their earnings above the equivalent of £5,000 relative to today's earnings, for a range of earnings up to the equivalent of £50,000 per year. In effect, the system is evolving from one which involves a substantial degree of earnings-relation for today's retirees to one which is, in a rather complex way, roughly flat-rate.

[Figure 5 about here]

If this evolution happened, its results would be progressive, in that it would tilt spending that was growing more slowly than the pensioner population towards those with lower lifetime earnings and lower private pensions. But there would be a price, illustrated in Figure 8 below: the proportion of pensioners affected by means-testing though one element or other of the Pension Credit would rise from just under 40 per cent today to 75 per cent by 2050. Notably, with the much reduced value of the basic

pension, nearly 40 per cent of pensioners would need to claim the GC to reach the minimum income set by the state, compared to just under a quarter today.

(c) Working longer

Alongside greater savings and/or higher public spending, the third possible response to population ageing is for people to work longer. Here there is an important difference between long- and short-term trends, as shown in Figure 6. Between 1950 and 1995, effective retirement ages for both men and women fell by about four years. This meant a steady increase in the proportion of adult (over 18) life spent in retirement – from 18 per cent for men and 26 per cent for women leaving the workforce in 1950 to 31 and 36 per cent respectively for those leaving it in 2005 (PC, 2005, figure 1.44). In effect, people retiring today can now expect to spend about a third of their adult lives in retirement, compared to less than a quarter for retirees in the 1950s and 1960s. Later entry into the labour market (see Banks and Smith in this volume) has compounded this trend.

[Figure 6 about here]

However, the figure also shows that in the last ten years effective retirement ages have risen by about one year, a rate almost fast enough to stabilise the proportion of adult life in retirement. This suggests that change is possible – but, it should be noted that this has happened against the background of a buoyant labour market, greater reluctance of companies to use their (now under-funded) pension schemes to pay for restructuring and redundancy, and greater reluctance by the public sector to use early retirement onto incapacity benefit as a way of disguising unemployment. As Whiteford (this volume) shows, the UK is mid-way through the OECD range in its effective age of retirement, but other countries including the Nordic states and the USA have significantly higher ages.

(c) Poorer pensioners

One result of the developments in both public and private pensions described above is that average pensioner incomes have risen relative to the population as a whole. While the gains have been much faster for better-off pensioners than for those in the poorest quarter of pensioners, the proportion of pensioners in relative poverty has fallen significantly, in recent years particularly because of the substantial rise in the relative value of the Guarantee Credit since 2000.

Nonetheless, pensioner incomes in the UK are still not high in international terms. The median income of those aged 65 or more was about 75 per cent of that of those under 65 in 2001, compared to an average for the then 15 members of the EU of about 85 per cent (PC, 2005, figure 2.2). Relative poverty for the UK's elderly population was below only that of Ireland amongst 17 countries covered by the Luxembourg Income Study at the end of the 1990s (Hills, 2004, table 3.6), and even allowing for the introduction of Pension Credit between a sixth and a fifth of pensioners were expected to have incomes below 60 per cent of the population's median in 2004-05 (Sutherland, 2004, tables 1 and 2).

In our first report we suggested that as a Commission we did not see the option of poorer pensioners as being an attractive response to the pressures the UK's pension system is under. None of the more than two hundred organisations and individuals giving evidence to the Commission disagreed (PC, 2005, appendix B). Focus groups carried out for the Commission put this option last out of the four responses, with very little support for it even as an element of a solution (PC, 2005, appendix D, pp.106-7). Quantitative research for the Commission suggested that the benchmark target replacement rates proposed in our first report (around two-thirds gross replacement for median earners but more for lower earners), lay between those regarded by the majority of people as being giving a "minimum" and "comfortable" level of retirement income for those with median earnings, but a higher figure of 80 per cent replacement fell short of these levels for those with low earnings (PC, 2005, appendix D, pp. 128 -132).

Our recommendations therefore propose combinations of the other three responses that could meet the demographic challenge and help to ensure that people's aspirations are more likely to be met while protecting the gains that have been made in reducing pensioner poverty in the last decade. But the next section examines whether there are alternatives to pension incomes that either reduce or remove the need for policy change.

III. ALTERNATIVE SOURCES OF RETIREMENT INCOME

We therefore face a combination of an ageing population, falling contributions into funded private pensions, and an already comparatively ungenerous state system which will become less generous per pensioner. This suggests potential problems for retirement incomes in the UK in the long-run. These would come on top of the gaps and inadequacies that already exist for particular groups, for instance many women with interrupted paid-work careers or self-employed people.

However, people have other assets which they may be able to rely on rather than pension rights. Further, as the discussion above makes clear, the cohorts that have recently retired or are nearing retirement have, taken as a whole, much better state and private pension rights than previous generations. Together these could mean that we do not need to worry about trends in pensions *per se*, or at least that we could wait before taking any action.

First, households have net non-pension financial assets equivalent in value to about half of their wealth held through pension funds and life assurance (PC, 2004, figure 5.1). In theory, these could make a substantial difference to retirement incomes. However, they are very unequally distributed, and those with significant financial assets tend to be those who also have good pension rights. Even for those near retirement the amounts involved, while not insignificant, are generally small by comparison with prospective pensions. Median holdings for non-retired 55-59 year-olds with median full-time earnings are for instance around £33,000, an amount which would produce an annuity income of about £1,700, or about 8 per cent of median earnings (PC, 2005, p. 76, based on data from the English Longitudinal Survey of Ageing, ELSA).

Much more significant and widely spread is housing wealth which, net of mortgages, now exceeds the value of funded pension rights. For the same group of median income 55-59 year-old households net housing assets were around £150,000 in 2002. If all, or even some, of this equity could be realised, it could make a substantial difference to retirement incomes. This is clearly important, but its implications need to be considered carefully:

- First, the growth of owner-occupation which these assets result from means that an important part of consumption in retirement is pre-funded: one would expect required replacement rates for owner-occupiers to be lower than for tenants to produce the same standard of living.
- Second, while this advantage would be lost if houses were sold entirely, some households will be able to liberate equity by trading-down. However, the scope for those on low- to middle-incomes to do this should not be exaggerated. As an indication, the difference between the average prices of semi-detached and terraced houses in England and Wales in early 2004 was about £23,000, only about 30 per cent of the implicit capitalised value of the basic state pension (PC, 2004, figure 5.18).
- Other households may be able to take advantage of "equity release" products, which give income now in return for surrendering what would otherwise be part of an inheritance. The return on such products is, however, low, reflecting the risks for insurers of taking on the compounded uncertainties of the longevity of those who choose to buy them and future house prices.
- Other households may be able to take in lodgers – the rent of a room being quite significant by comparison with state pensions – but this would not be attractive to all.

There are, however, other potential calls on housing wealth, not just people's desire to leave an inheritance, but particularly as a potential source of funding for long-term care in old age, which may limit people's willingness to realise their housing wealth for consumption in earlier retirement.

But what is potentially the most important role of housing wealth is through its role in inheritance. This is changing fast. Until the early 1990s, the majority of those aged over 80 were not owner-occupiers. Now two-thirds of them are. At the same time, three-quarters of 45-59 year-olds are owners (PC, 2005, figure 1,32). As a result, we have a new phenomenon, where some of a generation who are largely already owner-occupiers stand to inherit a house or a share in one, with a value which could make a very substantial contribution to their income in retirement.

This does not solve the problem of inadequate prospective pensions for the generation currently in their thirties or forties, because the benefits of such inheritances will be unevenly spread, and many will receive little or nothing. But it does suggest some caution in assuming that pensions will be the only potential source of retirement income for all, a consideration which affects the principles underlying our recommendations outlined in section V.

But even taking account of such limitations, the prospects for the generation near retirement are quite bright. If one looks only at current individual pension participation, around two-fifths of 50-65 year-olds appear to be in danger of having

replacement rates below the benchmark standards we suggested in our first report. But if one looks at assets more widely, using data newly available from ELSA analysis from the Institute for Fiscal Studies suggests that the proportion of 50-65 year-olds with potentially inadequate replacement rates could fall to 16 per cent, assuming that *all* non-pension financial wealth anticipated inheritances and *half* of housing wealth were liquidated to create retirement income (PC, 2005, figure 1.30).

Given the limitations to realising even half of housing wealth discussed above, this may be over-optimistic, but what is clear is that those closest to retirement are in a comparatively strong position. This follows from the trends described in section II: not only are those recently retired or near retirement those with the most valuable private pension rights, they are also enjoying the most generous combined payments from the state system. For instance, if one looks at the state pension income of someone who had average earnings throughout working life and a full contribution record, the state pension (BSP and S2P combined) on retirement would have been around 18 per cent of average earnings in the 1950s and 1960s, but rose above 25 per cent in the early 1980s and peaked at over 35 per cent for those reaching SPA in the late 1990s (when SERPS rights were at their most valuable). It would remain above 30 per cent of average earnings until 2015, but by 2035 it will have fallen back below 25 per cent again (PC, 2005, figure 1.3).

The problems that most concern us are therefore for those retiring after 2020, that is, currently aged less than 50. As Banks and Blundell from the ELSA team put it, "The currently retiring cohorts are the first generations to face less generous pension provision than their predecessors. This downward trend is set to continue….As such, other things being equal unless the younger cohorts arrive at 50 with more private assets, and/or greater (and realisable) expectations of retiring later … the inadequacy of retirement resources will be great than identified in these cohorts [aged over 50]."

But if the most acute problems do not emerge until 2020 or later as all this suggests, is there any need to take action now – why not just wait and see, and "muddle through"? Undoubtedly, we could do this: after all, the numbers will eventually have to add up in some way or another. But we do not believe that a muddle-through option would be a good one.

First, it would be very varied in its effects. Some groups will continue to do as well as now – people who became members of good private occupational schemes before they were closed to new entrants, the highest paid company executives, many within the public sector (even if their pension age rises to 65), and – relative to their equivalents today, if the Guarantee Credit remains linked to earnings – those with the lowest incomes. But many others would not. They would either face much lower retirement incomes than they might anticipate or much later retirement, if they can find work.

Second, in straightforward political terms, the elderly population will be a very large proportion of voters. If pensions are seen as inadequate – and particularly if seen as unfairly distributed between favoured groups and others – the pressure for government to do something about it through increased public spending will be intense. But such ad hoc adjustments are unlikely to be as economically efficient or as fair as those which we could plan for now.

The problem with pensions policy is that the lead times are so long. People need time to adjust their plans. For instance, the original government proposals for equalising men and women's pension ages were published in 1991, but the change does not start to happen until 2010. Funded pension rights being accumulated by people now in their thirties will still be being paid out in fifty years' time.

It is crucial that the comparatively strong position of the generation near retirement is used as an opportunity to build up changes for the future, rather than as an excuse for ignoring the long-term trends.

IV. FUNDAMENTAL ISSUES

In framing our proposals we take account of a series of findings about the working of the current private and public pension system in the UK. In particular, there are barriers to existing gaps and inadequacies being removed simply by hoping that voluntary decisions will lead to a reversal of the adverse trends.

Where people are not members of a comparatively large occupational scheme, costs are high. Although the annual charges for the recently introduced "stakeholder" pensions sold individually are a great deal lower than for personal pensions in the past, they still embody an annual charge which could average around 1.3 per cent of an accumulated fund. This is a large proportion of the real returns that can realistically be expected over the long run. As a measure of this, the eventual pension that might result from a scheme facing the annual costs of around 0.3 per cent enjoyed by larger occupational schemes would be 25-30 per cent higher than from one facing 1.3 per cent annual costs.

These costs are not necessarily the result of excessive charges by insurance companies, but are inherent in the nature of individually-sold pension products, which embody large initial lump sum costs, which are often spread out over quite short membership periods as a result of "non-persistence", for instance as people change jobs and join the scheme of their new employer (PC, 2005, appendix F). Because they tend to be lump sum amounts per policy, these costs are proportionately high for those saving relatively small amounts, that is, precisely the low- to middle-earners working for small and medium sized companies where current provision is lowest.

Savings behaviour does not follow the optimizing pattern predicted by some economic models. Instead, people procrastinate about difficult financial decisions and display considerable inertia. Interestingly, it appears that membership of otherwise identical pension schemes in terms of incentives such as employer contributions is much higher when people are automatically enrolled into them, with the right to opt out, than when they have to make a conscious decision to opt in.

The UK pension system is – perhaps understandably – poorly understood, and that understanding has if anything declined in recent years: in 2000, only 53 per cent of the population reported at least a "reasonable, basic" knowledge of pensions, but by 2005 this has fallen to 47 per cent (PC, 2005, figure D6). At the same time, levels of trust in pension providers and financial products are low. Even if people do realise that their pension will be inadequate, this combination makes it very hard for them to

make a plan to do something about it, as qualitative research for the Commission confirmed (PC, 2005, appendix D).

It is not that people necessarily need to understand the precise details of how their pension is calculated, but rather that they need to be able to have confidence in how it would be affected by their actions, for instance, if they increase or decrease their savings levels. This appears, again perhaps understandably, to be lacking.

Recent changes to means-testing have ambiguous effects on different people's rational incentives to save (Sefton, van de Ven and Weale, 2005), and indeed there are some people with below average incomes who actually have strong incentives to save via pensions as a result of the operation of the tax credit system for those in work (PC, 2004, pp.237-239). But few people know this, and the complexity of the system is one of the reasons for the low level of understanding. The potential future spread of means-testing makes it hard to give people a clear message that it is in their interests to save. Independent financial advisers tend to believe the incentives to accumulate pensions are weak for those with annual earnings below £25,000 (PC, 2005, figure 1.23). Indeed, they fear that they might be open to accusations of "mis-selling" if they sell to people later affected by means-testing, particularly those with earnings below £15,000.

While higher employer contributions do increase people's propensity to join pension schemes, and large employer schemes have substantial running cost advantages, employers are retreating from providing them. The full value of what they had – sometimes unwittingly – been offering has become apparent, as has the exposure to risk that Defined Benefit schemes embody for employers, but the labour market advantages of offering generous schemes (or penalties from withdrawing them) have been less apparent.

And while the fundamental pressures on the system as a whole result from demographic change, people do not appreciate either their own life expectancy, or the extent to which it is likely to improve further for currently younger cohorts. Our own surveys confirmed recent research by O'Brien, Fenn and Diacon (2005) suggesting that younger cohorts simply do not anticipate the increase in their life expectancy that actuaries now predict: people judge things by what happened to their grandparents and parents. The difference between people's expectations of how long their retirements might be combined with when they expect to retire generate anticipated life expectancies which are 3-4 years below the Government Actuary's most recent projection for survival beyond 65 those aged 56-65, but 6-9 years lower for those aged 26-35 (PC, 2005, figure D.36).

These perceptions mean both that people may not appreciate the full value of the pension rights they could accrue (or of annuities when they come to buy them), compounding the problems of inertia and myopia. They also mean that the politics of achieving adjustments in pension systems and pension ages are much harder.

Finally, although our task as a Commission was to look at the long-run outlook for pensions, we were also asked to look in particular at the position of women within the system. As Chapter 8 of our first report laid out, while there are some improvements in women's pension rights under way, in general women have much weaker rights

than men. This is not just as a result of lower private pensions reflecting lower lifetime earnings, but also as a result of gaps in the state system, even when "credits" for periods looking after children or in other caring activities are taken into account.

V. THE ROLE OF THE STATE

The problems and trends described above mean that it is not possible to suggest reforms to private pensions without also looking at the future structure of the state system. It is this structure that both sets the level of income on which people will need to build through private provision, and determines the incentives for them to do so. To do this implies the need for a view of the appropriate role of the State (see Barr and Diamond in this volume).

There are varied views on this. The appropriate role will also vary between countries, depending on their legacies of accrued private and public pension rights and political culture. At one end, some have argued that the State's role should or can *only* be that of poverty relief. At the other, people argue that the State should also organise earnings-replacement for all or nearly all, as indeed has been the case in many continental European countries.

But as the previous section implies, if the State's role stops at poverty relief many will end up discovering themselves under-provided for or pay very high costs to get what they want. On the other hand, the UK tried earnings-replacement when SERPS was introduced in the late 1970s, but we never really accepted the implied cost. Effectively we paid for SERPS by reducing the cost of the flat-rate BSP through the price-linking of the last 25 years. Those most dependent on the basic pension – the low-paid, women, and the self employed – have been the losers. The most recent reforms – and the move to the complex flat rate system described above – can be seen as ways of trying to wind back this clock.

At its heart, the Commission's recommendations accept the arguments put to us that the State should concentrate its *redistributive* power on providing a minimum platform on which people can build. But we suggest that its role does not stop there, and that it should use its *enabling* power to help people to achieve the levels of earnings-replacement they generally desire.

In particular, we propose that there should be new, low cost system for saving for a pension into which people would automatically be enrolled, harnessing the power of inertia to improve accumulation of funded pensions. However, people have very varied circumstances in terms of other assets or potential sources of retirement income, as discussed in the previous section, and very varied views of what would be an adequate income in retirement (PC, 2005, figures D.28 and D.29). We therefore suggest first that people would have the right to opt out of this system, and second that that the *automatic* system only takes people towards part of the replacement rate people see as desirable, say 45 per cent for those with median earnings, rather than the two-thirds replacement from all sources that most might see as desirable. However, the system would help and encourage people to save more towards that kind of target.

In summary, we suggest that, given the particular history of the UK system, the State should set its objectives as to:

- **Ensure** that all people are kept out of poverty in retirement
- **Encourage** people to achieve at least a base load of earnings-related pension provision
- **Enable** all people to save for a pension at low cost

VI. THE COMMISSION'S RECOMMENDATIONS

To achieve these objectives, we propose three linked areas for reform:

(a) Introduction of a low cost, funded National Pension Savings Scheme (NPSS), with employees automatically enrolled into this or good quality existing employer schemes. People would have the right both to opt out and to make additional contributions above the automatic minimum.
(b) This should be under-pinned by a less means-tested, more universal, flat-rate state pension than would result from unchanged policies. The cost of this, in the face of the demographic challenge described in the Introduction, implies facing the reality of need for *both* for public spending on pensions as a share of national income *and* state pension ages to rise in the long run.
(c) As a corollary of the last point, and indeed of increasing life expectancy, we suggest that a series of measures is needed to facilitate later retirement.

(a) State pension reforms

It is simplest to start with the state system, as this sets the framework for what would be needed from the NPSS or existing occupational schemes. The less generous the state system, the more that would be needed from funded additional savings to reach any given replacement rate. And the practicality of achieving a low cost system depends on avoiding a wide spread of potential means-testing, which could create the need for expensive individual advice, undermining the potential to secure the cost advantages of automatic enrolment.

There are many different ways of achieving the kind of an adequate, more universal, flat-rate platform on which people can build without means-testing spreading still further, which we suggest as the basic objective. If also, as we believe essential, a future system has at its heart the ability of women to have an independent income in retirement, demography implies that in the long-run *both* the SPA and public spending will have to rise. How much each does so is a trade off. The lines in Figure 7 below labelled as "proposed range for debate" show what spending would be needed simply to pay a flat amount equivalent to the current Guarantee Credit level as a state pension to each individual above particular ages (together with other pensioner benefits such as for disability or Housing Benefit).

In the short-term there are gaps in the system, but as sections II and III have shown, many people do have good rights from S2P and DB pensions. To achieve *structural* reform, the case for higher public spending than now comes later – although the impact of the rise in women's SPA after 2010 creates some latitude for reinvesting savings in measures that would begin to build long term reforms within the current level of spending as a share of GDP.

In dealing with increasing longevity, there is a strong argument that equity between generations implies that SPA should rise in some way in *proportion* to life expectancy. Indeed, if we were *only* dealing with increased longevity, this could allow constant spending as a share of GDP. But we are not – we are now facing the impact of fertility declines after the baby boom. Putting all of this cost on the near-retirement generation by increasing SPA far faster than life expectancy seems unfair, and unlikely to be politically acceptable.

The least aggressive approach would say that once men's and women's SPAs are equalised in 2020, the proportions of adult life spent in retirement should be kept constant. At that point the Government Actuary's current principal projections would imply average life expectancy at 65 of 22 years. Noting that that is half of adult life since 21, we could establish a "two for one" rule – two years after 21 before SPA for every expected year after it. A rule of this kind would be a more robust way of coping with uncertainty in future life expectancy than trying to set definitive state pension ages decades ahead. That kind of rule might take the SPA to 67 by 2050 under current projections – but with the implication that spending would need to reach around 8 per cent of GDP compared to 6.2 per cent of GDP today to achieve the individual flat rate pension described above.

At the other end, it is hard to imagine a reform in which the length of life after pension age actually *shrank* from where it is now as being politically acceptable. That would put a limit – again on current projections – of about 69 by 2050, which would allow public spending to achieve the same aims to be somewhat lower, at around 7 ½ per cent of GDP.

This is the kind of long-run structural trade-off that we believe faces us. And note that while this gives the uncomfortable message that *both* pension ages *and* spending on pensioner benefits as a share of national income need to rise after 2020, in both cases the rise is gradual. This range means for instance that today's 50 year olds, men and women, would still have an SPA of 65 as currently planned, but today's 40 year-olds could expect something around 66.

There are several different ways one could design a more flat-rate, less means-tested state pension that provides a platform on which people can build – and be persuaded to build – additional funded rights. Our report discusses in detail the pros and cons of some alternatives, but we reach the conclusion that, faced with the huge complexity of where we start, it is actually simpler to evolve from the current system, than to face the costs or what turn out to be great transitional complexities of a "big bang" immediate introduction of, say, a "Citizen's Pension".[5] What we propose as our preferred way forward has five elements.

1. Building on recent reforms, by accelerating the evolution of the State Second Pension to become flat-rate, with improved carer credits.

[5] A Citizen's Pension would replace existing state pensions, paying a flat amount to all individuals, based on residence in the country over a recent period. Within such a system there is a variety of choices about how the rights people have accrued in the past to state pensions would be treated.

2. Indexing the Basic State Pension to average earnings growth over the long term, and moving *accruals* of future rights onto a universal, individual basis.
3. Maintaining the recent progress which has been made in reducing pensioner poverty through the improved generosity of Pension Credit, but limiting the future spread of means-testing by freezing the real value of maximum Savings Credit.
4. Accepting that this kind of structure requires increases in both the State Pension Age and the level of public spending as a share of GDP in the long-run, with a trade-off between the two.
5. Ideally pay the Basic State Pension to all over 75 on an individual basis.[6]

The last element is proposed as the simplest way of dealing with past deficiencies in the state system, particularly for women, consistent with our proposed long-term reforms. It would, however, have short-run costs, and is not an essential element of the long-run structure we propose as a more secure base for the accrual of future rights.

If the first four elements were implemented from about 2010, the costs (subject to the usual health warnings about the inherent uncertainties of such projections) could be as shown in Figure 7 – the solid line shows their trajectory if the rise in SPA after 2020 reached 68 by 2050 for today's 23-year-olds, and the dots showing where it would reach on rules implying more or less rapid change at either end of the range described above.

[Figure 7 about here]

Such an increase in spending would, of course, be painful for tomorrow's taxpayers, even if it is to below a level which many other countries have already reached, even before their less favourable demography kicks in (see Table 1 in Whiteford's contribution to this volume). *[Editors: please check still Table 1.]*

The dashed line in the figure shows the total of spending if current indexation arrangements for state pensions continued indefinitely, as in Figure 4 (in particular with the BSP price-linked, but the Guarantee Credit earnings-linked). Two points should be noted. First, in the long-run, the cost of our preferred way forward is only slightly higher than would result from existing arrangements, but with no change in SPA after 2020. Second, in the medium-term, up to 2020, the cost of our proposal would be roughly constant as a share of GDP, but under existing indexation arrangements, spending would *fall* as a share of GDP as women's SPA rises. Clearly the choice such scenarios will depend on political priorities and competing pressures, but our analysis suggests that delaying the changes we suggest much beyond 2010 would lead to a less satisfactory long run structure and would make it harder to give clear messages to potential savers about the environment within which they would make savings decisions.

[6] With a recent residence test of the kind already embodied in "category D" pensions – these are paid (but at a lower level than the full basic pension) to those aged 80 or more who have been resident in the UK for at least ten out of the previous 20 years.

If indexation arrangements continued as now, our modelling suggests that there would be a substantial increase in the numbers affected by means-testing through the two elements of Pension Credit, as shown in the upper panel of Figure 8. Under our preferred alternative there would instead be a decrease, both in the proportion of pensioners affected at all from today's levels, *and* in the numbers requiring toclaim Guarantee Credit to make their income up to the State's minimum, rather than this rising to nearly 40 per cent.

[Figure 8 about here]

Under the current evolution of the system, the state will be reducing the pension it would be offering a typical earner with modest savings reaching 65 in 2030 or 2050 from its current level in mid-retirement. Our proposals would mean that instead, it would be slightly higher (PC, 2005, figures 6.4 and 6.19). The total state pension for typical cases with low life-time earnings and/or interrupted paid work careers would also grow slightly from the level for equivalent people reaching 65 today.

(b) National Pension Savings Scheme

Crucially, reforms of the kind described above would mean that people would not be losing the benefit of their pension saving through reduced Pension Credit, as they would if it spread in the way implied if current indexation continued indefinitely. This gives the underpinning needed for the second leg of our proposals – the message that, except for those in very unusual circumstances, saving for retirement is a good deal, and so enrolment in the National Pension Savings Scheme would be an offer you would not want to refuse.

The state system also sets the challenge for how much might be needed. As outlined in the previous section, the variation in people's circumstances and preferences means that we are a little cautious in the aims we set for the state to use the power of inertia in "strongly encouraging" people to build up a base-load of retirement income. For instance, if 45 per cent were set as the minimum base-load replacement rate that we should be aiming at for a median earner, the state system we suggest would get two-thirds of the way there. Another 15 per cent would be needed from private saving on top. To get that, for someone starting saving at 30, would need contributions equal to about 6 per cent of total gross pay (assuming retirement at 67 and a 3.5 per cent real return on investment).

To achieve this we suggest the following design for the default contributions to the NPSS, which everyone would be in, unless their employer was enrolling them into a good quality occupational scheme, or they chose actively to opt out:

- Minimum default contributions set at about 8 per cent of earnings between the income tax threshold and an upper limit, made up of:
    - 4 per cent from the employee's net pay,
    - 1 per cent from tax relief (if they are basic rate taxpayers), and
    - a 3 per cent compulsory employer matching contribution (which would have an aggregate net cost of about 0.6 per cent of labour costs).
- Additional contributions allowed up to twice this amount for a median earner (with voluntary rather than compulsory matching by employers).

- Contributions would be collected through the PAYE system or a newly created Pension Payment System.
- Funds would be invested on individuals' instructions, generally in funds bulk-bought at low cost, including default and low-risk gilt funds.

While we do not propose a general reform of tax relief for pension contributions, we also suggest that the government should examine in detail the case for a specific regime for the NPSS, giving a single rate of up-front matching payments (instead of tax relief on contributions and tax-free lump sums on retirement).

We also see the NPSS as a way of *enabling* people to save more at low cost – allowing them to get them closer to the two-thirds replacement rate people around median earnings tend to set as their objective. Put together, the elements of our proposals would build up in the way shown in Figure 9. By 2050, the two tiers of the state system would together generate a largely flat rate state pension of just over 30 per cent of median earnings (£125 per week in today's terms). Depending on how long someone maintained their enrolment, median earners might add a further 15-18 per cent through the automatic part of the NPSS, but could double this through voluntary additions to the system.

[Figure 9 about here]

The funds in the NPSS would be invested at each individual's discretion – but generally in bulk-bought funds of different kinds at the low management costs this kind of system would allow, potentially at around 0.3 per cent of accumulated funds. People would be building up their own asset – funds worth up to £161,000 (relative to today's incomes) for someone on median earnings saving the maximum amount.

The lead times involved for the scheme to reach maturity are of course long, but by 2050 it could be producing the 0.6 per cent of GDP needed to offset the likely fall in private pension savings we foresee, and by 2060 its output could be more than 1 per cent of GDP (PC, 2005, figure F.42).

Put together, we believe this is a progressive package involving the painful realities of later retirement, higher revenues needed for state provision in the long run, and greater private saving, but offering a better deal to women, carers and the low-paid than now on offer:

- The NPSS opens up low-cost earnings-replacement pension savings to those previously excluded from them.
- The very poorest pensioners, those failing to claim current entitlement to Pension Credit, would gain from automatic rights through the basic and state second pensions.
- State pension spending would be increasingly concentrated on individual rights to flat-rate minimum. Several elements of this would particularly benefit women:
  - Indexation of BSP to earnings would halt decline in its relative value.
  - Accruals of *future* rights to the basic pension would be on a universal (residence-based before retirement) basis.
  - Credits for carers would be improved within S2P.

– The proposals would mean reduced, not increased, reliance on benefits based on a family means-test.
– And we suggest the desirable addition of *payment* of the basic pension on a residency basis to all over 75 (building on existing 'Category D' pensions).

(c) Facilitating later working

But there is one further issue of which we are very aware – the trends in life expectancy discussed in the Introduction are averages for the population as a whole, but the UK has shamefully large differences in life expectancy by social class – five years between the least and most favoured social groups of men aged 65 still. And while all social groups have gained life expectancy, the gaps show no sign of narrowing (PC, 2005, figure 1.41). As a corollary the *proportionate* – but not absolute – impact of an increase in SPA of the kind proposed above on, for instance, manual workers would be greater than that on professional workers. While this should not be a reason to avoid the inevitability of state pension ages rising with life expectancy, it does mean that it is essential that any reform taken as a whole has to be progressive in its impact in other ways.

It also means that as a corollary of pension reform, it has to be a high priority to address the causes of such inequalities, crucially doing so *earlier* in people's working lives. Our proposals for the SPA do not affect those currently aged 50 or more, but they might mean an increase in SPA of around one year for those currently aged 40. This means that the key occupational health problems in this regard are not necessarily those affecting former heavy industrial workers now in their late fifties and early sixties, but the next generation of workers, facing different problems – but with the opportunity for action to do something about these problems over the next two decades through an focus on occupational health *earlier* in working lives.

We also believe that long-run pension reforms should be accompanied by an agenda that facilitates later working and gradual, rather than sudden, moves into retirement. We set out the elements of this in more detail in Chapter 8 of our second report, but they include:

- More focus on the education and training of older workers.
- Allowing earlier claim of the means-tested Guarantee Credit than the SPA (for instance, claims could be allowed at 65 even after the as the SPA rises above it).
- We suggest an option for increasing the pension age for the basic state pension more slowly than for the state second pension.
- Removing the default retirement age of 65 still allowed by the anti-age discrimination legislation which takes effect in October 2006.
- Improving knowledge of the advantages of deferring state pensions (which are then paid at a permanently higher level) and allowing people to claim part of their state pension while deferring the rest of it, supporting, for instance, a transitional move into part-time work.
- Incentives for employers to hire post-SPA workers (such as reduced employer NICs).

VII. CONCLUSION

Our report and recommendations were submitted to government and published in November 2005. The Government has promised a White Paper in response in the Spring of 2006. We believe that the major issues and choices for the future of pensions in the UK should be widely debated. Any reform of the kind we propose will only be successful if it can command a wide degree of consensus, not necessarily on the details, but on the broad principles underlying its architecture. It will be much easier for people to make plans to handle their retirement incomes if they can have some degree of certainty about the rules of the system within which they will make those decisions.

In some ways the UK is favoured in the less dramatic demographic changes it faces than some of its European neighbours and in the comparatively good outlook for many of those recently retired or near retirement. This gives us an opportunity to make adjustments which, while inevitably painful in one way or another, would allow us to achieve a sustainable pension settlement for the coming decades of this century. The problems in our pension system will grow increasingly worse unless a new settlement is now debated, agreed and put in place.

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