

PENSIONS REFORM GROUP

RESPONSE TO THE FIRST REPORT OF THE PENSIONS COMMISSION

Introduction

1. The Pensions Reform Group (PRG) was formed in 1999 to consider the best long-term public policy response to pensioner poverty. We have since published two reports, the latest being *Universal Protected Pension: the Follow-up Report*.¹ A list of PRG's members and those who have sat on PRG working groups is attached in the appendix.
2. We welcome the Pensions Commission's First Report (referred to in this response as "the Commission" and "the Report" respectively) as a thorough analysis of the challenges posed by the ageing of the UK population. The Report provides an objective starting point for an informed public debate before a Final Report later this year.
3. The Report asks for views on a wide range of issues. This response does not attempt a detailed assessment of all the Report's presentation of data and trends. Instead this response addresses a key aspect of retirement provision – the case for an adequate basic minimum retirement income - and how we believe this should be delivered.

Structure of response

4. This response is structured as follows:
 - Part 1: The case for an adequate basic minimum retirement income
 - Part 2: The Pensions Reform Group's proposal: The Universal Protected Pension

1. THE CASE FOR AN ADEQUATE BASIC RETIREMENT INCOME

The Pensions Commission

5. Whatever the immediate reasons were for establishing the Commission, the public reaction was to welcome the Commission's formation and to look to the Commission to lay the basis for a new and lasting political consensus on pension policy. In its report the Commission made five preliminary observations relevant to achieving this objective.
 - we must act decisively to make good past failure;
 - on present trends over 9 million people will face inadequate retirement income;
 - people do not make rational decisions about saving;

¹ Available at www.pensionsreformgroup.org

- the UK's pension system is complex, and for many low to moderate earners provides poor incentives to save;
- trust in both state and private pension provision is low.

The four unavoidable choices of ageing

6. The Commission also identified four 'unavoidable choices' for society caused by the ageing population, and suggested option 1, future pensioners being poorer on average relative to the rest of society, is unlikely to be attractive, 2 an increase in tax/National Insurance Contributions devoted to pensions, 3 saving more, and 4 an increase in average retirement ages. The first of these choices lacks electoral support, and there are significant barriers to solving the problem through a sole reliance on any one of the other options - judgements with which we would agree.

A new kind of politics – the politics of ageing

7. The Commission's Report breaks new ground in two significant respects. First, it gives detailed figures on the scale of the redistribution of resources from the working to the retired population required simply to maintain existing living standards for the retired. To maintain overall pensioner income at the current level requires over the next 50 years an increased in the share of GDP consumed by pensioners from 9.9 per cent to 15.1 per cent – an increase of over 50 per cent. Britain has never faced an inter-generational transfer of resources on this scale before. But, in addition, ageing will almost inevitably lead to increased health and care bills. The country is therefore faced with an even greater redistribution to the elderly than the figures above imply.
8. As the era of class politics in this country closes, with its agenda of redistributing income between different social groups, the Commission sees a new agenda opening up centring on a redistribution between generations on an unheard of scale. A new kind of politics will be necessary to sustain a peaceful transition from the old to the new redistributionist agenda. The Commission sees the building of a new consensus as the most likely means of successfully negotiating this new agenda and we agree.
9. While we also believe redistribution as a concept is inevitable we would prefer to see generations largely contributing to their own pensions to mitigate the burden on future generations.

Key aspects of the Pensions Commission's analysis

10. In addition to identifying the four choices available in response to demographic change, and the extent of redistribution required to maintain average living standards for pensioners, there are a number of key aspects of the Commission's analysis that are particularly important for any Government response.
 - **the decline of defined benefit provision:** much of post-war pensions policy has been based on a wish to see final salary schemes extended throughout the population. Yet the Commission's estimate of the rapid shift away from defined benefit (DB) schemes – a fall of 10 per cent in the number of active members of open private sector DB schemes since 1995, from 60 per cent to 50 per cent, with the Commission

estimating a further fall of 10 to 20 per cent in the future – carries important policy implications.

We suggest that the demise of private final salary provision has now passed the point of no return, and that the restoration of the status quo ante is not a viable policy option, even if the Advanced Corporation Tax advantages were fully restored.

- **Lower retirement savings than officially estimated:** the Commission's data indicates that the annual inflows to funded pension provision are significantly smaller than was previously thought. The Commission's calculations for 2002 suggest long-term savings are only at about two-thirds the estimate recorded by ONS/Blue Book data - £40bn rather than £61bn. Moreover, the Commission notes that about £11bn of the £40bn contributions is invested via contracted-out rebates which would otherwise ultimately have to be paid out through SERPS/S2P. Again this has important implications for policy. Advocates of a **Citizen's Pension** propose redirecting the contracted-out rebate currently used to finance pension investments to finance an immediate and large increase in pay-as-you-go state benefits. If this reform was accepted it would reduce to around £29bn the level of savings being made in funded pension provision (or half the current official estimate). It will also make it near impossible to achieve the Government's objective of reversing the current 60:40 ratio of state to private pension provision (which in economic terms can be interpreted as the ratio of pay-as-you-go to funded provision).
- **Benefits of funding:** the Commission suggests that an increase in funded provision can raise the long-term growth rate of the economy. Again this has significance for future policy in an age when the scale of the redistribution from the working to the non-working population will need to be at an historic high. The larger the national income, the easier it will be to achieve this redistribution.
- **Individual pensions are unlikely to deliver attractive returns for those on modest incomes:** the Commission's finding that providers' charges can wipe out 20 – 30 per cent of an individual's pension fund suggests that it is a mistake to look to the private market alone for a solution of the provision an adequate minimum pension. The higher average returns of funding compared to pay-as-you-go could be lost unless a mechanism can be found for providing funded pensions with sufficiently low reductions in yield. The Commission noted that the reductions in yield for large DB occupational schemes were much lower. We believe that, for political and economic reasons, compulsory funded pensions require similarly low charges.
- **Voters' views on the four choices:** the Commission tested with voters its four unavoidable choices. The results are again significant for policy. Voters do not favour a scenario where future pensioners will on average be poorer relative to average net incomes than they are today. There is support however for a mixed policy of increasing the retirement age somewhat and combining that policy with an increase in savings. We believe our proposals for a Universal Protected Pension (UPP) set out later in this response, fit the parameters set by voters for long-term pension reform.

Ideas of adequacy

11. The Report posed the philosophical question of how to define adequate retirement income, asking what the state's role should be in pension provision.

12. We believe the primary role of the state in pensions should be to ensure the avoidance of poverty throughout retirement. The fact that throughout developed economies it is unacceptable for pensioners to be left destitute indicates broad social support for this objective. We would add to the Commission’s analysis that the current system fails to eliminate poverty. Having a net disposable income below 60 per cent of the household median income is the officially recognised definition of poverty. Currently there are about 20 per cent of pensioners living below this level.
13. The state currently attempts to ensure that pensioners do not live in poverty through a combination of contributory and means-tested benefits and, at a growing cost, tax reliefs. These costs are not sustainable. As the Commission noted, this system is complex and fails to provide adequate incentives to save for low to moderate earners.
14. It is also unclear that the current reliance on means-testing is, in the longer-term, any cheaper than an accrued pension strategy. With an adequate minimum pension in place means-tested welfare for pensioners will be dramatically reduced. Currently the main items of means-tested welfare for pensioners cost £18 bn. The cost of Pension Credit alone will rise to £33 bn in 40 years time if current policy remains unchanged (or slightly more than expenditure on SERPS/S2P at that time.) The DWP has projected that in 40 years time the overall cost of means-tested welfare for pensioners will be £59n.²

Higher levels of replacement income is a separate and secondary issue

15. In the Report the Commission argued that for a number of reasons the state might wish to ensure higher levels of “replacement” income. This is a separate issue on which we do not take a view other than the following observations:
 - the objective of ensuring higher levels of replacement income is a separate issue and secondary to ensuring an adequate basic minimum;
 - the existing tax relief on pensions valued at £13bn fails to ensure the provision of an adequate minimum pension income. With an adequate basic minimum pension in place, tax reliefs will no longer have any role in helping to avoid poverty and can be granted – or indeed abolished – entirely on an assessment of their efficacy in achieving higher replacement levels of income;

2. THE PENSIONS REFORM GROUP’S PROPOSAL: THE UNIVERSAL PROTECTED PENSION

The Universal Protected Pension

16. Our proposal, the “Universal Protected Pension” (UPP), is structured around five principles:
 - **a universal defined benefit pension of 25-30 per cent of national average earnings throughout retirement**, with the first part of this guarantee coming from the basic state pension;
 - **increased compulsory contributions** to meet the cost of the additional benefits;

² www.dwp.gov.uk/asd/asd4/Table3_Long_Term_Projections.xls

- **redistribution**, as a pension of this level could not be afforded by many people;
- **funding** to make up the difference between the 25-30 per cent of national average earnings and the pay-as-you-go state pension;
- **an independent governance structure**, to give people a trusted vehicle for their retirement savings.

The UPP is a framework not a finished article

17. It is important to understand that we are here providing a framework for pensions reform, with the particularly novel features being partial funding and an independent governance structure. The level of benefits and contributions, the degree of redistribution, the balance between pay-as-you-go and funding, the age at which benefits are paid, and the course the transition takes, are all key decisions but would clearly be subject to debate. The final decisions on issues such as these can be fitted into the framework.

A universal defined benefit pension of 25 – 30 per cent of national earnings throughout retirement

18. To free all pensioners from poverty and almost all pensioners from means-tested assistance requires a pension at around 25 per cent of national average earnings. The UPP proposes a pension valued at between 25 to 30 per cent of national average earnings to give the proposal some flexibility for the setting of contribution rates, fluctuations in investment returns and changes in longevity.
19. In monetary terms this would currently be equivalent to around £125 - £150 per week.³ This is above the official poverty line of £122 per week⁴; above the £105 per week guarantee credit level below which the disincentives to save increase significantly; and above the £118 per week level the Family Budget Unit at York University has calculated as a “low cost but acceptable income”.⁵ Our target income therefore meets the objectives of lifting pensioners free of poverty and reducing disincentives to save. Referencing a benefit against average earnings will provide a level of income that maintains its value relative to rest of society and is therefore consistent with the Commission’s view that pensioners becoming poorer relative to the rest of society is unlikely to be acceptable.
20. The State Second Pension would cease further accruals, but existing entitlement to SERPS and the State Second Pension would be paid.
21. The UPP contributions would encompass the entire working population and groups that were doing socially important tasks such as caring for very young children or frail elderly relatives. These groups would have their contributions paid for them. However, because a funded scheme takes time to accumulate, those above a certain age would be receive an actuarially reduced benefit. Our 2000 costings suggested this pivotal age would be 25 – i.e. all those below this age when the first contributions were made would, on retirement, receive the full 25 – 30 per cent guarantee. The pivotal age is one of a number of variables that can be adjusted if appropriate adjustments are made elsewhere – for example the required contribution period can be made shorter if the guaranteed level of income is lower, or the contribution rate higher.

³ Based on full-time average earnings level of £476 per week from the 2003 New Earnings Survey, adjusted to give 2004 value.

⁴ Based on data from Households Below Average Income 2002-3, DWP, 60 per cent of net median household income of £118 per week in 2002-3, adjusted to give 2003-4 value.

⁵ *Low Cost but Acceptable Budget for Pensioners*, Family Budget Unit, University of York, April 2004.

22. There are a number of advantages to including people who are in work (or other socially important useful tasks) but, because they are older than whatever pivotal age is chosen, will not receive the full benefit:
- paying out benefits relatively quickly will mean the UPP can address under-provision for retirement in the short and medium term, as well as the long-term;
 - by building up partial entitlements many individuals, who would otherwise have been dependent on means-tested assistance in retirement, will be floated free of means-tests, or will have to clear a lower savings hurdle to be free of means-tested assistance;
 - including the entire workforce will build up a very large constituency of supporters amongst the electorate as soon as the scheme is up and running;
 - it will help speed up the transition from the current State Second Pension to the UPP.

Increased compulsory contributions to meet the cost of the additional benefits

- 21 In 2000 the UPP was costed by the Government Actuary's Department as requiring a 9.9 per cent increase in the employee primary rate of National Insurance between the lower and upper earnings limits. Further work on the costs indicated that if the contracted-out rebates formed part of the contribution, then the required increase falls to 5.2 per cent, or 4.2 per cent if the ceiling in National Insurance contributions is lifted (as it has been for the special NI levy for the NHS). If the retirement age is lifted to 70 these figures read 6.9 per cent, 2.2 per cent and 1.2 per cent respectively. However these original costings did not allow, or did not allow in full, for a number of factors including:
- reduced expenditure on means-tested benefits as the UPP comes into payment;
 - changes in tax revenues;
 - reduced expenditure on the State Second Pension;
 - any longer-term changes to the Basic State Pension which may occur between now and any implementation of major reforms such as the UPP.
- 22 More generally, assumptions relevant to the UPP actuarial calculation have changed since 2000. Life expectancy has increased and actuaries now make more conservative estimates on the return on capital. In addition, a review of the size of the National Insurance rebate will be made later in 2005. The Government has requested the Government Actuary to recost the UPP proposals taking these changes into account and we will submit to the Commission the results as soon as they are available.

Redistribution

- 23 The benefit of the UPP to lower income groups is obvious. Less obvious are the benefits to those from whom wealth is being redistributed, however we would suggest that there are at least three benefits:

- as private defined benefit provision disappears, a guaranteed level of pension will become increasingly valuable and sought after. The UPP provides a much improved collective guarantee for everyone;
- the trend towards defined contribution is also likely to increase the upward pressure on the cost to providers of providing annuities – in part because appropriate assets to back annuities might be in scarce supply. This will mean that a guaranteed retirement income in the form of a deferred annuity may be financially unattractive if bought in the market. The UPP effectively provides a deferred annuity at a relatively low price even for many of those on higher earnings;
- the reduction and ultimate elimination of poverty among pensioners is a social good and avoids the need to tax the better off to fund such means tested assistance.

Funding

24. The Commission noted that funding and pay-as-you-go have a number of specific characteristics. In the context of the UPP the following considerations are relevant:
- as the Commission noted funding should generate higher returns on average than the implicit rate of return under a pay-as-you-go system;
 - at least during the transitional phase when demographic change is at its most dramatic funding should help manage the demographic transition by allowing investment in other markets;
 - the Commission stressed that the extent to which funding would generate higher returns was dependent in part on the reductions in yield arising from various charges. The UPP structure is somewhat similar to a large private sector defined benefit scheme which, as the Commission noted, typically incur the lowest reduction in yield;
 - the Commission set out the different risks attached to funding and pay-as-you-go. If these are accepted, then diversifying between the two financing mechanisms should provide a greater sense of security to its members;
 - the ability of either method to finance a pension depends on producing adequate returns. If the Commission's argument is correct that the implicit rate of return in a pay-as-you-go system is equal to GDP growth then a part-funded, part pay-as-you-go system should allow greater financial diversification to the extent that GDP growth varies from returns on real assets.
25. We believe that in addition to the advantages discussed by the Commission, funding is likely to give a greater sense of security and ownership and that, assuming the funds are not tax-advantaged from the outset, it would be more difficult for a Government to reduce the value of funded provision than it would be to reduce the value of pay-as-you-go benefits. From the Pension Reform Group's own quantitative research on the Universal Protected Pension, 74 per cent of people "approved" of funding and 13 per cent thought it "excellent", although qualitatively people expressed nervousness about the reliability of the stock market.

An independent governance structure

26. Central to the UPP concept is that it should be independent from Government. So much of what is wrong with UK pension provision is down to the comings and goings of different political projects and perspectives. The UPP is intended as a scheme that is established by Government but thereafter membership is owned and governance is independent from Government. Planning for one's retirement is a long-term business requiring long-term stability.
27. A two-tier governance structure is proposed so as to deliver independence from Government, effective representation of members' views, and financial stability:
 - a relatively large first tier of governors. Governors will be appointed by the Government but will serve long, staggered terms, thereby limiting the control of any one administration over its composition. The governors' main task will be to nominate trustees. The governors will also be able to dismiss trustees where they have failed in their duty to protect members' interests;
 - a second tier of trustees who, having been nominated by the governors, will be put before the membership of the scheme at an election.
28. Trustees will have an objective framed purely in terms of their members' financial interests. Trustees will have substantial powers including the power to:
 - vary contribution rates;
 - decide the level of pension to be paid within the prescribed band of 25 to 30 per cent of national average earnings.
29. Trustees will be required to devolve management of the assets to fund managers. It is likely that the scheme will have a small core of investment expertise but will also seek to contract out the management of some funds to capitalise on other private sector fund management expertise.

Double payment

30. Double payment arises when tax/National Insurance financed benefits (i.e. pay-as-you-go benefits in a broad sense) are replaced by funded benefits. Double payment can therefore arise in connection with the basic state pension, the State Second Pension, and means-tested benefits.
31. Double payment does NOT arise with UPP scheme in connection with the basic state pension, as we are retaining it. There is potential for a double payment to arise under the UPP from SERPS/ State Second Pension (where no further entitlement will accrue). But to the extent that there are improvements in the basic state pension to stabilise its position as a percentage of the overall UPP guarantee, double payment with respect to the State Second Pension can be avoided or mitigated and, the costs can be covered by redistribution.
32. There is a limited double payment issue with respect to means-tested benefits. UPP members will be paying taxes for benefits for current poor pensioners, as well as paying taxes to fund UPP benefits for future poor pensioners. This is however a relatively limited form of double payment.

33. Once poorer pensioners are receiving the UPP there will be savings on means-tested benefits. Theoretically the double payment problem could be eliminated by passing on these savings to those more affluent UPP pensioners.

Ownership of the scheme

34. Crucially important for the scheme's durability is that members feel the scheme is theirs, and have an interest in how it is run. This proper sense of ownership will be fostered in a number of ways:
- death before retirement age will result in a member's contributions being returned to his or her estate;
 - membership of the UPP will carry with it £100,000 life insurance for each member with coverage up to the point of retirement. This coverage will allow other benefits – such as widow's and widower's benefits – to be phased out;
 - members will approve or reject trustee nominees;
 - members will be able to access their statement by request, and by the internet through entering their national insurance number and a password. Statements would show contributions and projected benefits;
 - a website giving details of the fund's investments, benefits, contribution entitlement rules, and a secure area where members can access their details, should be established;

Rewards for good citizenship

35. The scheme has been designed so that those members of working age who are not in paid employment, such as those caring for young children or elderly or disabled relatives, will have their contributions paid upfront into the scheme.
36. Once the Government's New Deal proposals are working effectively with benefit claimants of working age being personally helped back into the labour market the scheme could even be extended to Jobseeker Allowance's claimant.

Conclusion

37. As a nation we need to ensure pensioners are properly provided for. It is demonstrably not enough to leave pension provisions to choice – many simply do not make rational decisions and many simply can not afford to provide for themselves. Some element of compulsion and therefore redistribution is essential
38. People must start saving for their pensions – putting money aside in the sure knowledge it will be there on retirement brings significant personal security – a guarantee that would facilitate an individual's right to choose, to plan and ultimately to take responsibility;
39. We need, both in real terms and in terms of public perception, to ensure that such pensions can be relied upon, understood and ultimately delivered. A new way of protecting our inheritance is needed.

40. We welcome the pioneering work of the Pensions Commission and we look forward to discussing this submission with its members shortly.

Pensions Reform Group
January 2005

APPENDIX: ONE

The Pensions Reform Group

The Pensions Reform Group was established in 1999 with membership drawn from politics, industry, academia, voluntary bodies, and other stakeholder groups. Our joint endeavour is to begin a serious and detailed debate on banishing pensioner poverty from our shores.

Current members of the Pensions Reform Group

- **Frank Field MP** – Chair, and former Minister for Welfare Reform
- **Simon Linnett** is the executive vice chairman of Investment Banking at Rothschild in London.
- **Sir Steve Robson** retired as Second Permanent Secretary at HM Treasury in January 2001. Non-executive director of Partnerships UK, Cazenove, Xstrata and the Royal Bank of Scotland.
- **Tim Lefroy** heads Radical, a consultancy specialising in corporate positioning and transformation.
- **Nicola King** is a former director of Rothschilds where she was responsible inter alia for the Government Advisory team and latterly the UK Defence & Aerospace advisory team.
- **Ben Forsyth** is Research Secretary to the Pensions Reform Group. He has formerly worked for Frank Field as his research secretary in the House of Commons, and is currently working for Prudential.

Participants in Pensions Reform Group working groups and former contributors

- Richard Astle - Director of Corporate Affairs, AMP
- Richard Brooks - Social Policy Team, IPPR
- Deborah Cooper - William M Mercer
- Baroness Davies - Director, Pre-Retirement Association
- Maria Evandrou - Sage Project, London School of Economics
- Jane Falkingham - Sage Project, London School of Economics
- Mervyn Kohler - Head of Public Affairs, Help the Aged
- Alison O'Connell (chair) - Director, Pensions Policy Institute
- Steve Webb MP - Liberal Democrat Work and Pensions Spokesman
- David Willetts - Shadow Secretary of State for Work and Pensions
- David Yeandle - Deputy Director of Employment Policy, Engineering Employers' Federation
- Andrew Young - Directing Actuary, Government Actuary's Department
- Martin Campbell
- Howard Flight MP – Shadow Chief Secretary to the Treasury
- Roger Urwin - Watson Wyatt LLP
- Alan Deacon - Professor of Social Policy at the University of Leeds.
- Peter Gray - Chairman of the welfare reform unit, Hertford College, Oxford University.
- Paul Ormerod director of Volterra Consulting
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- Kate Barker - Monetary Policy Committee
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- Michael Foot – FSA
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