

**Universal Protected Pension  
The Follow-Up Report**

**Report by the Pensions Reform Group**

## Contents

|  |    |
|--|----|
| Summary  | 2  |
| Review   | 6  |
| The increasing need for fundamental pensions reform                                | 9  |
| Overview of the Universal Protected Pension  | 13 |
| Principle 1: a pension of 25-30 per cent of average earnings throughout retirement | 14 |
| Principle 2: universal membership  | 16 |
| Principle 3: redistribution  | 20 |
| Principle 4: funded  | 21 |
| Principle 5: independence from Government  | 23 |
| Developing the Government's reforms  | 26 |
| Conclusion   | 28 |
| Endnotes   | 30 |

## Summary

### 1. The pensions problem

It is possible to end a working life of 40 years or more and yet retire in poverty. Pensioners are poorer than the rest of the population with between a fifth and a quarter living below the official poverty line. This proportion has been more or less unchanged over the past six years. Translated into cash terms this means net disposable incomes below £107 per week for single pensioners and below £176 for pensioner couples. Almost as many live in persistent poverty, defined as being poor in at least 3 years out of 4.

There is no prospect of a sustainable improvement of this situation with the current pension system and trends. All the signs are that over the coming decades the income provided by occupational pensions will peak and then fall; that the income from state pensions will rise by little; and that personal pensions and Stakeholder pensions will fail to make good these shortfalls. In short, over the next few decades, as the population ages, Britain is likely to have very large numbers of pensioners living in poverty.

### 2. Principles of the Universal Protected Pension

The October 2001 report of the Pensions Reform Group set out a radical yet affordable and sustainable solution to this growing pensions crisis – the Universal Protected Pension (UPP).<sup>i</sup> We believe that there should be a decent first tier pension encompassing every worker. The pension will be of a defined benefit type – in effect a good occupational pension for the nation - and be generous enough to lift every worker above poverty throughout retirement. It will have five key features:

- **a pension of 25-30 per cent of average earnings throughout retirement**, ensuring that all those ending a working life have an income above the poverty line;
- **universal membership**, with the scheme starting with younger workers paying contributions, possibly including some older workers, and building up from there;
- **redistribution**, with all paying a similar proportion of their income for a pension that is, like the Basic State Pension, the same for all;
- **funded**, with the Basic State Pension remaining pay-as-you-go and making up the first element of the 25-30 per cent of average earnings guarantee;
- **independence from Government**: the UPP is supported by a governance regime to ensure the fund is robust from political influence as with the Bank of England's Monetary Policy Committee.

### 3. Details of the Universal Protected Pension

So the UPP will have 5 key features. This section looks at these more closely:

- **a pension of 25-30 per cent of average earnings throughout retirement**, ensuring that all those ending a working life have an income above the poverty line.

The UPP will have two components. The first component is the existing Basic State Pension. By keeping this in place we avoid the classic 'double payment' problem when people contribute to the pay-as-you-go pensions of others but do not receive anything themselves from the pay-as-you-go system in the future, at the same time as having to fund their own future pensions. The second component is a new funded element. Together these two elements will deliver a pension of between 25 and 30 per cent of average earnings. This sum will be

increased with average earnings once in payment. In addition, every member will have over £100,000 of life insurance cover once they begin contributing.

- **universal membership**, with the scheme starting with younger workers paying contributions, possibly including some older workers, and building up from there;

The Basic State Pension is thought to be simple, is durable, and has strong public support because it is universal. This universality also makes the Basic State Pension's redistribution more sustainable. The Pensions Reform Group believe that everyone retiring after a working life should have a decent pension and that a universal scheme is the best way to ensure this.

The various options for how the scheme is rolled out are discussed at more length later in this document. However we envisage that younger workers will receive the full pension and that perhaps older workers will receive part of the pension to reflect their shorter contribution period. Carers – including mothers of young children - will have their contributions paid by other members.

Our scheme does therefore mean an extension of compulsory pension contributions. We make no apologies for the fact that better pensions cost more money. The alternative is to rely on increasing means-tested benefits that have to be financed through increased taxation – another form of compulsion.

- **redistribution**, with all paying a similar proportion of their income for a pension that is, like the Basic State Pension, the same for all;

The simple fact is that if we all want good pensions then we will have to contribute more. Those on low incomes cannot contribute enough to finance a good retirement income. Calculations from the Government Actuary's Department indicate that for the Universal Protected Pension each member of the scheme will pay in an additional 2 per cent on employee National Insurance plus the equivalent of their State Second Pension rebate. The scheme is therefore 'stand alone' with no need for a contribution from general taxation.

Once in payment the UPP will mean massive savings on means-tested benefit expenditure on pensioners – currently about £13bn per year.

- **funded**, with the Basic State Pension remaining pay-as-you-go and making up the first element of the 25-30 per cent of average earnings guarantee;

Any pension is more likely to be delivered if risk is spread widely. The UPP scheme spreads risk by having a funded element and the pay-as-you-go element of the Basic State Pension. With the demographic changes over the next fifty or so years there is a very good case for funding as it allows investment in emerging markets which often have demographics more favourable to economic growth.

Having a part-pay-as-you-go, part-funded scheme also means that risk is spread between capital and labour markets, which may further lessen the possibility of the scheme not being able to meet its liabilities.

Because the investments are pooled, and the pension benefits defined by average earnings, there is not the risk that defined contribution schemes suffer from – that winners and losers are created due to luck in choosing good investments. We believe that this funding approach is appropriate for the level of benefits involved. But the UPP then encourages further individual or company provision for those who can afford it by defining a clear floor for future pensions,

removing the disincentive to save that the uncertainty of today's environment creates.

Similarly, because the scheme is a national one with benefits defined by average earnings it suffers neither of the classic disadvantages of final salary schemes – that they restrict labour mobility, and that they encourage employers to make older staff redundant prematurely.

- **independence from Government:** the UPP is supported by a governance regime to ensure the fund is robust from political influence as with the Bank of England's Monetary Policy Committee.

British Governments are not trusted on pensions. In part this is down to an inherent incompatibility between the demands of the electoral cycle and the very much longer time spans involved in retirement provision.

The UPP will be a new product with its own governance structure. Our governance model is one of 'democratic trusteeship'. Trustees will be nominated by a special board of governors to stand for election before the scheme's membership. Trustees will be able to alter contribution rates and, within the 25 to 30 per cent band, determine pension levels.

They will also be required to appoint a chief executive to head the management of the fund. Members will have access to all their details on contributions and projected pensions. The trustees will be required to have regular actuarial assessments of the scheme and will be exposed to Parliamentary scrutiny.

The trustees' objective will be to manage the scheme in the members' financial interest. Should they fail to do so, the board of governors can dismiss them.

#### 4. Developing the Government's reforms into the Universal Protected Pension

One of the neatest features of the UPP is that it time-limits financial commitments to measures such as the Minimum Income Guarantee or the Pension Credit. Once the UPP is in place Governments know they have not made an open-ended financial commitment to these benefits and that people will not be discouraged from saving by the means-tested character of these benefits.

The State Second Pension can be developed into the UPP. There are some similarities. Eventually the State Second Pension is to deliver a flat-rate pension in return for earnings related contributions – as with the UPP. Although the State Second Pension was envisaged as a replacement for SERPS focussing expenditure on lower earners and financed on a pay-as-you-go basis, it could be usefully enhanced to become the central plank of the Government's pensions strategy.

However for the State Second Pension to deliver the benefits of the UPP there would have to be four crucial changes:

- the flat rate benefit of the State Second Pension would have to be made more generous;
- once in payment the State Second Pension would have to be uprated with earnings;
- contracting-out would have to be abolished;
- the State Second Pension would have to be funded.

The Pensions Reform Group proposes an evolutionary approach to such changes.

## 5. Next steps

Since the publication of our previous report in October 2001 the pensions problems we identified have worsened. The past year or so has seen a quickening of the move away from good defined benefit schemes to generally less generous defined contribution schemes. Stakeholder has not sold in large numbers to its target group. Confidence in personal pensions and other individualised investments has been further eroded by the Equitable Life debacle, and by declining equity markets.

The Universal Protected Pension is an opportunity for the Government to establish a trusted, independent bulwark of civil society. It is affordable and could make the dream of abolishing pensioner poverty a reality.

An extraordinarily wide range of people from politics, finance, Government, academia, and other fields have come together to test these ideas. We believe the Government should now take them up and seriously consider the scheme as a way for the nation to lead the world in ensuring its citizens have a secure retirement.

## 2. Review

After the publication of the original report, the Pensions Reform Group was keen to test its ideas in seminar groups composed of people from the pensions industry, business, finance, politics and academia. Three seminar groups were convened (listed at the end of this section) to review three key aspects of the reforms:

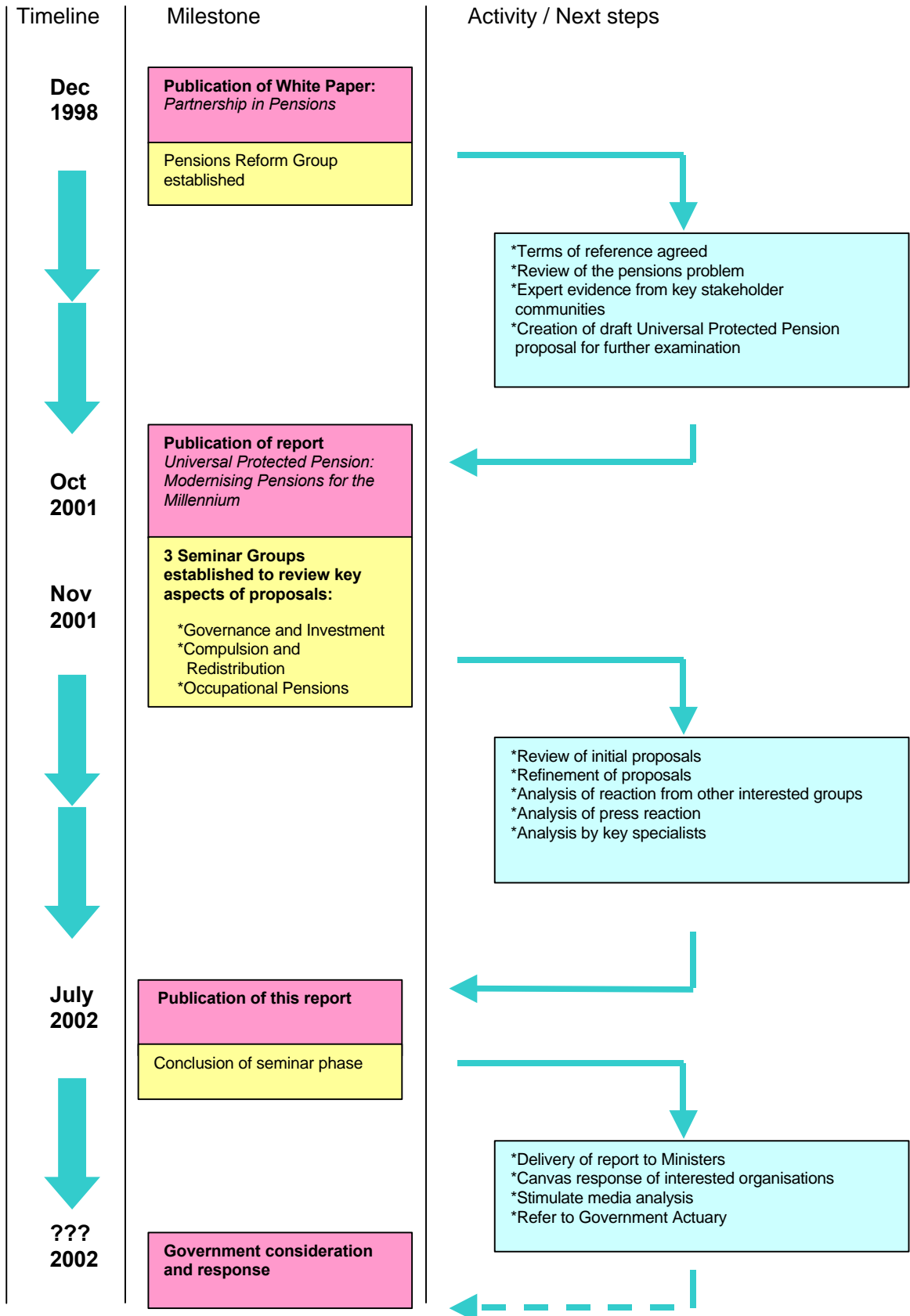
- **governance and investment** of the Universal Protected Pension scheme. This group also looked at how the scheme would communicate with members;
- **compulsion and redistribution** in the Universal Protected Pension: in particular how a modest increase in compulsory National Insurance contributions might be phased in;
- **occupational pensions** and the Universal Protected Pension, and how the UPP would fit in with existing provision.

The seminar groups – like the Pensions Reform Group - were drawn from a very wide range of backgrounds. Naturally not everyone agrees with all aspects of the proposals. However all participants feel that the UK pensions system needs major reform to tackle pensioner poverty. Every participant also felt that these proposals are worthy of serious consideration at the highest level of Government. The revised proposals presented here are based on both the October 2001 report of the Pensions Reform Group and the contributions of the three seminar groups.

We are presenting this report to the Government for serious consideration. In particular we would like the Government to invite the Government Actuary's Department to review the analysis of the UPP and to assess more accurately and update some of the estimates of cost and value implied in this and the original October 2001 report. We would also hope that the GAD could examine some of the alternatives for flexibility discussed in this document.

We believe that the UPP should be usefully adopted as an initiative around which a broad consensus of interests could form.

## Pensions Reform Group Review - Process



## Pensions Reform Group Review – Participants

### Pensions Reform Group

|                            |  |
|----------------------------|--|
| Kate Barker                | Monetary Policy Committee, Bank of England                         |
| Professor Alan Deacon      | Professor of Social Policy, University of Leeds                    |
| Frank Field MP (chair)     | Former Minister for Welfare Reform                                 |
| Howard Flight MP           | Shadow Paymaster General   |
| Ben Forsyth                | Secretary, Pensions Reform Group                                   |
| Peter Gray                 | Chairman, Welfare Reform Unit, Hertford College, Oxford University |
| Carolyn Hayman             | Director, Foyer Federation   |
| Simon Linnett              | Managing Director, NM Rothschild & Sons                            |
| Alison O'Connell           | Director, Pensions Policy Institute                                |
| Paul Ormerod               | Director, Volterra Consulting                                      |
| Matthew Owen               | Morgan Stanley   |
| Tom Ross OBE               | Principal, Aon Consulting  |
| Lord Vinson of Roddam Dene |  |
| Steve Webb MP              | Liberal Democrat Work and Pensions Spokesman                       |

### Compulsion and Redistribution Seminar Group

|                          |  |
|--------------------------|--|
| Richard Astle            | Director of Corporate Affairs, AMP   |
| Deborah Cooper           | Actuary and Senior Consultant, William M Mercer                            |
| Mary Davies              | Director, Pre-Retirement Association                                       |
| Jane Falkingham          | Reader in Population Studies and Social Policy, London School of Economics |
| Frank Field MP           | Former Minister for Welfare Reform   |
| Ben Forsyth              | Secretary, Pensions Reform Group   |
| 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 MP        | 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                         |

### Governance and Investment Seminar Group

|                       |  |
|-----------------------|--|
| Kate Barker           | Monetary Policy Committee, Bank of England                         |
| Frank Field MP        | Former Minister for Welfare Reform                                 |
| Michael Foot          | Managing Director, Financial Services Authority                    |
| Ben Forsyth           | Secretary, Pensions Reform Group                                   |
| Ram Gidoomal          | Better Regulation Task Force                                       |
| Sheenagh Gordon-Hart  | Head of Strategy and Research, EMEA Investor Services, JP Morgan   |
| Peter Gray            | Chairman, Welfare Reform Unit, Hertford College, Oxford University |
| Malcolm Gray          | Finance Director, Railways Pension Trustee Company                 |
| Tim Lefroy            | Chief Executive, Radical   |
| Simon Linnett (chair) | Managing Director, NM Rothschild & Sons                            |
| Alison O'Connell      | Director, Pensions Policy Institute                                |
| Paul Myners           | Former Chairman, Gartmore; Chairman, Guardian Media Group          |
| Sir Steve Robson      | Former Second Permanent Secretary to the Treasury                  |
| Roger Urwin           | Global Head, Investment Consulting, Watson Wyatt Worldwide         |
| David Willetts MP     | Shadow Secretary of State for Work and Pensions                    |
| Andrew Young          | Directing Actuary, Government Actuary's Department                 |

### Occupational Pensions Seminar Group

|                        |  |
|------------------------|--|
| David Bright           | Pensions Management Institute                                      |
| Frank Field MP         | Former Minister for Welfare Reform                                 |
| Ben Forsyth            | Secretary, Pensions Reform Group                                   |
| Peter Gray             | Chairman, Welfare Reform Unit, Hertford College, Oxford University |
| John Hough             | Managing Director, Aspen plc                                       |
| Kevin LeGrand          | Head of Technical Services, Buck Consultants                       |
| Chris Lewin            | Head of UK Pensions, Unilever                                      |
| Andrew Mitchell MP     | Former Minister for Social Security                                |
| Peter Murray           | Chairman, Railways Pension Trustee Company                         |
| Peter Thompson (chair) | Chairman, National Association of Pension Funds                    |
| Ed Vaizey              | Head of Public Affairs, Consolidated Communications                |
| Steve Webb MP          | Liberal Democrat Work and Pensions Spokesman                       |

### 3. The increasing need for fundamental pensions reform

No one in this country who reads the media and has even a rudimentary understanding of the subject can fail to appreciate the urgency of the need for pensions reform.

#### 3.1. Pensioner poverty

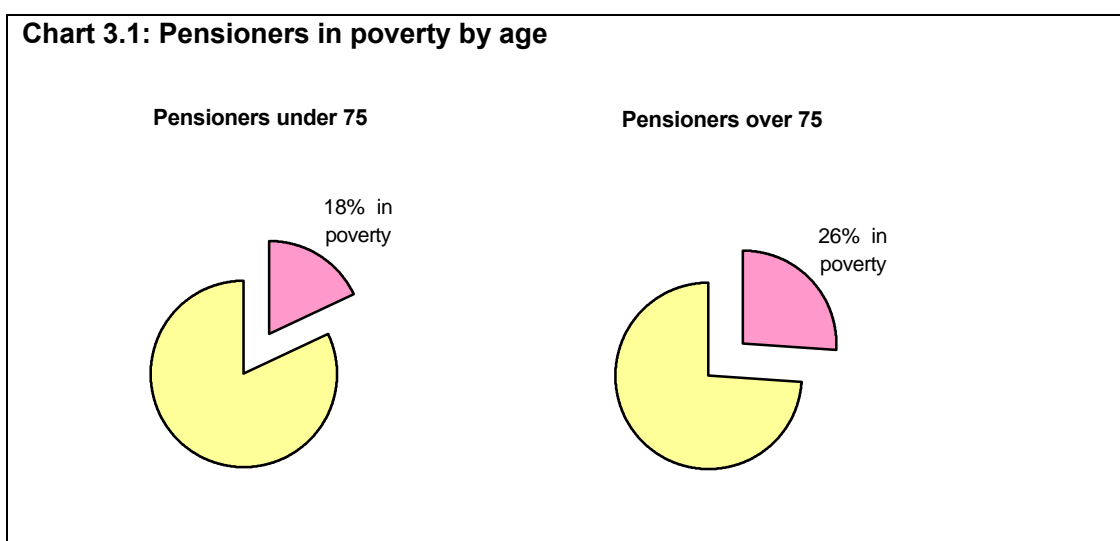
On average pensioners are poorer than the rest of the population with between a fifth and a quarter living below the official poverty line. This proportion has been more or less unchanged over the past six years.<sup>ii</sup> About one in six pensioner couples and one in four single pensioners are persistently in poverty.<sup>iii</sup> Official statistics on persistent poverty suggest that while the problem is lessening amongst the general population, amongst pensioners it is at best stable and may be worsening.<sup>iv</sup>

Some 2 million of the 9.5 million pensioners are below the official poverty line of 60 per cent of median income. Translated into cash terms this means single pensioners with net disposable incomes below £107 per week and pensioner couples with net disposable incomes below £176 per week.

A much higher proportion of older pensioners are poor and persistently poor. Particularly likely to be poor are:

- elderly single female pensioners;
- those in couples with at least one elderly pensioner.

**Chart 3.1: Pensioners in poverty by age**



The evidence suggests that at retirement, and for the few years following retirement, pensioner poverty is no more severe than for the population as a whole – although pensioners are much less likely to leave poverty once they fall into it. But despite poverty not being more severe, during these years pensioners' incomes are lower than the population as a whole with greater numbers on low incomes slightly above the poverty level. Thereafter a consistent pattern emerges of large numbers of younger pensioners in the second bottom income quintile falling into the bottom income quintile as they age.

So while younger pensioners are disproportionately more likely to be just above the bottom of the income pile, their incomes tend to fall over time relative to the population as a whole, dragging them down into the lowest reaches of the income distribution. Furthermore once pensioners are poor they are less likely than any other group to exit poverty – primarily because their earnings opportunities are so limited.<sup>v</sup>

### 3.2. The drawbacks of the means-testing strategy

In the short run it is possible to alleviate poverty through ever-greater means-tested benefits. This is the strategy the current Government is maintaining. And there is no doubt that this Government has the best of intentions in doing so. It has understandably targeted money at today's poorest pensioners. Since 1997-98 expenditure on means-tested benefits for pensioners has grown considerably, by nearly 40 per cent in real terms from £9.7bn in 1997-98 to an estimated £13.4bn in 2003-04 (including the Pension Credit).<sup>vi</sup>

The Government has also introduced the Winter Fuel Payment and free television licenses for the over 75s. The Winter Fuel Payment is non-means-tested and can be spent as the recipient chooses. The scheme is popular and does not penalise savings as does a means-test, but it is not a 'right' in the way that an accrued pension right is and therefore could be relatively easily withdrawn. This means that increasing it to the point where it is a major component of pensioners' incomes would be a questionable strategy.

The Government's intentions to help poor pensioners are laudable, but the wisdom of pursuing over the longer run a strategy with so much means-testing must be doubted. Means-tested benefits suffer because:

- they discourage saving, and are therefore likely to substitute state provision for private provision. The more generous such benefits are the more they discourage saving; the less generous such benefits are the less they do to ameliorate poverty;
- they do not carry the rights of accrued pension entitlement, and can be changed significantly by an incoming Government, making long term planning for retirement much more difficult;
- they are highly complex and generate resentment and dependency, and fail in their primary objective, as many people do not claim.

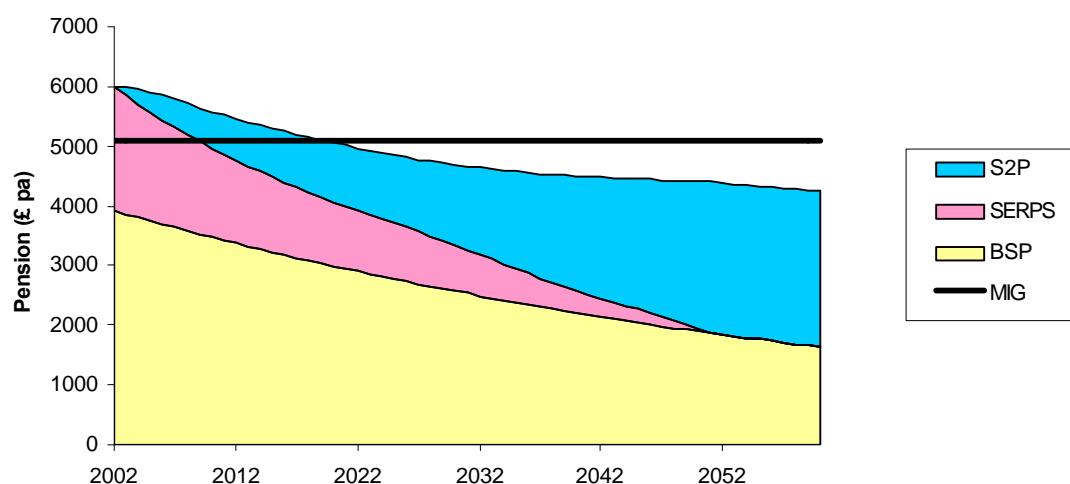
The Universal Protected Pension attempts to answer all these concerns by lifting every worker above means-tested benefits in retirement and thereby sidestepping the dependency and disincentives so created.

### 3.3. Other reforms by the Government

Most people would agree that it is more desirable to have accrued pension entitlement sufficient to provide at least an acceptable standard of living than to rely on the uncertainty of taxpayers financing a means-tested retirement. However the coverage of occupational pensions has never reached large numbers of lower paid workers and appears now to be becoming increasingly less generous for most workers. The Government shares the view that all workers should build up substantial pension rights and has sought to increase provision through the State Second Pension (S2P) and the Stakeholder Pension.

In a later section of this paper we suggest how the State Second Pension could be usefully developed to achieve the aim of ending pensioner poverty. The State Second Pension is the Government's replacement for the State Earnings Related Pensions Scheme (SERPS). However in its current form it is unlikely to last, or achieve its aims, both because it is not universal – thereby limiting political support, and because it does not provide a pension generous enough to take people off means-tested benefits – its reason for being. In fact, even with the State Second Pension ever more people are likely to be dependent on means-tested benefits throughout retirement. Chart 3.2 shows how these reforms will fail to achieve the objective of lifting pensioners off such benefits.

**Chart 3.2: Forecast retirement benefits for an individual on median earnings**



Source: William M Mercer Human Resource Consulting: *Update, July 2002, Issue 3/02.*

Stakeholder is a useful reform. As well as driving down charges, Stakeholder has allowed non-earners to build up pension entitlement. But all the indications are that Stakeholder will fail to achieve its objective of getting the 5m workers earning between £10,000 and £20,000 per annum without adequate provision to save enough for a good retirement income. This failure will in part be a consequence of the crushing complexity of the pensions system, but it will also be because few of these earners can afford to save enough for their retirement. With a universal scheme such as the UPP with its principle of redistribution, Stakeholder can become the ideal second-tier savings vehicle.

#### 3.4. The problem gets worse with delay

While the levels of pensioner poverty are fairly stable, there are clear signs that as a nation we are not saving enough for retirement. Research commissioned by the Association of British Insurers from Oliver, Wyman and Co. found that only those in their late 30s or older on incomes of over £35,000 per annum were likely to be saving enough for a retirement income that would not mean a significant fall in standard of living in retirement. Similarly the consultant economists Lombard Street Research have produced data showing that new inflows into pension savings are now around a quarter the level they were five years ago.<sup>vii</sup> This problem affects personal pensions, Stakeholder pensions and occupational pensions. Overwhelmingly the evidence suggests that unless savings increase future pensioners are going to be increasingly reliant either on benefits or else on releasing equity from their home, which aside from being an unpopular activity when actually undertaken, is a risky investment strategy.

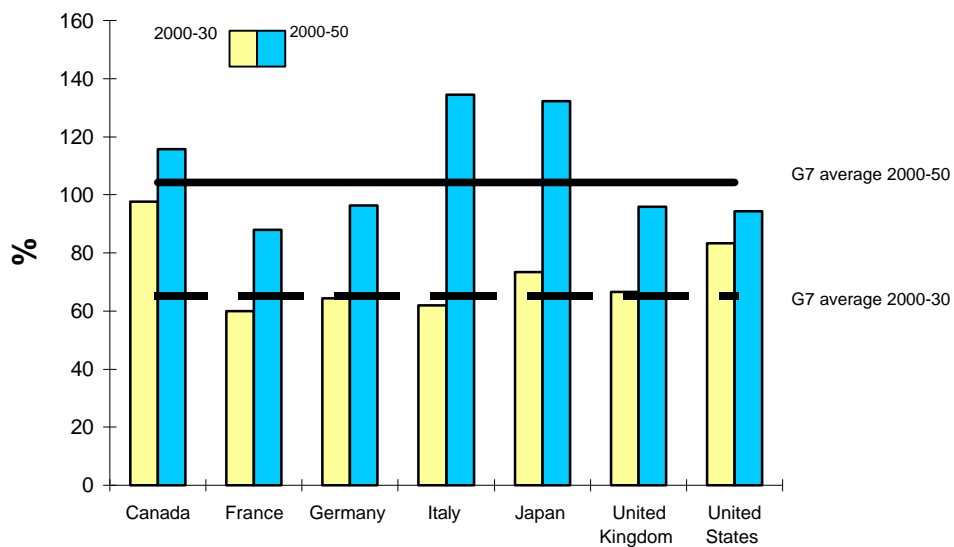
#### 3.5. The UK is not alone in having pensions problems

If individuals were not saving enough they could still be accumulating sufficiently generous pay-as-you-go pension rights. For many in the public sector this is true. For most other workers the Basic State Pension and SERPS/State Second Pension will deliver an increasingly modest income in retirement.

Some other major European countries have much more substantial pay-as-you-go rights than the UK. Demographic change poses a particularly serious challenge to such pension structures as they depend entirely on domestic labour to provide for the retired population through taxation.

The UK is relatively well placed both in terms of the relatively small size of unfunded liabilities and the demographic outlook. One measure of this is the 'dependency ratio' – usually expressed as the population over 65 as a percentage of the working-age population. At present Britain, France, Germany, Italy and Japan have a similar dependency rate, with Canada and the US enjoying slightly lower levels of old-age dependency. Chart 3.3 shows how the dependency ratio for the G-7 and Europe is predicted to change over the next 50 or so years.

**Chart 3.3: Percentage change in old-age dependency ratios, 2000-30 and 2000-50**



Source: *World Population Prospects, The 2000 Revision* (New York: United Nations, 2001), Table A.35.

Scare mongering about a 'demographic time bomb' in the UK seems slightly exaggerated. However there is little doubt that the UK's pension system is currently heading in the wrong direction and that it needs to be quite radically reformed if it is to stand up to the challenges of the coming decades. With a scheme such as the Universal Protected Pension the UK could achieve adequate pension provision on a basis that would be sustainable for generations.

### 3.6. An opportunity for the UK to lead the way

The UK is well placed to establish a model for other countries facing similar problems to emulate. But this is not just an opportunity for the UK to fulfil a role of world leadership; it is important that our EU neighbours, on whom our prosperity in part depends, are not weakened, economically or socially, by the deferred pensions burden.

#### 4. Overview of the Universal Protected Pension

Our October 2001 report set out a radical yet affordable and sustainable solution to this growing pensions crisis – the Universal Protected Pension (UPP).

##### 4.1. Principles of the Universal Protected Pension

We believe that there should be a decent first tier pension encompassing every worker. The pension will be of a defined benefit type – in effect a good occupational pension for the nation - and be generous enough to lift every worker above poverty throughout retirement. It will have five key features:

- **a pension of 25-30 per cent of average earnings throughout retirement**, ensuring that all those ending a working life have an income above the poverty line;
- **universal membership**, with the scheme starting with younger workers paying contributions, possibly including some older workers, and building up from there;
- **redistribution**, with all paying a similar proportion of their income for a pension that is, like the Basic State Pension, the same for all;
- **funded**, with the Basic State Pension remaining pay-as-you-go and making up the first element of the 25-30 per cent of average earnings guarantee;
- **independence from Government**: the UPP is supported by a governance regime to ensure the fund is robust from political influence as with the Bank of England's Monetary Policy Committee.

These principles are unpacked in the remainder of this report.

##### 4.2. Seminar group overview

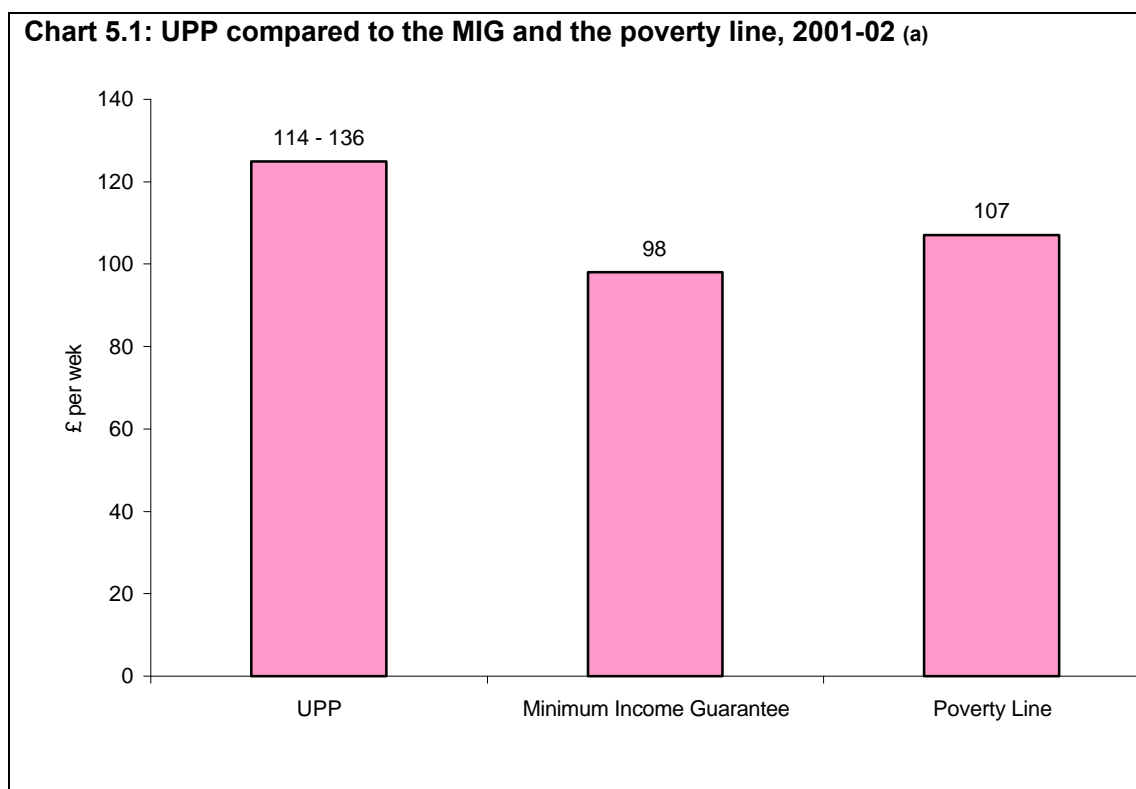
Amongst the participants in the three seminar groups the view that something needs to be done to lift essentially all the population above a realistic minimum level of income was almost universally held. There was little doubting too that such an income should be set consistently at a level that will ensure benefit support does not encroach upon the incentive to save. Similarly, the concept that, in the context of the current debate on perverse investment incentives, mis-selling and simplification, compulsion was likely to be the only realistic method of reaching this objective of sufficient universal saving was also rapidly endorsed.

Having established a universal acceptance of the need for a compulsory scheme to raise those retiring above support levels, there was some debate surrounding the need for funding, the benefits of redistribution, and the universality of the scheme. These issues are all discussed in the remainder of this report.

## 5. Principle 1: a pension of 25-30 per cent of average earnings throughout retirement

Our October 2001 report set out the Government Actuary's costings for the Universal Protected Pension worth 28.2 per cent of full-time national average earnings in retirement. This sum was simply the result of setting the pension equal to a hypothetical future income support level.

This pension is both significantly above the official poverty level and the current Minimum Income Guarantee were it to be maintained in line with earnings increases throughout the lifetime of the UPP.



(a) This assumes the UPP is paid at some level between 25 and 30 per cent of average earnings.

### 5.1. Variable pension rates

The Governance and Investment Seminar discussed at some length the nature of the guarantee for the Universal Protected Pension.

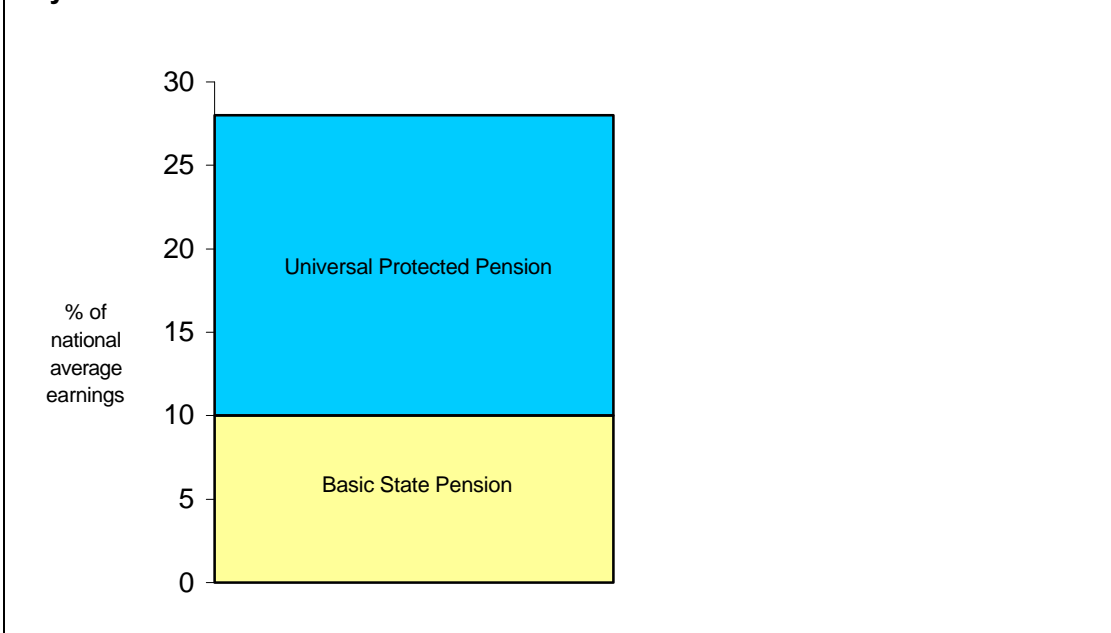
In short it was decided that there would have to be some flexibility in the level of pension provided by the UPP. Tying the trustees to a particular percentage is likely to encourage them to raise excessively the contribution rate and runs the risk of the membership losing interest in the running of the scheme, as their pension level is statutory. And some flexibility is useful in controlling the financial balance between contribution income and pension costs.

It was decided therefore that the defined benefit-type guarantee is to extend to both the Basic State Pension and the Universal Protected Pension to give a total pension between 25 and 30 per cent of average earnings. Members will have some exposure to the fund's performance through having an improved pension if the trustees decided that a surplus existed and should be distributed. In this case pensioners could be paid up to 30 per cent of average earnings – although this would only be a payment guaranteed for one year – depending on the decisions of the trustees their pension could then fall back to the 25 per cent baseline in subsequent years. Pensioners might have first call on the

distribution of a surplus. But if the fund was doing very well then the trustees could decide to lower contributions. The pension would never fall below 25 per cent.

Once in payment the level of UPP will be indexed to increases in average earnings. It would be sensible for this to apply also to the Basic State Pension to ensure that the full guarantee allows pensioners to maintain their standard of living above the poverty line throughout retirement.

**Chart 5.2: How the UPP 'guarantee' will be composed for young workers retiring in 45 years time**



Included in the costings is provision for all members to have life insurance worth over £100,000. Also included is provision for carers who have no earnings or earnings below the National Insurance Lower Earnings Limit in receipt of child benefit for a child under 6 and/or are entitled to Invalid Care Allowance or Home Responsibilities Protection for caring for a sick or disabled person.

### 5.2. Variable contribution rates

The trustees of the UPP (see section 9) would have the right to set contribution rates for the UPP. The original report estimated the required contribution rate would be the equivalent of the SERPS rebate plus an additional 5 per cent on employee National Insurance based on the pension age remaining at 65. After further consideration in the seminar groups looking at governance/ investment and compulsion, it was felt that for those retiring in 40 years time the arguments were overwhelmingly in favour of raising the pension age to 70 to allow a much lower additional National Insurance contribution of just 2 per cent. By the time the higher pension age took effect there will probably be further very significant increases in longevity. Over the past thirty years alone there has been a 4 to 5 year increase in life expectancy at age 20, and a 3 to 4 year increase at age 60.

The debate also addressed the possible rebalancing of the scheme between funding and pay-as-you go. There is a balance to be struck between the different risks attached to the two methods. Issues such as the size of the fund and the degree of independence from Government would require careful consideration by policymakers legislating for the UPP.

## 6. Principle 2: universal membership

The Compulsion and Redistribution Seminar looked at the various arguments for and against compulsion and concluded that in the context of the UPP further compulsion was essential and desirable. This section looks at some of the arguments for and against further compulsory contributions and how they might be introduced relatively painlessly.

One objective of the UPP proposals was that the role of the state in pensions should be defined in a way that can be sustained in the future. That is, that the state should enable a sufficient decent minimum pension to be provided for all. The UPP proposals suggest a pension of around 25-30 per cent of national average earnings should be received by everyone as a first tier (and that the state should not compel people to save above this level as currently with the complex multi-product second tier).

### 6.1. Compulsion can overcome 'moral hazard'

The scheme is to be financed by each member paying an equivalent of a 2 per cent increase in employee National Insurance contributions and the use of the equivalent of their State Second Pension rebate for UPP investment. This is discussed in more detail in next section. These additional National Insurance contributions are essential to the scheme providing a pension above poverty level, yet they are of course likely to be one of the scheme's most controversial aspects.

The levels of compulsion and redistribution in the UPP proposals may still be too high for comfort for some. But this illustrates one of the essential trade-offs inherent in designing pension policy. If compulsory contributions are set much lower then not everyone will secure a good first tier pension and there will be pensioners in poverty. On the other hand, if compulsory contributions are set too high, then workers will suffer, high earners will feel that there is too much redistribution, and discretionary savings might be reduced. But the Pensions Reform Group wish to improve the prospects for pensioner income, not stay in a means-tested environment.

At present some people save for their pension, and others who could do so, do not. As has already been mentioned recent research has found that only those aged over 35 with household incomes over £35,000 were likely to be saving enough for their retirement. If those who do not save then claim state benefits as pensioners, they are being subsidised for their choice of spending instead of saving.

This "moral hazard" problem is particularly acute today as the present level of compulsion is inadequate relative to means-tested provision. The Institute of Actuaries has estimated that someone contributing only what they are compelled to via the Basic State Pension and the State Second Pension will in 2050 receive a pension of £88 per week in current earnings terms, compared to a possible Minimum Income Guarantee of £98 per week in current earnings terms.<sup>viii</sup> This gap could widen throughout retirement because of different indexation.

This illustrates that there is no logic to the present level of compulsion in today's pension system. Nowhere has a justification been given for the level of compulsory pension entitlement. Before deciding on whether or not further compulsion is desirable this issue should be addressed. The simple, robust answer offered by these proposals is that compulsion should be set at a level sufficient to provide an income throughout retirement above the Minimum Income Guarantee.

Those who are against further compulsion have to face the fact that at the moment an ever-greater amount of retirement income is being financed by general taxation – which is of course compulsory. The Government's own figures show a 40 per cent rise in real terms expenditure on means-tested benefits from £9.7bn in 1997-98 to an estimated

£13.4bn in 2003-04 (including the Pension Credit).<sup>ix</sup> Expenditure on such benefits would become exceptionally costly if the present rate of growth was sustained over the next few decades. The official projections for the Pension Credit alone suggest that it would cost up to £20bn per year in real terms in 2040.<sup>x</sup> Compulsory contributions to a pension do not carry the same disincentive effects as compulsory contributions to tax finance benefits. They are therefore likely to be cheaper.

## 6.2. Compulsory contributions allow redistribution

Without further redistribution there is no way that the vast majority of low paid people in this country can build up a decent pension. Compulsory contributions allow additional redistribution. The Pensions Reform Group originally proposed a system of higher redistribution both because of the extreme inequalities in pensioner incomes today and the high probability of this situation continuing given savings behaviour and incomes distribution.

Compulsion should build a sense of “we are all in it together”. Everyone has a stake in universal benefits to which we all contribute. Universal compulsory contributions, invested in a pooled fund are fair in the sense that everyone paying the same contributions gets the same investment return. There are no “lucky” winners or losers who invested in portfolios that happened to turn out well or badly.

Further compulsion in the UPP scheme also allows those who take breaks from working to care for young children, the sick or disabled to continue to build up the same pension. Their contributions to the UPP would be paid from the fund.

## 6.3. Arguments against compulsion

There are arguments put forward equally strongly against the idea of additional compulsory pension contributions. A particular cause for concern is that those on low incomes, even with the best will to contribute, cannot do so. Examples are given of parents of young children who would prefer to spend their money on their children’s welfare; or those for whom paying off debt might be a better financial decision than contributing to a pension.

Furthermore, saving money every month is not the only way of building up a pension. The self-employed are often quoted in this regard. Self-employed people today are only required to contribute to the first tier Basic State Pension. Second tier pensions (SERPS, the State Second Pension or contracting out) are compulsory only for employees. This gives self-employed people the choice of investing in their business, which can then be sold to provide for retirement, or contributing to second tier pension provision.

From this the argument can be widened to a view that rational self-interest must always be better than compulsory contributions. This argument has at least two strands. First, that people are better off investing any money themselves (or choosing not to invest), rather than pooling it to share the same investment outcome with everyone else. This implies that it is acceptable to have “winners and losers” in investing – even for such a basic level of provision. It also requires that people make their own efforts (and/or pay for advice) to make decisions on investment choices that hopefully will increase their chances of being a winner rather than a loser.

The second strand holds for those at the richer end of the income scale who will be contributing more, but getting less out as pension benefit, as some of their contributions are redistributed to poorer people. Essentially, this argument comes down to how much redistribution people are comfortable with.

Finally, there are seen to be drawbacks if additional compulsion is levied on employers rather than individuals. It would be seen as an additional burden, particularly for small businesses, but in the longer-run the charge would very probably be passed on to employees as lower pay or higher prices.

#### 6.4. How should further compulsion be introduced?

A significant fear with any additional level of compulsory contribution is that it will be difficult for those in debt or on low incomes, for example young parents paying off student loans. The group examined several ways of mitigating the cost of the additional compulsion in the UPP proposals including requiring something to be paid by employers and phasing-in contributions. These are considered below.

A controversial view currently being advanced in public debate is that if it is the case that employers have reduced their contributions over time (perhaps as part of a switch from defined benefit to defined contribution schemes) then perhaps employers should pay some of the additional cost of securing a good second tier pension. Currently, the average contribution by employers who sponsor occupational schemes is 6 per cent of total pay, with employers running larger schemes typically contributing 8 or 9 per cent.<sup>xi</sup> In addition, employers running a contracted-out salary related scheme receive a rebate equivalent to around 5.1 per cent of relevant employee National Insurance payments. Under the UPP proposals, this rebate will be diverted to the UPP fund.

However economic theory suggests that the idea that ultimately employers can be 'made to pay' is mistaken, as in the long-run the additional costs are passed back to employees. This theory was corroborated when compulsory contributions were imposed on employers in Australia, as the first year's contributions were paid in lieu of salary increases.

An implication of the universality of the UPP is that the self-employed should be included, and yet as pointed out above, current policy is not to compel the self-employed to contribute to second tier pension provision. However, the problem with this policy is that the self-employed turn out as a result to be more reliant on the Basic State Pension in retirement than employees. Also, the self-employed today are a diverse group – they do not all build up business assets that can be sold on retirement. This diversity is likely to increase in future. For these reasons, the Pension Provision Group called for the self-employed to be brought into state second-tier provision.<sup>xii</sup> There is clearly a very good argument for including the self-employed, but there would need to be careful consideration of the possible fall in investment that might result from the cost of pension contributions.

Further compulsory contributions will mean a fall in disposable income during the working lives of most of those required to contribute. Pension saving is much more effective if begun early so that compound investment returns can be accrued over a relatively long period. However the first decade or two of a working life is usually the period of greatest financial commitment and, at least during the first ten years or so of work, lowest earnings.

As discussed earlier, without compulsion there can be no redistribution and there is therefore likely to be significant moral hazard for those on low and moderate incomes. At its worst this could mean reckless spending, incurrence of debt throughout life and reliance of others - through the state – during retirement. Many cases are much less clear-cut. In particular, the use of income to finance education and housing may well be legitimate alternatives to explicit pensions savings. There are therefore competing investment alternatives during these years. One suggestion is that the UPP contribution could be stepped to reflect these financial commitments. The guiding principle here is that regular saving is easier than a sudden start to large contributions. A small reduction

from a payslip becomes a habit that is less painful to increase later. With a lower contribution initially, there would clearly have to be higher contributions during later life to keep the original pension level.

#### 6.5. Rolling out the UPP

As well as discussing the gradual phasing-in of contributions to allow for other financial pressures, the Compulsion and Redistribution Seminar group looked at the issue of how the UPP scheme should begin to roll out its membership. While the outline plan was to include everyone aged 25 and then encompass more of the population as cohorts reached 25 years of age, it was felt that it would be preferable both to have people paying contributions at an earlier age and for the scheme to pay out sooner than the 40 or 45 year wait involved if 25 year olds were to be the oldest members.

The issue of whether older people should have to join, or be allowed to join, needs to be thought through carefully. The more people the scheme includes quickly the sooner it will start to ameliorate pensioner poverty. Furthermore, there is little doubt that a scheme paying out within 10 or 15 years is likely to have more credibility than a scheme taking 40 or 45 years to make its first payment. However the argument against compelling older people to save is that some of them will have already made satisfactory alternative provision. For this reason we suggest three possibilities for UPP coverage:

- (a) Everyone born after a date 25 years before the scheme comes into operation enters UPP paying the full contribution.
- (b) As (a) but with everyone born after another date – perhaps somewhere between 30 and 45 years before the scheme comes into operation – entering UPP and eventually receiving a pension that is actuarially reduced to reflect their shorter contribution period.
- (c) As (a) or (b) but with older workers having the option to buy into the scheme.

We make a suggestion at the end of this paper that the Government Actuary should make an assessment of some of the costs and implications of this scheme. These different methods of introducing the scheme are one aspect that could be reported on.

## 7. Principle 3: redistribution

The simple fact is that if we all want good pensions then we will have to contribute more. Those on low incomes cannot contribute enough to finance a good retirement income. This fact is recognised in the state system through redistribution in both the Basic State Pension and the State Second Pension, although even these two pensions combined will not provide an income adequate to lift poorer workers off means-tested benefits.

### 7.1. 'Moral hazard' and redistribution

At present some people save for their pension, and others who could do so, do not. If those who do not save then claim state benefits as pensioners, they are being subsidised for their choice of spending instead of saving.

This "moral hazard" problem is particularly acute today as the present level of compulsion is inadequate. The Institute of Actuaries has estimated that someone contributing only what they are compelled to via the Basic State Pension and the State Second Pension will in 2050 receive a pension of £88 per week in current earnings terms, compared to a possible Minimum Income Guarantee of £98 per week in current earnings terms.<sup>xiii</sup> This gap could widen throughout retirement because of different indexation.

### 7.2. Redistribution under the Universal Protected Pension

Calculations from the Government Actuary's Department indicate that for the Universal Protected Pension each worker will pay in an additional 2 per cent on employee National Insurance plus the equivalent of their State Second Pension rebate. The scheme is therefore 'stand alone' with no need for a Government subsidy.

As discussed earlier, the scheme is made up of two components. The first being the Basic State Pension and the second being the funded Universal Protected Pension. The funded element of the scheme mirrors the financing of the basic state pension with all paying a similar proportion of their income for a pension that is flat rate. Accordingly, under the UPP proposal the whole of the contribution, including the foregone SERPS/S2P rebate, is treated the same for redistribution purposes.

Future savings on welfare benefits can to a very large extent offset the costs of the UPP. Once in payment the UPP will lift so many people above means-tested benefits that massive savings will be possible. Currently such expenditure runs at about £13bn per year – equivalent to 5p on the basic rate of income tax – most of this money could be saved with the UPP in full operation.

## 8. Principle 4: funded

Any pension promise is a claim on future national income. How that claim is met, in particular what the best way of ensuring the claim is met, is rapidly becoming one of the key political issues in developed countries. With the Universal Protected Pension the aim is to establish a durable mechanism to meet the claims of contributors.

### 8.1. Managing demographic change

The past century or more has seen expanding workforces throughout the developed world. This fact has made it much easier to deliver on pensions promises – up until now. An expanding workforce is likely to make delivering both pay-as-you-go pensions and funded pensions much easier.

The coming decades will very probably see a contraction in the workforce relative to the retired population throughout the developed world. This is likely to be the case even if there are modest increases in official pension ages. Relatively smaller workforces will have to pay for more pensions.

There is no risk free way of financing a pension. If it is financed through pay-as-you-go then the scheme is usually locked into a particular demographic profile and is very much dependent on future workers accepting tax levels that may be considerably higher than those paid previously by the retired population. If a pension is financed through the sale of assets accumulated during a working life, then the main risk present is investment and economic performance. The accumulation of a funded pension may feel more tangible and offers scope for higher returns, but, as the past two years show, markets go down as well as up. Without some form of risk pooling retirement income becomes a lottery.

### 8.2. Universal Protected Pension has two components; one pay-as-you-go, one funded

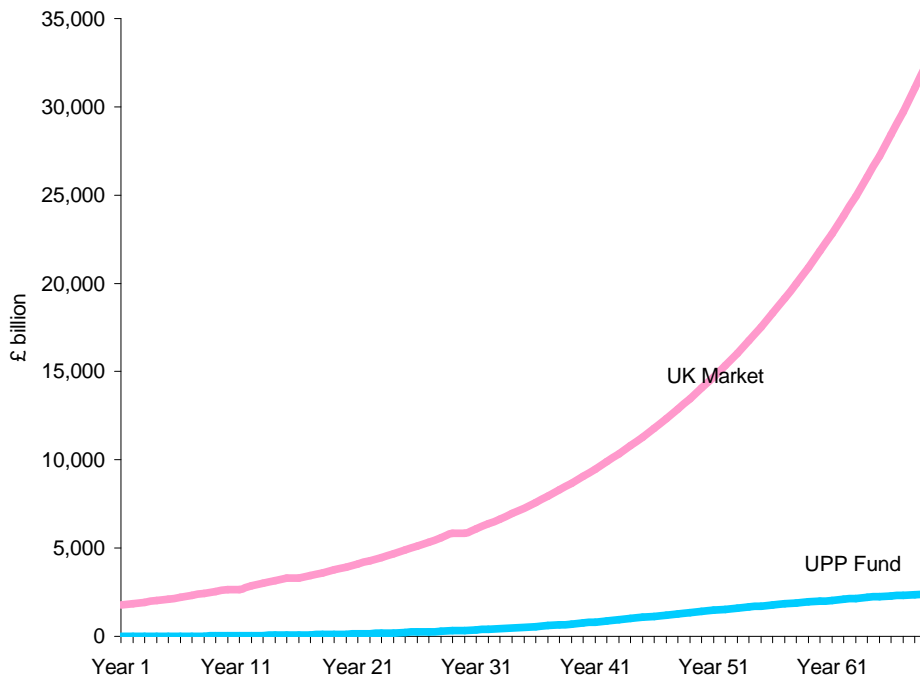
The Universal Protected Pension will have two components. The first is the existing pay-as-you-go Basic State Pension. If this were to be scrapped it would give rise to the classic 'double payment' problem whereby one generation pays their contributions for current pensioners but receives no pension in return. The Basic State Pension will continue and will be uprated in line with earnings as part of the full guarantee. The main projections by the Government Actuary indicate that after 2030 there is sufficient slack in the National Insurance fund to afford this.

The second component of the UPP is the funded element for which additional contributions are being levied. Funding introduces a requirement for governance arrangements to determine investment strategy and related issues. These issues are discussed in the next section.

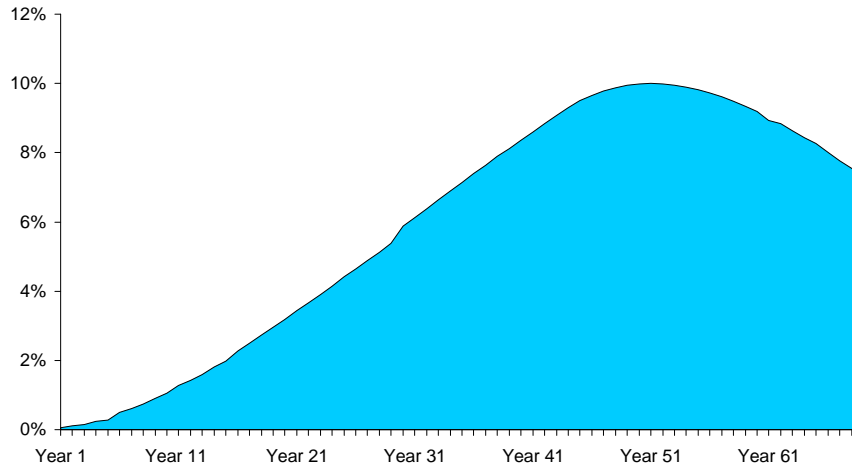
### 8.3. Size of the Universal Protected Pension fund

The size of the funds under management and what impact they may have on markets is another important issue for a compulsory funded scheme. Our estimates suggest that if the funds were to be invested broadly in line with the larger UK occupational pensions, with 55 per cent in UK equities, then at maturity in 70 years time it would probably constitute between 5 and 10 per cent of the UK equity market. Invested on this 55 per cent UK equity basis, at no point in its growth is the fund likely to constitute more than 10 per cent of the market.

**Chart 8.1: Growth of UPP fund and UK equity market**



**Chart 8.2: Universal Protected Pension fund as a share of the UK equity market**



There is however a general trend towards greater global investment. The UPP fund would be larger than other UK schemes and perhaps better placed to exploit emerging opportunities in foreign markets. A more global investment strategy could lead the fund to own perhaps only 3 or 4 per cent of the UK equity market. The Irish National Pensions Reserve Fund and the Canada Pension Plan are somewhat similar schemes pursuing a global investment strategy.

## 9. Principle 5: independence from Government

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 going of different political projects. The UPP is intended as a scheme that is established by Government but which is governed independently on behalf of its members. Planning for one's retirement is a long-term business that requires long-term stability.

### 9.1. Governance structure for managing the UPP pension fund: democratic trusteeship

The UPP will have a board of trustees as with a company pension scheme. The aim is to achieve a structure that is stable, expert, relatively immune from political interference, and which allows members a say in the running of their scheme. The October 2001 report suggested that these trustees would be part-elected and part-nominated.

When this issue was discussed in the Governance and Investment Seminar there was a feeling that with direct election the risk of selecting inappropriate and inexperienced trustees was quite considerable, and that some form of democratic control likely to produce expert trustees was desirable. A new two-tier governance structure is therefore proposed:

- a relatively large first tier of governors. Governors will be appointed by Government but will serve long, staggered terms, thereby limiting the control of any one administration over the composition. The governors' main task will be to nominate trustees. 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, would be put before the membership of the scheme at an election.

Trustees would present their credentials to the membership. Their objectives for the scheme should be clear to the membership and they should feel 'known' by members.

### 9.2. The role of trustees

Trustees will have an objective framed purely in terms of their members' financial interests. Trustees will have the power to:

- vary contribution rates;
- within the prescribed band of 25 to 30 per cent of average earnings, decide the level of pension to be paid.

Trustees will be required to devolve management of the assets to fund managers. It is likely that the scheme will have a core of investment expertise and would then seek to contract out management of some funds to capitalise on other private sector fund management expertise. There is a debate to be had on whether particular types of investment – for example those with a higher risk of being thought controversial or intimately linked to Government policy – should be contracted out as a matter of course. Less potentially controversial investments, such as index tracking investments, could perhaps be undertaken more efficiently by the scheme's own managers.

Although the work that trustees will be doing is quite different to that of the Bank of England's Monetary Policy Committee, that Committee has shown that a body with very significant power can be established by the state to operate very effectively with independence from Government. We think that the trusteeship structure suggested here could produce similarly beneficial results.

Trustees will also appoint a chief executive to manage the scheme. The management will have a responsibility to handle communications with members including an annual statement of contributions and entitlement forecast.

This structure bears some similarities with the funded Canada Pension Plan, although the detail of our proposals has gone further in seeking to ensure accountability and good governance.

### 9.3. Communication

Big decisions taken by trustees on investment will clearly have a major bearing on the fund. The extent to which details of the major decisions by trustees should be made public is an issue that would have to be resolved. Clearly it would be self-defeating to immediately release details of an investment strategy. It may however be possible for the trustees to disclose some more general information from time to time on the fund's overall position and strategy.

As well as this there would be a statutory requirement to disclose, perhaps on an annual basis, a valuation of assets and liabilities, plus an actuarial evaluation every two years or so.

Crucially important for the scheme's durability will be for members to feel that the scheme is theirs and that they have an interest in how it is run. The UPP will have to be accessible, understood, and valued by its members if it is to have a good chance of ongoing support from both members and Governments. The methods by which people communicate have changed radically even in the past ten years. Further radical change during the life of scheme is almost certain and the scheme should take advantage of such opportunities. Were the scheme to be set up over the next few years it might feature:

- individualised annual statements showing contributions and expected benefits;
- a website giving details of the fund's investment, benefits, contribution and entitlement rules, and a secure area where members can access their details.

In the course of their work trustees would communicate a range of information about economic prospects, investment and savings. Part of the benefit of the UPP should be that a greater proportion of the population would become financially literate, not only regarding the terms of their UPP investment but also in terms of a better general understanding of savings and investments.

### 9.4. Extension of the scheme to build credibility

In the outline proposals put forward in the October 2001 report we suggested that 25 year olds entering the scheme on day one would be the first recipients of the UPP. One argument put forcefully in two of the seminar groups was that this would create at least a 40 year wait before the scheme paid its first pension, and that politically at least, this was unlikely to be acceptable.

The Governance and Investment Seminar was keen that the introduction of the scheme would be extended to include those with a more immediate retirement date than those aged 25. They felt that the benefits would include:

- a more immediate balance to the scheme to cover both contributors and beneficiaries;
- a better funding profile for the scheme;
- better opportunities for communication of the scheme from the outset.

It would be useful to find a way of augmenting the compulsory element for the additional participants to allow those on lower incomes to buy extra years in the fund. However, extensive use of such a freedom without explicit Government subsidy could significantly disturb the balance of redistribution and involve excessive direct cost by the members. While, therefore the scheme could usefully be extended to include those older than 25 at the outset, it is unlikely to alienate absolutely the need for income support for many years; before then, however, it should begin to have a material impact on the incentive to save.

To reiterate the three alternative forms of coverage that were put forward:

- (a) Everyone born after a date 25 years before the scheme comes into operation enters UPP paying the full contribution.
- (b) As (a) but with all workers born after another date – perhaps somewhere between 30 and 45 years before the scheme comes into operation – enters UPP and eventually receives a pension that is actuarially reduced to reflect their shorter contribution period.
- (c) As (a) or (b) but with older workers having the option to buy into the scheme.

As well as alleviating pensioner poverty amongst these groups, bringing in older workers has a significant bearing on the likelihood of good governance as it forces the scheme's trustees and management to act in the knowledge that the scheme has to pay out pensions relatively soon. An inherent danger with any pension scheme taking in contributions but not paying out for decades is mis-management and unaccountability during the early years.

## 10. Developing the Government's reforms

The State Second Pension is in many ways a commendable attempt to extend the benefits of the basic state pension. The Pensions Reform Group believes that it could be developed to fulfil the objectives of the UPP.

Existing reforms can be developed to achieve the aims of the UPP. The Government's State Second Pension (S2P) could be developed and enhanced to offer the benefits of the UPP.

### 10.1. The State Second Pension and the UPP

The S2P replaced SERPS for new contributions in April 2002. From that date no further SERPS pension accrued. SERPS accrued entitlement and pensions in payment will be paid as previously planned. There will, therefore, be a large number of people retiring over at least the next fifty years or so who have some S2P and some SERPS on top of their Basic State Pension.

Initially S2P will offer an earnings related pension in return for earnings related contributions. For earnings below about £25,000 S2P will be more generous than SERPS with the greatest benefit for low earners. For earnings above £25,000 S2P will offer the same benefits as SERPS.

However the Government's aim is to persuade everyone earning above a specified level called the Low Earnings Threshold (£10,800 in 2002-03) to contract out of S2P into a Stakeholder, personal pension, or occupational pension. Rebates are being offered to encourage this. The aim then is to make S2P a flat rate pension in return for the same earnings related contributions. In this form S2P is meant to look a poor deal for moderate and higher earners, meaning that those with wages at or above this level will rationally opt to contract out.

Data on the numbers contracting-out of S2P are unavailable. The hitherto low take up of Stakeholder amongst those on earnings between £10,000 and £20,000 suggests that the strategy is not working as hoped. The Government's position is that S2P will move to the flat-rate structure only once Stakeholder has established itself with the target group.

A shift to the flat rate format would clearly make S2P much more similar to the UPP as both would have earnings related contributions but flat rate pensions.

However for the State Second Pension to deliver the benefits of the UPP there would have to be four crucial changes:

- the flat rate benefit of the State Second Pension would have to be made more generous;
- once in payment the State Second Pension would have to be uprated with earnings;
- contracting-out would have to be abolished;
- the State Second Pension would have to be funded.

### 10.2. Improving the level of benefit of the State Second Pension

As noted earlier, the likely benefits from the State Second Pension are inadequate even to float everybody off the Minimum Income Guarantee at the point of retirement. As their retirement progresses more and more people would fall into means-tests. Passported benefits compound this problem.

Although there is some force in the argument that because the State Second Pension will bring people nearer to the MIG level and therefore make saving worthwhile, the level of saving required is still too high for many. Saving made during a working life should translate into a more or less proportionately higher retirement income, and those with the least to save are here being handed the hardest decision about whether it is worth it or not.

One option would be to make the accrual rate for the State Second Pension higher or increase the earnings on which the pension accrues. Assuming the State Second Pension survives this could deliver a pension above the poverty line. If price-indexed the pension would have to be generous enough at the outset to stay ahead of possibly earnings linked benefits. It would be simpler to link the pension to earnings once in payment.

### 10.3. Ending contracting out

However the fundamental weakness of the State Second Pension with respect to its own survival is the contracting-out provision. If the scheme works the effect will be a membership of around 4 million of the poorest workers with incomes below about £11,000 per year.

State pensions with contracting out provisions have not lasted well in the UK. The first such scheme, the graduated retirement benefit, lasted from 1961 to 1975, and SERPS from 1978 to 2002. The contrast with the longevity of the Basic State Pension is stark.

The Basic State Pension is often said to be simple. But the perceived simplicity comes from universal membership, meaning that most people get roughly the same amount and that there is a very large coalition of voters' interests to defend the scheme. In many ways contracting-out is a complication too far. To keep the additional costs of the scheme to a minimum we envisage that for members of the UPP national insurance rebates would end with the contribution being diverted into the UPP.

An end to contracting-out would mean a reduction in the income available for occupational pensions, and, offsetting this to some extent, a reduction in their complexity. It is likely that some occupational schemes would remodel themselves as a result. UPP is to be universal. This is a crucial feature. It should be pointed out that an end to contracting-out would mean that schemes would most probably offer proportionately lower benefits – and should be allowed to do so – meaning therefore that for company schemes this move would be revenue neutral.

However this move could pose a further threat to final salary occupational schemes. An objective of the Pensions Reform Group is to safeguard those occupational schemes that have been the clear welfare success story of the past century. The Pensions Reform Group is therefore consulting with employers sponsoring pension schemes to see whether it is possible to extend the hybrid nature of the scheme to cover those occupational schemes which deliver a pension as good or better than the UPP. How such a change would affect the UPP's finances is an issue on which we shall seek the Government Actuary's advice.

### 10.4. The State Second Pension transformed

With these enhancements the State Second Pension, added to the Basic State Pension, would become a universal first-tier pension sufficiently generous to free those ending a working life from means-tests. In the longer run there would be very substantial savings on expenditure on means-tested benefits. With these developments more sense could be made of the means-tested strategy to help today's pensioners. The bill for these benefits would be time-limited and younger workers would know it would pay to save.

## 11. Conclusion

The review process following the October 2001 report, and events over those nine months have strengthened the conviction of the Pensions Reform Group that reform is urgent. Our proposals have been greatly improved and challenged by the Seminar Groups although the fundamentals have remained intact.

### 11.1. An increased need for reform

Since the PRG published its original report in October 2001, there has arisen an increasing need for a solution to the universally recognised problem that large proportions of our population are saving insufficiently for old age:

- the continued gradual withdrawal of company defined benefit schemes does not help the problem as replacement forms of provision are likely to produce lower and more uncertain levels of pension;
- the initial lack of success that stakeholder has achieved means that there is no easy or obvious solution available;
- the spending boom and the population's concentration on placing all its eggs in the housing basket may exacerbate the issue;
- recent financial "scandals", in particular the problems associated with Equitable Life, make it no easier to persuade others with no history of investing to take that first step;
- the recent suggestions made by the Sandler and Pickering reports will hopefully simplify savings products and the running of occupational pensions, but their proposals do not go as far in advocating the fundamental need for compulsion and redistribution to ensure that adequate pensions are accumulated by all.

Likewise there is continued concern that the rates of real return on investments have no immediate prospect of returning to the levels many of those who are properly prudent may have presumed in arranging their finances; as a result they too may be underfunded.

The Government has a laudable commitment to ensuring that people in old age are not destitute but, regrettably, all those best intentions have made it no easier to offer a persuasive message to those on the lower incomes (those who face the greatest danger) to save. Accordingly, the UPP offers a real alternative to ensure that all the working population of this country has enough to live on in retirement; it is a proposition that does not leave matters to chance but which ensures that the outcome will be delivered by making people invest in a fund that is independently managed for all along the lines of an occupational pension. Moreover, it ensures that the compulsion is affordable by offering a level of redistribution that is consistent with National Insurance.

### 11.2. The answer: the Universal Protected Pension

To recapitulate, the Universal Protected Pension has five key features or principles:

- **a pension of 25-30 per cent of average earnings throughout retirement**, ensuring that all those ending a working life have an income above the poverty line;
- **universal membership**, with the scheme starting with younger workers paying contributions, possibly including some older workers, and building up from there;
- **redistribution**, with all paying a similar proportion of their income for a pension that is, like the Basic State Pension, the same for all;
- **funded**, with the Basic State Pension remaining pay-as-you-go and making up the first element of the 25-30 per cent of average earnings guarantee;

- **independence from Government:** the UPP is supported by a Governance regime to ensure the fund is robust from political influence as with the Bank of England's Monetary Policy Committee.

The proposition is intimately interconnected with the National Insurance system in two respects – the contributions would be collected by the Contributions Agency on behalf of the UPP and the funding of the UPP depends significantly on using the S2P rebate. Accordingly, we would propose that this UPP is considered carefully as a natural development of the State Second Pension. By doing so, this country, ahead of all its European neighbours, would be ensuring that all its working citizens would be properly and sufficiently provided for in old age and would have created a universal incentives for saving and betterment beyond that level. We do not attempt to disguise the fact that better pensions cost more and that these proposals will require a modest increase in contributions, and for the youngest workers a change in the pension age.

On behalf of the Pensions Reform Group we commend this proposition to this Government and all those who aspire to that office.

#### Follow up

The proposals presented here are a development of those in the Pensions Reform Group's October 2001 report as costed by the Government Actuary. One aspect that has hopefully come through in this report is that there is considerable scope for flexibility in the scheme with regard to the phasing-in of contributions, the pension age, the level of pension, the balance between pay-as-you-go and funding and so on. One way in which the Government could usefully stimulate the pensions debate is by asking the Government Actuary to look at some of the possible variations on the scheme.

As this scheme has generated considerable interest not only amongst those involved in the seminar groups but also amongst politicians, the financial community, the press, and the general public, we hope that the Government will discuss seriously the merits of this report and respond in detail.

## Endnotes

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- <sup>i</sup> Pensions Reform Group: *Universal Protected Pension: Modernising Pensions for the Millennium*, Institute of Community Studies, October 2001.
- <sup>ii</sup> Official data on pensioner incomes in presented in the Households Below Average Income series and since 1994-95 has been derived from the Family Resources Survey.
- <sup>iii</sup> Recent research on the dynamics of poverty amongst different parts of the population by the Department of Work and Pensions, Research Report No.157: *The Dynamics of Poverty in Britain*.
- <sup>iv</sup> Households Below Average Income 2000-01.
- <sup>v</sup> See for example the Department of Work and Pensions, Research Report No.157: *The Dynamics of Poverty in Britain*.
- <sup>vi</sup> Department of Work and Pensions, Analytical Services Division, *Benefit Expenditure Tables*, and Department of Work and Pensions: *The Pension Credit: Long Term Projections*.
- <sup>vii</sup> Lombard Street Research: *Daily Note*, 18<sup>th</sup> March 2001.
- <sup>viii</sup> Institute/Faculty of Actuaries Pension Provision Taskforce paper: *The Size of the State Pension*, 2001.
- <sup>ix</sup> Department of Work and Pensions, Analytical Services Division, *Benefit Expenditure Tables*, and Department of Work and Pensions: *The Pension Credit: Long Term Projections*.
- <sup>x</sup> Department of Work and Pensions: *The Pension Credit: Long-term Projections*, Table 1.
- <sup>xi</sup> Department of Work and Pensions: *Employers' Pension Provision 2000*, Table 5.22.
- <sup>xii</sup> Pension Provision Group: *Pension Provision and Self-employment*, December 2001.
- <sup>xiii</sup> Institute/Faculty of Actuaries Pension Provision Taskforce paper: *The Size of the State Pension*, 2001.