

THE CHANCE OF A LIFETIME

**THE CHANCE OF A LIFETIME:
how to pay for reforming the basic
state pension**

PENSIONS REFORM GROUP

24 APRIL 2006

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The issue to be decided

With the publication of the Pensions Commission's final report the Chancellor is reported to be in 90-95 per cent agreement with the Commission's proposals. There appears to be two questions in the Government's mind. The first is whether the Pensions Commission's proposals for reforming the basic state pension (BSP) are affordable. To this question of affordability must be added the equally important question of trust. Will a major pension reform financed by tax increases be delivered in the longer-term? Or will an investment-led reform more securely lock politicians into delivering the pension promise? The Pensions Reform Group (PRG) believes voters know the answer to this question.

This memorandum compares the two proposals before the Government for reforming the BSP: a tax led as opposed to a savings/investment led reform. The first option is proposed by the Pensions Commission which suggests making the BSP non-contributory and indexing it to earnings rather than prices. The Commission also proposes a substantial reform to the state second pension (S2P). Currently a contributor pays earning-related contributions for an earnings related pension. Under the Pensions Commission reforms earnings related contributions would remain but the benefit would over time be converted into a flat rate benefit. There are costs here in the conversion of the BSP into a citizenship pension and its indexation to earnings. Additional contributions will be required to the National Pension Savings Scheme (NPSS). The reforms would save on pension credit, housing benefit and council tax benefit.

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The second option, put forward by the Pensions Reform Group, advocates a Universal Protected Pension (UPP) paying a minimum of 25 per cent (but not more than 30 per cent) of national average earnings. This pension is made up of two parts: the existing basic state pension and a funded pension. Once the UPP is in payment, both parts (the basic state pension and the funded element) will be linked to earnings. This pension is funded by additional national insurance contributions. Against this cost can be placed the abolition of pensioner welfare as we have know it.

Reforming the BSP is a pre-requisite to any debate on NPSS or any savings beyond the basic. People have to know that they are permanently provided for at a basic level free from means-tested benefits before they can address sensibly (or should be asked to address) decisions that go beyond that, especially so if such decisions are overlaid by Government's encouragement in the form of auto-enrolment.

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The Chance of a Lifetime

Gordon Brown's pension credit has created a unique opportunity for sustainable and far reaching pension reform that has not existed before in Britain's century-long debate on state pension provision. Politicians previously devising a pension strategy had to meet two irreconcilable demands. The long term goal to universalise through legislation the best private pension provision was thwarted by demands that large sums of money were needed immediately to reduce the abject poverty among too many pensioners. Acceding to this demand made it impossible to plan for a funded pension scheme along the lines, for example, that Beveridge proposed in 1942. His plan was overturned by Labour MPs insisting that in the early post-war years the additional weekly contributions were immediately directed to paying higher pensions, rather than building up an investment fund over the longer term from which more generous pensions could be paid at some stage in the future.

Pension credit has transformed the politics of pension reform. This benefit has directed more additional money to the poorest pensioners than any other post-war anti-poverty initiative. For the first time there is little demand in the country that a government priority should be to plan for large sums of additional money to be paid on top of pension credit. The Government has earned a political breathing space in which it must initiate long-term reforms to ensure that future pensioners have a generous enough pension to make them ineligible for pension credit.

Two options are open to the Government. The first is to make less generous the indexing of pension credit. The second is to build up a pension generous enough to lift pensioners free of pension credit.

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The first option is a negative one, of refusing to embrace any further reform while at some stage letting a future Chancellor de-couple the indexation of pension credit from earnings. Such a move could only be bought at a damaging cost to individuals. At the moment perhaps 40 per cent of the working population know that, by saving what they can, they cannot make themselves better off, or not much better off. They recognise that they can simply spend today and let pension credit look after them tomorrow. The private sector, still stung by its previous experience of mis-selling, is anxious not to sell to this group.

However, once the formula for indexing pension credit is revised downwards, a very considerable number of today's working people will find over time that they are ineligible for part, or indeed whole, of the pension credit upon which they were depending for their retirement. Their relatively low earnings will prevent most of them from making up the pension savings they had been advised not to make under the current rules. And the longer it is before such changes are made to pension credit's eligibility the larger will be the proportion of the working population affected.

Such a strategy:

- would result in a whole cadre of existing workers being condemned to poverty in their retirement, i.e. would see the re-emergence of significant numbers of poor pensioners;
- would thereby unpick one of this government's major achievements: eliminating significant numbers of pensioners who

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had historically existed on a standard of living considerably below that enjoyed by the rest of society.

Political risk to the Government

Both the Pensions Reform Group and the Pensions Commission share the belief that it is vital to increase substantially the value of the current basic state pension and at the same stage link its growth to earnings. This is the basic building block which has to be in place before any other reforms – such as establishing a National Pension Savings Scheme (NPSS) – can be safely embraced. The Chancellor has made it clear that with any reform a key question is affordability. The Pensions Reform Group's proposals are an alternative either to no reform, or to a tax financed reform of the basic state pension put forward by the Pensions Commission.

The PRG has consistently maintained that most voters see a difference between tax increases, which might be spent on any area of government policy, and a ring fenced national insurance increase that is clearly focused exclusively on providing their state pension. This distinction in the voters' mind between tax and national insurance has been given an even clearer focus by the Chancellor when he put an additional 1p contribution on national insurance rates in order to help finance the growth in NHS expenditure. Again, the PRG builds on this precedent set by the Chancellor. Our proposal is for the Universal Protected Pension to be financed by additional national insurance contributions over and above the sums realised by redirecting the national insurance rebate into the new scheme.

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There is a widespread perception amongst voters that a fundamental reform is required of both the basic state pension, and of that proportion of current income saved, in order that individuals may secure a more adequate retirement income. To oppose either of these alternatives to reforming the basic state pension involves considerable risk both politically as well as for the country. The Opposition are, after all, anxious to portray the Chancellor as being a road block to reform and that a Brown premiership will signal the end of New Labour's reform programme.

There are also risks more generally to the Government in allowing voters to believe that the reforming zeal of New Labour is beginning to ebb. There are, in addition, distinct risks for savers if the Government decides not to reform the basic state pension, while preserving the pension credit and simultaneously moving ahead in establishing a National Pension Savings Scheme. Such a scenario would be the worst of all possible outcomes. Large scale eligibility for pension credit would remain while many of those at work may be persuaded to save through the NPSS who would be best advised not to do so. Establishing a NPSS in these circumstances would open the Government to giving mis-promotion and, the private sector, to mis-selling charges.

There is an alternative

There is an alternative to this outcome. PRG believes that a shelf-life should be put on pension credit through the introduction of a Universal Protected Pension which guarantees a reasonable retirement income for full members.

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As our scheme has been set out in detail in www.pensionsreformgroup.org we only need to give the briefest outline of the proposal here. Our costings assume:

- the basic state pension will continue to increase in line with prices during a person's working life;
- at retirement a Universal Protected Pension, valued at between 25 per cent and 30 per cent of national average earnings, is paid and this sum is made up from the basic state pension and a funded pension, i.e. in aggregate, in today's prices, a pension of £130 a week compared to the £82.05 paid up to April 2006;
- both parts of this Universal Protected Pension will be indexed in line with earnings;
- the total scheme will mirror existing arrangements: collected through the Collections Agency, it will be compulsory and redistributive.

Constitutional innovation

The governance of our scheme is of fundamental importance to its success. There is what has now become a fundamental question for the electorate, the extent to which they trust, or more accurately, do not trust, politicians. Without such trust it is difficult for politicians to gain the voters' support for a reform programme.

A pension reform on the scale we are proposing is too significant and far reaching to exclude government entirely, but voters are understandably reluctant to trust government alone to deliver a pension promise. We have therefore built on the most significant constitutional change Labour has

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made since 1997 in establishing a clearly independent Monetary Policy Committee of the Bank of England. The Pensions Reform Group proposes the use of the Bank of England model in establishing a civic company. The UPP would be guarded by a set of governors appointed by the Government who would under the auspices of the Bank of England:

- reflect the long term nature of the problem, be appointed for long periods of approximately 15 years as are the governors of the Federal Reserve, with these appointments being staggered over time;
- have the duty, set in legislation, to run the UPP delivering a pension between 25 and 30 per cent of average earnings.

The governors would appoint trustees who themselves would have to be approved by the membership. Trustees, governed by trust law, would use a range of fund managers to invest UPP funds; they would also decide on contribution and distribution rates. Together with the Governors, the Trustees could be responsible for varying the pensionable age by reference to expected mortality; to do this would further derisk the pension commitment.

Even when the scheme is fully mature, and if all the investments were made in UK firms, which is very unlikely and not particularly desirable, the size of the investments would amount to only 10 per cent of the British Stock Market. With appropriate governance arrangements, it would not therefore distort the market.

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The cost of the Pensions Commission and the Pensions Reform Group's proposals

i) The Pensions Commission proposals

The Commission proposes two significant changes to the basic state pension which have significant costs for taxpayers. The first is to make the basic state pension free of any eligibility rules. The second is to index this new citizenship pension to earnings. With the help of the House of Commons Library the costs of these two reforms have been converted into national insurance contributions so that a direct comparison can be made with the costings the Government Actuary has undertaken of PRG's proposals. Indexing to earnings has little effect on costs in early years. The cost, however, accumulates and the indexing costs here are taken 15 years after the link with earnings is made.

Table One: The estimated annual increase to national insurance contribution of the Pensions Commission's proposed changes to the Basic State Pension

Citizenship pension	1.5
Indexing to earnings	2.4
Total	3.9

In addition the Pensions Commission proposes a 8 per cent of salary contribution to the NPSS split so that employees pay 4 per cent, employers 3 per cent and taxpayers contribute 1 per cent. There will be further taxpayer costs resulting from any abatements now proposed to exempt in part or completely NPSS contributions from small employers.

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ii) The PRG reforms

Better pensions require additional contributions. The PRG builds on the pensions strategy of the Chancellor. The indexation of the BSP to prices is the starting point. PRG proposes additional contributions to build up the fund which, after a full contribution record is achieved, offers a basic pension in today's terms of £130 a week including the £82.05 of the 2005-6 BSP, and which would ensure that both parts of the UPP – today's BSP and the additional element – are indexed to earnings once the pension is in payment.

A funded scheme is highly sensitive to the assumptions about investment returns. We asked the Government Actuary to cost our proposals under a number of assumptions and we have set out in Appendix One the reasons why we believe it is reasonable to assume over the long term a real return of 4.5 per cent (this compares with the return allowed by regulators for regulated utilities). For its own National Pension Savings Scheme the Pensions Commission assumes a 3.5 per cent real rate of return. But the Pensions Commission's costings are determined partly by life-style factors, i.e. the necessary movement into bonds as a contributor to an individualised NPSS account moves towards retirement. They are also determined by the fact that one of the NPSS funds is a default fund with naturally a rate of return below that of the other two funds.

Because the PRG scheme is a collective scheme it therefore differs fundamentally from all other proposals. A company scheme for the whole nation, for that is what the UPP proposals are, has new members

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balancing retirees. Trustees are not therefore bound to model their investment strategy on the traditional model for pension investments.

Workers contracted out of the S2P take what is called the national insurance rebate into their company, personal or stakeholder pension. Under our proposals this contribution will be redirected into financing the UPP and company schemes would be able to subtract the UPP from the pension promise they have given employees. Our proposals, unlike those of the Pensions Commission, protect company schemes. The current national insurance rebate is 5.1 per cent and we asked the Government Actuary to estimate how far would this sum, plus the basic state pension (linked to prices), bring the UPP scheme within striking distance of a pension valued of at least 25 per cent of national average earnings. It is proposed to raise this rebate to 5.3 per cent but we had asked the Government Actuary to cost our proposals before the higher rebate was announced. There will be the need, however, for the contracted out rebate scheme to be universalised so that those who are currently in the S2P bring an equal drawdown to the UPP fund or for the existing rebate to be shared out equally amongst all workers.

The result is significant. Leaving additional contributions to be settled at a later date when the Chancellor believes it prudent to increase national insurance contributions, the rebate alone, invested in the UPP, for the whole of the person's working life, together with the basic state pension, would deliver a pension of a little over the PRG minimum target of 25 per cent of national average earnings.

Additional contributions are required to ensure a pension payment of between 25 and 30 per cent of national average earnings as well as to

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index the pension once in payment to national average earnings. In order to work out how much this sum would be we also asked the Government Actuary to cost the UPP proposals on the assumptions that national insurance contributions would be levied on income between the lower and upper earnings level, with the upper earnings level lifted, with contributors working until they were 65 or 67 and assuming a 44 and 46 years of contributory life. The results of these costings are summarised thus.

Table Two: Level of additional national insurance contributions for 44 and 46 years contributions with upper earnings level in place and abolished

Years worked	44	46
Lower and Upper Earnings Level	2.9	2.0
Lower but no Upper Earnings Level	2.2	1.5

Illustrative costings were also requested for older workers joining the scheme. The proportion of the UPP these workers would gain is illustrated below.

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Table Three: Proportion of UPP gained depending on the number of contribution years

Age of contributor	Retirement age	
	65	67
21	100	100
35	75	75
45	62	62

Many of those workers gaining only part UPP because of their age will have earned significant SERPS and State Second Pension payments. The worker of 45 years, having 20 years' SERPS contribution, would bring an additional £55 to the UPP while a 10 year contributor would bring an additional £27 a week.

Additional benefits

The UPP costings have been undertaken on an individualised basis. The total scheme is therefore costed on the basis that should a contributor die before reaching retirement age their entire contributions would be refunded to their estate, unlike the present state scheme where an early death wipes out contributions.

We asked the Government Actuary the cost of offering £100,000 life cover to all those whose early death would result in the return of contributions less than this sum. The Government Actuary estimated that this optional benefit would be gained by an additional 2.5 per cent contribution of earnings if the lower earnings level is retained and 2 per cent if it is lifted. Over the longer term, when substantial funds have been

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built up, the Government Actuary estimates the respective figures as 1.5 per cent and 1 per cent respectively. We also asked the Government Actuary what size the capital sums would be if the scheme had no life insurance cover but contributions were returned to those contributors who died before drawing the UPP. Unlike the current National Insurance Scheme where all contributions in such circumstances are lost, a contributor for 20 and 30 years would have £24,000 and £43,000 respectively added to their estate.

The best buy

We believe the PRG's proposals are the best buy open to the Government.

- PRG does not propose to universalise the basic state pension. It believes that the question of those women who have been carers, for example, and have poor contribution records as a result, does need to be looked at and periods of caring linked and valued in such a way that a greater number of women qualify for the basic state pension through the current system of accreditation. The PRG does not believe that it is a good use of taxpayers' money to finance those women who have not had to work, and therefore have not paid contributions, or, having been at work, opted in opposition to their colleagues to pay at what was once called the Married Women's Option.
- The PRG scheme takes longer to come into fruition (pension credit is taking care of the poorest pensioners so the reform is able to build up over the longer term). Full membership of the UPP takes

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between 44 to 46 years to complete and in the early years there is little additional pension to be drawn down from the funds.

- A funded scheme builds up assets which earn dividends which are themselves invested to grow the pension fund still further.
- The indexation to earnings only applies to those within the new scheme. The Pensions Commission proposals break with the status quo in the indexing of the basic state pension to earnings – the PRG proposes such an indexation but only at retirement for the pensions of UPP members. To begin indexing within the timescale proposed by the Pensions Commission will involve in the short to medium term no additional income to pensioners on lower incomes as the higher pension would be clawed back from their pension credit payments. PRG leaves this group to be protected by the pension credit and it does so knowing that, in time, the UPP, with top-up payments in earlier years from SERPS and the State Second Pension, will lift an ever-greater number of pensioners free of means-tested benefit. PRG's proposals are for a fundamental recasting of the minimum pension everyone would earn, putting a shelf life on pension credit, and holding out the prospect of abolishing pensioner welfare as we currently know it.

Trust also a key to reform

The PRG believes once reforms are deemed affordable, the means by which they are financed touches on the fundamental question of trust. The Pensions Commission proposes a tax-based reform. PRG proposes a savings/investment based reform. The question voters will ask themselves

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is which of these reforms is most likely to last over the longer term. Would future governments find it easier to revise future pension promises if those promises are being financed through taxation? Or would a raft of investments underpinning that pension promise be more likely to be resistant to political tampering? The PRG believes that there is little doubt which of the two means of financing pension reform voters would choose if they were given a choice. This would be further reinforced if they were made aware of the future cost of leaving a raft of the underprovided to be provided for by means tested benefits; increases in income tax of up to 13p on the standard rate have been mooted.

As the PRG scheme builds up pension entitlement to the UPP the bill for means-tested benefits becomes capped and then falls. When fully operative the PRG's savings on means-tested benefits are such that a future Chancellor might wish to reward the members by abolishing direct tax on pensioner income – such is the size of the savings on pensioner welfare due to the building up of a funded scheme along the UPP lines.

Conclusion

For a government wishing to maximise The Chance of a Lifetime made by pension credit to establish a sustainable long-term reform which abolishes pensioner welfare as we currently know it, there is only one choice on offer – the PRG proposals. The clear advantages of the PRG scheme are:

- **It builds on the success of Pension Credit.**
- **It spreads investment risk across all contributors and shares longevity risk.**

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- **It will offer the lowest administrative cost of any scheme on offer.**
- **It will help meet the Government's objective of reversing the 40-60 ratio of private to state provision.**
- **It will help to maximise the extent of its investments in equities which historically out-perform gilts.**
- **It will be the best safeguard for protecting good existing company pensions.**
- **It eliminates the possibility of mis-buying.**
- **It does not force retirees to take their savings and buy annuities at whatever the going rate is.**
- **It does not put an increased tax burden on future public expenditure rounds.**

Above all, it enables Government to promote an unambiguous message that it always pays to save. This has to be the foundation for the consideration of any additional propositions such as NPSS

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Appendix One: Investment and price inflation assumptions

Our investment return assumption is 4.5% per annum real return (i.e. in excess of prices). We have assumed that prices increase annually at 2.5% - the same central assumption as used by the Government Actuary's Department and HMT.

Our investment rate of return assumption is below the 5% per annum real rate of return for equities that underlies the FSA's prescribed consumer projections used by the financial services industry (1). As discussed below, we believe the structure of the UPP would allow it to invest predominantly in equities over the long-term.

The investment rate of return assumed for NPSS by the Pensions Commission is 3.5% real per annum, with price inflation again assumed to be 2.5%. The Commission has not segmented this rate of return by asset class. There are three reasons however why an NPSS rate of return would be expected to be lower than the UPP:

- because NPSS is an individualised defined contribution model, the Commission feel there is a need to reduce asset price volatility in the years before annuitisation – “lifestyling”. To achieve this, a progressive switch into less risky, lower return gilts and bonds is made shortly before retirement;
- the NPSS rate of return assumption is an average for the entire membership based on a mixed portfolio of investments – many of whom are likely not to make an investment choice and therefore be in

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the default fund, which, given the implied liability for Government in designing this fund, is likely to be relatively conservative;

- in the post-retirement phase NPSS members will annuitise with a commercial annuity provider, meaning a move into lower risk, lower return underlying assets such as gilts and bonds. The UPP, because it has a guaranteed future stream of contributions and can invest for the very long term, will be able to pay annuities directly from its funds.

Why the UPP could have a high proportion of equity investment, and correspondingly high returns

Higher equity returns carry higher risk, but a key feature of the UPP is that contributions would be legally mandated. This means that trustees could determine investment policy on the basis that the scheme was guaranteed an indefinite stream of future contributions, so for example annuities could be paid directly from the funds, rather than by having to asset match through investment in bonds.

As equities are held for longer, the risk of holding equities declines (2). A long-term equity investment strategy would in fact be able to enjoy equity returns with less risk than schemes that do not have the same freedom to invest for the long-term. This is an advantage, for example, over the reduced returns that arise from switching into gilts (“lifestyling”) that arises in both Stakeholder and the proposed NPSS model.

(1). For the assumptions underlying FSA prescribed consumer projections see the report on long-term market conditions undertaken by

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PricewaterhouseCoopers: “Rates of return for FSA prescribed projections”, June 2003.

http://www.fsa.gov.uk/pubs/other/projection_rates.pdf

(2). On the declining risk of equities with holding period, see the speech given by Adair Turner to the Cass Business School, 7 April 2005.

<http://www.pensionscommission.org.uk/publications/2005/cass-presentation-7apr05.ppt>

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Appendix Two: The Government Actuary's letter of 20th April 2006

Pensions Reform Group – Universal Protected Pension

1. The Pensions Reform Group (PRG) has asked the Government Actuary's Department (GAD) to estimate the required contributions for their proposed Universal Protected Pension (UPP).
2. This report has been prepared for the PRG for the purpose of assisting them in developing their UPP proposals. The report should be considered as a whole and extracts should not be quoted out of context. The report should not be disclosed to third parties without the prior permission of GAD. GAD is unable to accept any liability to any third party that relies on the report.

Benefits under the UPP

3. The target benefit of the UPP is a pension of between 25% and 30% of national average earnings. This pension is to be financed from two sources: part will be financed from the existing Basic State Pension (BSP) on a pay-as-you-go basis and the balance of the UPP target pension will come from a new funded arrangement. Contributions will be paid into the funded section with the intention that the accumulated fund will be sufficient to pay the pension of the worker when he or she retires. In addition a lump sum payment will be made on the death of a contributor before state pension age. The details of the scheme that we have costed are set out below.
4. Contributions to the funded UPP have been taken as a fixed percentage of earnings above the Lower Earnings Limit (LEL). Two scenarios are considered for the upper limit on UPP contributions. In one scenario, earnings above the Upper Earnings Limit (UEL) are not considered for contributions, while in the other contributions are payable on all earnings above the LEL. It should be noted that National Insurance contributions are currently payable on earnings above the primary threshold which is set at the level of the single person's tax allowance, slightly above the LEL. However, we have assumed that contributions to the UPP would start from the LEL because that is the approach that applies for the purpose of the contracted-out rebate. If you preferred that UPP contributions started from the primary threshold (£97 per week in 2006-07) instead of the LEL (£84 per week in 2006-07) the required contribution rates shown in this letter would be slightly higher.

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5. For the purposes of UPP contributions, the LEL and UEL (where relevant) are uprated in line with average earnings. This is consistent with the proposed indexation of the UPP target pension.
6. People who would have been eligible for S2P credits receive a year's contribution credit into the UPP. The criteria for S2P credits are broadly:
 - a. Looking after a child under age 6
 - b. Looking after an ill or disabled person for at least 35 hours a week
 - c. Entitled to carer's allowance
 - d. Entitled to incapacity benefit or receiving severe disablement allowance
7. An individual with a full UPP record will receive a total retirement income from the state which is between 25% and 30% of national average earnings. For the purpose of the calculations for this letter, we have assumed that this proportion will be 25%. This target pension will increase each year in line with average earnings. As already mentioned, the UPP target pension is inclusive of the Basic State Pension (BSP) which will continue to be earned in the same way as under current legislation and it is assumed that its rate will be increased in line with prices. The total UPP pension can therefore be regarded as having three elements as follows:
 - a. the BSP uprated in line with prices
 - b. the extra increases on the BSP in payment, being the difference between indexation of the BSP in line with average earnings and indexation in line with prices
 - c. the balance of the UPP pension uprated in line with average earnings

The total of these elements makes a pension of 25% of national average earnings indexed to average earnings levels.

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8. The UPP is not inherited and there is therefore no pension for spouses or other dependants. There will however be a life assurance benefit, which is assumed to be paid in respect of any individual who has made a contribution towards the UPP and who dies before state pension age. The benefit is the greater of the value of the UPP earned by the individual up to the date of death and £100,000 in 2010 and indexed to average earnings thereafter.
9. For the purpose of the costings it has been assumed that accruals of State Second Pension (S2P) cease in April 2010, when the UPP commences. However, S2P earned up to April 2010 continues to be paid.
10. An individual who has made (or been credited) contributions for the maximum number of years is entitled to the full UPP and does not need to make any further contributions. The costs have been evaluated for three scenarios for state pension age (SPA) and the maximum number of years as follows:
 - a. SPA is 65 and the maximum number of years is 44
 - b. SPA is 67 and the maximum number of years is 44
 - c. SPA is 67 and the maximum number of years is 46.
11. An individual who has not made (or been credited with) contributions for the maximum number of years will receive a proportion of the target UPP benefit. This proportion has not yet been fully defined but will in principle be based on the number of years for which the individual has contributed.
12. The precise details of how the benefit would be calculated for an individual reaching retirement age after 2010 but with some entitlement to SERPS or S2P have not been specified. Therefore the costs set out in this letter are generally applicable for cohorts who reach retirement with no pre-2010 accrual.

Actuarial assumptions

13. The choice of investment return assumptions will need to reflect, amongst other things, the Trustee's investment strategy, their attitude to risk and their funding strategy, and clearly at this stage these are unknown factors. When valuing a benefit that is linked to earnings

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levels, it is investment returns relative to earnings that are most important, rather than the nominal return on investments. We have, as requested by the Pensions Reform Group, carried out our calculations on the assumption that investment returns will average 3% a year above earnings increases both before and after retirement. This figure is net of investment management expenses. We have also assumed that average earnings will increase by 1.5% a year above price increases.

14. The implied rate of return is therefore about 4.5% a year relative to prices. To achieve a return of this level, the Fund would probably have to invest most if not all of its assets in equities or other risky assets. Investment in these assets provides a higher expected return on investments but also brings with it a higher risk of poor investment returns. If the fund did adopt this type of investment strategy, then it would be appropriate to have procedures in place to deal with the consequences of worse than expected investment returns. This is likely to involve, for example, an adjustment to contributions and/or the target UPP benefit.
15. In addition, when an inflation assumption is required, we have assumed that inflation will average 2.5% a year. Thus, the assumed total rate of investment return is a little above 7% a year, and the total rate of increases in national average earnings is about 4% a year.
16. The UPP target pension will be based on the National Statistics ASHE mean earnings for full-time workers. In 2005, this was £517 a week.
17. Mortality rates are the same as those assumed for the GAD 2004-based population projections and for simplicity half of UPP benefits are assumed to be paid to men, and half to women. The proportion of people eligible for credits relative to contributors is assumed to remain constant at 2005 levels. We have also made a number of other simplifying assumptions.
18. The assumption of investment returns of 3% a year in excess of earnings growth has been interpreted as incorporating an allowance for investment expenses. However, there will also be expenses involved in the administration of the UPP scheme and no allowance has been made for these expenses which will therefore be in addition to the contribution rates shown below. Given that the UPP is designed to be a universal national scheme, we would not expect the

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expenses to be high when expressed as a percentage of earnings. As an example, the National Insurance Fund has expenses equivalent to about ½% of earnings between the LEL and UEL.

19. It should be noted that the results of the calculations will be sensitive to the assumptions adopted and different assumptions produce substantially different results. For example, if we had made more pessimistic assumptions about investment returns, the costs shown in this letter would have been higher. The previous costings of the UPP will have been based on different actuarial assumptions, and this is one reason why the results of the previous costings are different to the results presented here.

Methodology

20. The methodology adopted is the entry age method. In broad terms, using this approach we calculated the contribution rate required to be paid in respect of an individual who has a full contribution record from a particular age of entry to the scheme. Entry ages in 2010 of 21, 35 and 45 have been considered. Although we are in theory considering a new entrant at a particular age, we have assumed the contribution rate would be applied to the earnings of all contributors.
21. The contribution rate is that required to be paid by those earning, including the self-employed. This contribution rate includes the cost of crediting entitlement to UPP for those eligible for credits.
22. An additional contribution rate has been calculated for the value of the life assurance benefit over and above the return of the value of the UPP earned up to the date of death. This element of the benefits is assumed to be financed as it falls due, and so is a pay-as-you-go benefit.

Results

23. There are two elements to the costs of the funded scheme. Firstly, the extra increases to BSP once it comes into payment to bring it up to earnings indexation, and secondly payment of the UPP over and above the level of the BSP. We have considered these two costs separately.
24. We understand that it is the intention that the contracted-out rebate should be used to fund part of the cost of the UPP. The results

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assume that the contracted-out rebate is paid in respect of all contributors, not just those formerly contracted-out of S2P. Since not everyone is currently contracted-out, paying contributions at this level could add to Government costs through the diversion of part of the NIC income to the UPP. In addition, the average rebate paid may not necessarily be 5.1% of earnings.

25. The rebate is currently set at 5.1% of earnings between the LEL and UEL for contracted-out salary-related (COSR) occupational pension schemes. Separate age-related scales of rebates apply to appropriate personal pension schemes and contracted-out money purchase schemes. However, the rebate order for the quinquennium 2007-08 to 2011-12 has now been approved by Parliament. This specifies a COSR rebate rate of 5.3% and new age-related rebate rates. Nevertheless, for consistency with our letter of 23 February, we have assumed that the rebate is 5.1% for all contributors. The UEL is assumed to be retained for the purpose of the rebate.
26. Table 1 below shows the cost of earnings-uprating the basic state pension after it comes into payment, expressed as a contribution rate as a percentage of earnings. This calculation assumes that this contribution rate is paid in respect of those at the entry age in 2010. The rebate is assumed to be funding this benefit, so for consistency the UEL is assumed to be retained here.

Table 1: Entry-age contribution rate required to enable BSP to be earnings-uprated after retirement

		max years	44	44	46
		SPA	65	67	67
Entry age	21		0.5%	0.4%	0.4%
	35		1.2%	1.0%	1.0%
	45		2.5%	2.0%	2.0%

27. For instance, for people joining at age 21 and retiring at age 65, a contribution of 0.5% of earnings between the LEL and UEL would be sufficient, on the assumptions adopted, to finance additional pension increases to the BSP in order that it is indexed to average earnings in payment, rather than prices. The reason why the required contribution rate increases sharply for those older than 21 in 2010 is that the number of years' contributions is reducing whereas the additional pension increases are still applied to the whole of the BSP.

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28. The rate of the BSP at SPA is assumed to remain indexed to prices and is therefore reducing as a proportion of national average earnings. This means that the required contribution rate will gradually reduce for those under age 21 in 2010.
29. Once the additional increases to the BSP are paid for, the remaining part of the rebate can be used to pay for the balance of the UPP. Table 2 shows the proportion of national average earnings that can be provided by the remaining part of the rebate of 5.1% of earnings.

Table 2: The retirement pension as a proportion of national average earnings that can be funded by the part of the contracted-out rebate not used for earnings-uprating the BSP in payment

max years		44	44	46
SPA		65	67	67
Entry age	21	10.6%	12.0%	12.3%
	35	4.8%	5.9%	5.9%
	45	1.8%	2.6%	2.6%

30. For instance, for people joining at age 21 and retiring at 65, the rebate of 5.1% of earnings would be sufficient, on the assumptions adopted, to finance an additional pension of 10.6% of national average earnings, as well as the extra pension increases to the BSP so that it is indexed to average earnings rather than prices in retirement.
31. A target pension above the level identified in Table 2 (plus the BSP) must be financed from further contributions. Table 3 and Table 4 show the percentage of National Average Earnings that could be financed through increasing the contribution rate by one percent, while retaining and removing the UEL, respectively.

Table 3: Additional pension available as a percentage of national average earnings if contributions were raised by one percent of earnings, with the UEL retained

max years		44	44	46
SPA		65	67	67
Entry age	21	2.3%	2.6%	2.6%
	35	1.2%	1.4%	1.4%
	45	0.7%	0.8%	0.8%

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Table 4: Additional pension available as a percentage of national average earnings if contributions were raised by one percent of earnings, with the UEL removed

max years		44	44	46
SPA		65	67	67
Entry age	21	3.1%	3.4%	3.5%
	35	1.6%	1.9%	1.9%
	45	0.9%	1.1%	1.1%

32. For instance, for people joining at age 21 and retiring at 65, a contribution of 1% of earnings between the LEL and UEL would be sufficient, on the assumptions adopted, to finance a pension of 2.3% of national average earnings. If contributions were levied on all earnings above the LEL (i.e. removing the UEL) a pension of 3.1% of national average earnings could be financed from a contribution rate of 1%.
33. The final element of assessing the costs of UPP pensions is to calculate the contribution rate required to fund the benefit up to the target level. It is proposed that under the UPP benefit part of the 25% target pension will be met by the BSP. Since the BSP is price uprated, the proportion of benefit which will be met by the funded UPP will increase each year as the BSP reduces relative to the target pension (which is indexed to average earnings). Thus, the required contribution rate will increase for each successive cohort of entrants. Table 5 and Table 6 show the required contribution rates for those at the given 3 entry ages in 2010 assuming that only the target pension in excess of the BSP needs to be financed by the funded UPP. Again, the contribution rates given are in addition to the contracted-out rebate.
34. The UPP may also be offset by S2P and SERPS. However an individual's SERPS and S2P entitlement is heavily dependent on work records, so will differ greatly between individuals, so the effect of offsetting S2P and SERPS has not been considered.

Table 5: Required contribution rate to fund benefits above the price-uprated BSP so that total benefits (inclusive of the BSP) are 25% of national average earnings for those at the given entry age in 2010, given that the rebate rate of 5.1% is paid in addition for all earners and assuming the UEL is retained

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max years		44	44	46
SPA		65	67	67
Entry age	21	2.9%	2.2%	2.0%
	35	8.8%	7.0%	7.0%
	45	17.6%	14.2%	14.2%

Table 6: Required contribution rate to fund benefits above the price-uprated BSP so that total benefits (inclusive of the BSP) are 25% of national average earnings for those at the given entry age in 2010, given that the rebate rate of 5.1% is paid in addition for all earners and assuming the UEL is removed

max years		44	44	46
SPA		65	67	67
Entry age	21	2.2%	1.6%	1.5%
	35	6.6%	5.2%	5.2%
	45	13.2%	10.6%	10.6%

35. For instance, for people joining at age 21 in 2010 with a pension age of 65, a contribution of 2.9% of earnings from the LEL to the UEL or a contribution of 2.2% of earnings with no upper limit (in each case in addition to the contracted rebate of 5.1%) would be sufficient, on the assumptions adopted, to finance a pension of 25% of national average earnings inclusive of the BSP.
36. There is an additional life assurance benefit proposed. This will pay the greater of the value of the UPP earned to the date of death and a guaranteed sum. The guaranteed sum will be set at £100,000 in 2010 and thereafter will be increased in line with average earnings. The cost of paying out the value of the UPP is included in the figures above. The remaining element is paying sufficient to take the payment up to £100,000. Soon after the scheme starts, little UPP will have been earned (and the fund will be small), and so almost all of the benefit will be funded from the year's contributions. We estimate that in the short term, the required contribution to pay the additional life assurance benefit will be about 2½% of earnings, assuming the UEL is retained and 2% if it is removed. In the longer term when UPP contribution records have been built up, we estimate the additional cost will reduce, for example in 2055 it will be 1½% with the UEL retained or 1% with the UEL removed.
37. If there were to be no top-up to £100,000, then the amount paid would be smaller. For instance, someone who has paid 20 years'

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contributions would be entitled to a death benefit of around £24,000, and a person with 30 years' contributions would be entitled to a death benefit of around £43,000. These figures assume that the contributions are paid in continuous years and that the year of death is one of these contributory years. These amounts are in 2005 earnings terms and would increase in line with National Average Earnings.

Potential entitlement of older entrants

38. If the scheme commences in April 2010, with everyone paying the contribution rate calculated to be required for 21 year old new entrants and experience following the assumptions made, then the UPP fund will not be sufficient to pay the full UPP target of 25% of national average earnings to older entrants in that year. Table 7 below shows the proportion of the 25% national average earnings target (including the part relating to the BSP) that could be financed by paying the age 21 contribution rate for new entrants at different ages in 2010, assuming they contribute in every year from 2010 to SPA.

Table 7: Proportion of target UPP pension (including the part from the BSP) that could be financed for new entrants in 2010 by paying contributions at the rate applicable to entrants at age 21, assuming contributions are paid in each year from 2010 to SPA.

	max years			
	SPA	44	44	46
		65	67	67
Entry	21	100%	100%	100%
age	35	71%	72%	72%
	45	59%	60%	60%

Alternative Scheme

39. A variant to the scheme described above has also been specified in which the only contribution to the funded UPP would be one equal to the contracted-out rebate. As above, we have assumed that the rebate is taken to be 5.1% of earnings between the LEL and UEL. For the purposes of this calculation, we have considered a pension that does not increase after the individual reaches retirement. The lack of indexation will mean that the proportion of the target pension will drop each year after an individual reaches retirement. Similarly, we

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have not included the cost of indexing basic pension to earnings after retirement.

40. Table 8 and Table 9 below show the proportion of target pension available if a contribution equal to the COSR rebate is paid in respect of all employed and self-employed earners, and if those eligible for a S2P credit accrue UPP for each creditable year, with and without including the price-uprated BSP.

Table 8: Proportion of target UPP pension (excluding the part from the BSP) that could be financed for new entrants in 2010 by paying contributions at 5.1% of earnings between LEL and UEL, assuming contributions are paid in each year from 2010 to SPA.

max years		44	44	46
SPA		65	67	67
Entry age	21	71%	78%	80%
	35	38%	43%	43%
	45	22%	25%	25%

Table 9: Proportion of target UPP pension (including the part from the BSP) that could be financed for new entrants in 2010 by paying contributions at 5.1% of earnings between LEL and UEL, assuming contributions are paid in each year from 2010 to SPA.

max years		44	44	46
SPA		65	67	67
Entry age	21	102%	108%	109%
	35	76%	80%	80%
	45	65%	68%	68%

41. As discussed in paragraph 24, not everyone receives a contracted-out rebate so there would be implications for Government costs if such a contribution were paid in respect of individuals not contracted-out.
42. If earnings indexation were required, so that the pension received keeps pace with the target at retirement, then the initial pension is significantly smaller. For instance an earnings-indexed pension of 47% of the target could be funded for a 21-year old entrant with retirement age of 65, compared with 71% of the target if there is no indexation.

Transitional effects

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43. The costs of pension benefits during the transition from the current scheme to the UPP regime depend on the exact transitional arrangements put in place. In particular, it should be noted that while it is proposed that S2P accrual ceases in 2010, payment of accrued S2P (and SERPS) rights will continue for many decades. The UPP system would lead to changes in the finances of the National Insurance Fund, through abolition of the S2P but the requirement to continue paying accrued S2P rights and through the utilisation of the contracted-out rebate to help finance the UPP (both for those contracted-out and not contracted-out under the current system).
44. The proposed full UPP benefit will provide a level of income above the Guarantee Credit (even assuming it is indexed to average earnings) for those with a full contribution record. Therefore ultimately, Pension Credit payments should be greatly reduced, even if it is retained to protect the retirement incomes of those with low earnings or poor contribution records.

Conclusions

45. The cost of the UPP depends critically on the final benefit design decided upon, and the transitional arrangements for those who have started their careers by the time the UPP comes into force.
46. Based on the assumed benefit design and the actuarial assumptions outlined in this letter, the entry-age contribution rate, over and above the 5.1% rebate, required for a 21-year old new entrant with SPA 65 is either 2.2% or 2.9% depending on whether or not the UEL is abolished. This compares with the costs of 6.9% and 9.3% shown in our letter of 23 February and costs of 5.0% and 6.6% shown in our letter of 8 March. The assumptions in the first letter were the same as here except that investment returns were assumed to be 2% a year above increases in average earnings before retirement and 0.5% a year after retirement. In the second letter, the assumption was 2% a year both before and after retirement. This demonstrates that the results are very sensitive to the assumptions used. These figures are an indication of the long-term cost of the UPP structure. The short to medium term costs will be very dependent on the transitional arrangements put in place.

Government Actuary's Department
April 2006

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