Executive Summary: overall conclusions and outline recommendations

This Executive Summary sets out our key findings and recommendations, in 12 sections:

1. Present situation and trends: deepening and extending the First Report analysis
2. Objectives and key elements of required reform
3. A National Pension Savings Scheme: auto-enrolment and cost-efficiency
4. Reforms to the state system to underpin private saving
5. The unavoidable long-term trade off: public expenditure versus State Pension Age
6. The key recommendations: overall principles and possible details
7. The implications of reform for women and carers
8. Facilitating later working and protecting the position of lower socio-economic groups
9. Tax relief and the contracted-out rebate
10. Securing long-term sustainability and consensus
11. The timing of reform: challenges and trade-offs; a new settlement needed soon
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1. Present situation and trends: deepening and extending the First Report analysis

In our First Report, "Pensions: Challenges and Choices," we set out an analysis of pension provision in the UK and the trends in that provision. Key conclusions of that analysis are outlined in the panel at the end of this Executive Summary. Over the last year we have extended and deepened that analysis. We have now concluded that:

i) The current system of private funded pensions combined with the current state system will deliver increasingly inadequate and unequal results.

- Average pensioner income today compares well with that of previous generations. Many retirees with Defined Benefit (DB) pensions enjoy a historically high level of private pension provision: and many present retirees are receiving state earnings-related pensions more generous than in the past and more generous than planned for the future. But the distribution of current pensioner income is highly unequal, not only because of disparities in lifetime earnings, but also because of the wide dispersion of private pension provision, and because the historic state system has left major gaps in provision for people who have had interrupted paid working lives and caring responsibilities, in particular women.

- Looking forward the state is planning to play a reduced role in pension provision for the average pensioner. Policy has been based on the assumption that private provision will grow to offset this decline.

- But voluntary private pension provision is not growing: rather it is in serious and probably irreversible decline. Employers' willingness voluntarily to provide pensions is falling and initiatives to stimulate personal pension saving have not worked.

- While particular groups of people, those in the public sector, in still open private DB schemes, and many higher earners, are on target for good pensions, an increasing number of people will, on current trends, face pensions they will consider inadequate.

ii) These problems are not solvable through changes to the state system alone, nor by incremental measures to encourage voluntary provision. But attitudes to compulsion are ambivalent.

- Reforms to the state system are needed not only to address the significant gaps in provision for people with interrupted careers and caring responsibilities, but also to create a more understandable, less means-tested platform on which individuals and employers can build private provision.

- But reforms to the state pension system will not be sufficient because of:

  - The inherent behavioural barriers to people making rational long-term savings decisions without encouragement;

  - The limited impact of providing better information and generic advice;

  - The decreasing belief among many employers that there are self-interested reasons to provide good pensions to achieve recruitment and retention objectives; and

  - The cost barriers in the currently underprovided market. There is a segment of the market, employees of average and lower earnings working in small and medium companies, plus many self-employed, which the retail financial services industry cannot serve profitably except at Annual Management Charges (AMCs) which are disincentives to saving and which substantially reduce pensions available in retirement.

- But attitudes to compulsion are ambivalent. While many people say they want to "have to save", many respond adversely to the idea of compulsory savings. And there is a danger that compulsory savings contributions may be seen as equivalent to taxation, reducing people's willingness to support an adequate system of flat-rate state pension provision.

iii) Savings through house purchase and inheritance of housing assets will make a significant contribution to pension adequacy for many people, but housing cannot be considered a sufficient response to pension adequacy problems for all people.

- Latest analysis of individual stocks of wealth and flows of saving confirms the finding that for most people non-financial assets are modest but that housing assets are far more important.

- The accumulation and decumulation of housing assets can therefore play an important role in providing resources to support consumption in retirement.

- Compelling people to make sufficient pension provision so as to achieve average desired replacement rates would therefore force some people to over save.

- But analysis of the risks involved in savings through the housing market, and of the distribution of the ownership of housing wealth, shows that housing cannot be a sufficient answer to pension adequacy problems for all people.

iv) Long-term pension policy needs to be robust in the face of rising life expectancy and of major uncertainty about the pace of that increase.

- Over the long-run, fairness between generations suggests that average pension ages should tend to rise proportionately in line with life expectancy, with each generation facing the same proportion of adult life contributing to and receiving a state pension.

- The long-term trend in the old-age dependency ratio (defined on a static retirement age of 65) is a steady rise driven by life expectancy increases [Figure Ex.1]. For the last 30 years however the ratio has diverged increasingly below the long-term trend as a result of the expansion of the working age population which the baby boom of the 1940s to 1960s produced. But looking forward, the retirement of the baby boom generation, (i.e. the delayed effect of the fall in fertility which occurred between the early 1960s and mid-1970s) will produce a rapid return to the trend line, with this effect concentrated in the years 2010 to 2035.

- As a result, over the next 40 years, an increase in average pensionable ages in proportion to rising life expectancy, while essential, is not a sufficient response to the demographic challenge.

v) Analysis of pension systems and pension reforms in other countries suggests two major ideas of potential relevance to the UK.

- The potential to reduce costs via a system of nationally administered individual accounts.

- The potential to apply automatic enrolment to pension saving schemes nationally as well as at individual employer level.

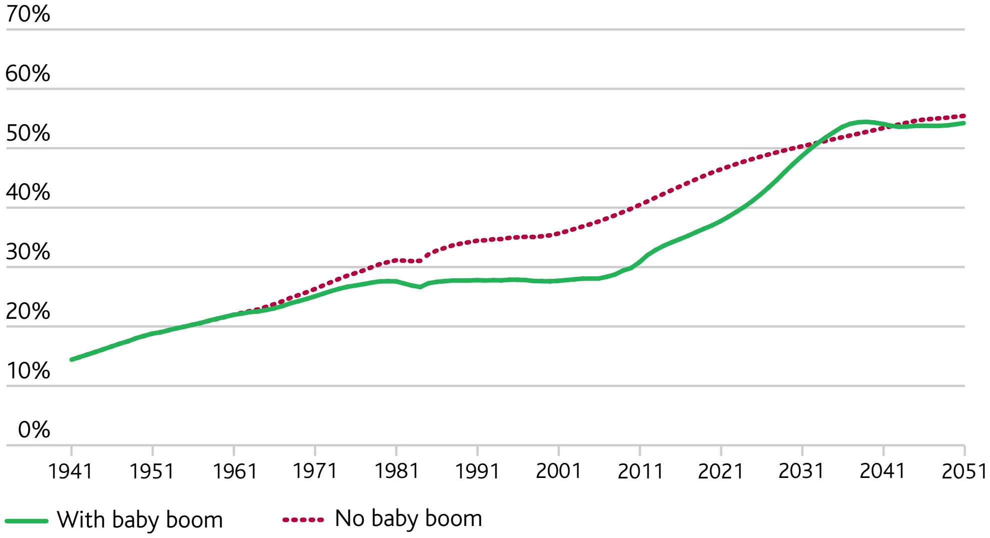
2. Objectives and key elements of reform

Given these conclusions we believe that major reform of the UK pension system is needed to create a new settlement for the 21st century. This settlement needs to:

- Deal with the major gaps which exist in the current state system for people with interrupted careers and caring responsibilities;

- Overcome the barriers of inertia and high cost which deter voluntary private pension provision;

Figure Ex.1 Impact of the 1940s-1960s baby boom on the old-age dependency ratio



Source: Pensions Commission analysis based on a synthetic model of the England and Wales population.

- Maintain employer involvement in good quality pension provision;
- Prevent the spread of means-testing which would occur if present indexation arrangements continued indefinitely;
- Be sustainable in the face of rising longevity and of uncertainty over how fast that rise is occurring;
- Be less complex and more understandable;
- But maintain the improvements in the relative standard of living of the poorest pensioners which the present means-tested approach has achieved.
- And entail a transition from current arrangements which is acceptable in terms of cost, distributional impact, and administrative complexity.

To achieve these objectives we recommend two key elements of reform:

- The creation of a low cost, national funded pension savings scheme into which individuals will be automatically enrolled, but with the right to opt-out, with a modest level of compulsory matching employer contributions, and delivering the opportunity to save for a pension at a low Annual Management Charge.
- Reforms to make the state system less means-tested and closer to universal than it would be if current indexation arrangements were continued indefinitely. In order to achieve this while maintaining the standard of living of the poorest pensioners it will need to be more generous on average. In the long-term this implies some mix of both an increase in taxes devoted to pensions expenditure and an increase in State Pension Ages.

We describe below the key features of these two elements, and the structure of the overall pension system we are therefore proposing. We then set out other supporting recommendations.

3. A National Pension Savings Scheme: auto-enrolment and cost-efficiency

Reforms of the state pension system (discussed in Section 4 of this Summary) to make it more understandable and less means-tested would improve the effectiveness of voluntary private pension savings. But we are not convinced by the argument that state pension reform can be sufficient in itself to remove barriers to adequate private pension provision.

Compelling all people to aim for "adequate" replacement rates would however fail to allow for the diversity of individual preferences (for instance between saving and working later) and circumstances (for instance the extent of home ownership).

We therefore recommend the creation of a National Pension Savings Scheme (NPSS) applying the principle of automatic enrolment at the national level. We have analysed the options for the operation of this scheme in sufficient depth to be confident that it can be successfully implemented, but the details of its design will need to be decided in the light of further work and consultation. Key objectives which the scheme must achieve are however:

- **Overcoming inertia and greatly increasing participation in pension savings**
  All employees not covered by other adequate pension arrangements should be automatically enrolled into the scheme but with the right to opt-out. A modest level of matching contribution by employers should be compulsory. The self-employed should be able to participate on a voluntary but cost-effective basis.

- **Aiming for a "base load" of earnings replacement**
  We recommend that, as a minimum, total default level contributions (arising from employer and employee contributions and from the benefit of tax relief) should be around 8% of earnings above the "Primary Threshold," (the level of income at which Income Tax and National Insurance become payable, currently £4,888). These contributions would be made up of 4% contributions from employees' post-tax pay, 1% from tax relief/tax credit and 3% from matching compulsory employer contributions. On reasonable assumptions about rates of return and years of contribution this might secure the median earner a pension at the point of retirement of about 15% of median earnings on top of the 30% which state provision will deliver under our proposals. Many will want to secure a higher level of pension replacement. We therefore also recommend that voluntary contributions on top of the default level should be allowed, subject to a cap: for the median earner this would enable the individual and/or their employer to contribute in total about twice the default amount, accumulating a pension pot which would take them to a total combined replacement rate approaching the two-thirds that many say is their target.

- **Encouraging the maintenance of existing high quality pension provision**
  Where employers already provide more generous contributions than those defined as the default within the scheme, procedures will be required to allow them to opt-out from the national scheme and automatically to enrol employees into these alternative arrangements.

- **Ensuring low cost of operations**
  The scheme should aim to deliver to all employees and the self-employed the opportunity to save for a pension at the Annual Management Charge (e.g. 0.3% per year or less) today enjoyed only by employees of large firms, by public sector employees or by high income individuals. To achieve this, the National Pension Savings Scheme will have to:

  – Use a national payment collection system, such as Pay As You Earn (PAYE) or a newly created Pension Payment System, to collect contributions in a cost-effective fashion and in a fashion which imposes minimal administrative burdens on business.

  – Provide members with the option of investment in very low cost funds bulk bought from the fund management industry.

We estimate that under reasonable assumptions on participation rates, contribution rates and rates of return, the NPSS will play a significant role in offsetting the decline in private pension income which will otherwise occur, contributing an additional 0.7% of GDP to pensioner incomes by 2050, and about 1.2% by 2070. The success of the NPSS in achieving high participation and adequate contribution rates should however be kept under constant review to identify whether changes are required to achieve the objectives.

4. Reforms to the state system to underpin private saving

The objective of a state pension system which is less means-tested and fairer to women could be pursued through a number of alternative routes. The key choice to be made is between moving to a single unified state pension (referred to below as an Enhanced State Pension (ESP)), or building on the present two-tier system which combines a Basic State Pension (BSP) and the State Second Pension (S2P).

Deciding between these two routes entails a trade-off between different desirable objectives. In particular it requires a trade-off between the benefits of a radically simplified system and the implementation complexities of radical change. While our detailed analysis identifies that both approaches have advantages and disadvantages, the Pensions Commission favours the two-tier approach. The key reasons for this preference are:

- A single unified state pension clearly has the huge merit of simplicity.

  – But if it was introduced today at a level high enough to ensure that most present and future pensioners were free of pensions means-testing (e.g. at the £109.45 per week Guarantee Credit level) it would require an immediate and significant increase in public expenditure. Much of the benefit of this would flow to better-off pensioners who are already well provided for by historical standards. Younger workers would have to pay higher taxes to finance this at the same time as having to save more for their own retirement.

  – In theory, the public expenditure costs of the "unified and immediate" option could be reduced by "offsetting" higher ESP pension rights against accrued gross State Earnings Related Pension Scheme (SERPS)/S2P rights. But our detailed analysis suggests that this introduces major transitional complexities, does not completely deal with the problems of increased cost, and creates some undesirable distributional effects.

  – These problems can be limited by an approach which would slowly step-up the level of an ESP over time, for instance, reaching by about 2030 the level required to reduce significantly the role of means-testing. But this step-up approach would sacrifice the ESP's key benefit of simplicity: and it would be difficult to create certainty around a policy which required a sequence of governments over a long time to implement step increases in the pension level. It also only moderates, rather than removing entirely, some of the adverse cost and distributional effects of an immediate move to a full ESP.

  – Abolishing S2P immediately would moreover remove from the system the existing element of earnings-related compulsion at the very time that voluntary provision is in serious decline. It would be likely to speed the closure of remaining private sector DB schemes. We therefore believe that it is risky to abolish S2P before establishing and proving the success of the proposed National Pension Savings Scheme.

- The alternative approach is to evolve from the system as it exists today, and to create a system with two flat-rate pensions: the existing BSP (but with its value linked to average earnings growth) and the S2P (which would become over time an entirely flat-rate addition). This gradual and evolutionary approach has three advantages:

  – It greatly reduces transitional complexities.

  – It allows the flexibility of moving the BSP onto a universal accrual basis, while leaving S2P as a contributory system.

  – It allows the flexibility of two different pension ages, higher for the S2P than for the BSP, thus making possible a slower rate of increase in the earliest age at which some state pension can be drawn.

We recognise however that there are trade-offs involved in deciding between our recommended two-tier approach and a gradual step-up to a unified ESP. The latter would undoubtedly, after a long transition period, create a simpler system. But given the starting point, there is no way forward to a simpler, single-tier system which does not introduce more complexity en route or involve high initial costs.

Our preferred way forward would therefore build on the present two-tier system but would:

- Accelerate the evolution of the S2P to a flat-rate system by freezing in nominal cash terms the Upper Earnings Limit for S2P accruals. This would enable us to concentrate the use of constrained tax resources on the provision of as generous and non-means-tested, flat-rate provision as possible.

- Over the long-term, link the value of the BSP to earnings and freeze in real terms the maximum amount of Savings Credit payable. This would stop the spread of means-testing which would occur if present indexation arrangements were continued indefinitely. Figure Ex.2 shows the impact which we estimate that our proposals would have on the proportion of pensioners receiving different categories of means-tested benefits. [See the note below Figure Ex.3 for a description of the assumptions in the "current indexation arrangements" scenario].

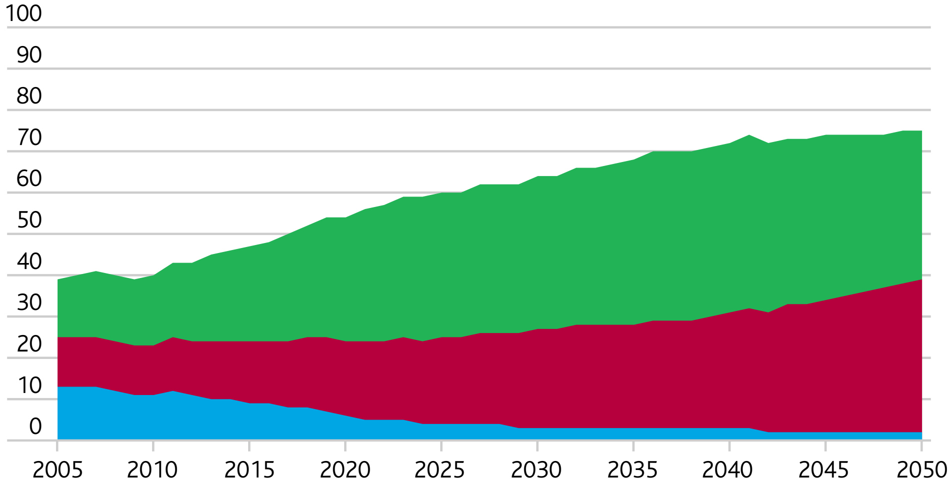
- Make future accruals of BSP rights individual and universal. (By individual we mean each person accrues entitlement in their own right rather than through their spouse. By universal we mean based on residency rather than contribution records or eligibility for credits.) This will ensure that all people, including those with interrupted paid work records and caring responsibilities can be certain of a significant floor of non-means-tested state provision. In addition improve the value of carer credits within S2P.

We believe reforms such as these are required in order to create clear incentives and an understandable base on which private pension saving looking forward can build.

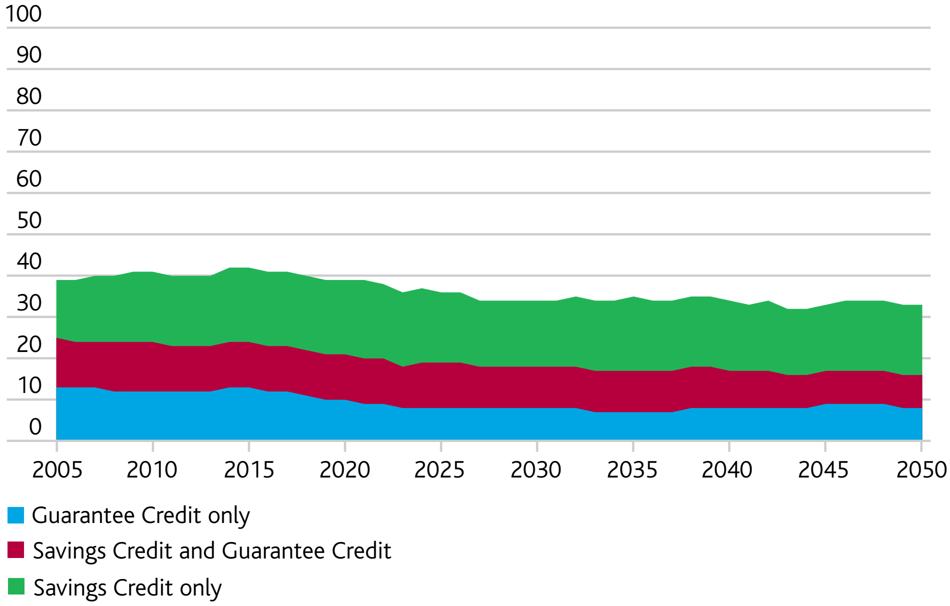
In addition it would be desirable to address some of the gaps and inequities which exist among today's pensioners as a result of the past operation of the contributory system. The best way to do this in a targeted fashion and within tight medium-term public expenditure constraints would be to make the BSP universal in payment above a specific age, such as 75.

Figure Ex.2 Percentage of pensioner benefit units on Pension Credit

If current indexation approaches continue indefinitely: 2005-2050



With proposed state system reforms and introduction of the NPSS



Source: Pensions Commission analysis using Pensim2

Note: Pensioner benefit units are defined as any household with an individual aged over the State Pension Age.

5. The unavoidable long-term trade-off: public expenditure versus State Pension Age

We have proposed that earnings-related pensions should in the long-term be provided via funded private savings, rather than via a state PAYG scheme. This will focus future public expenditure on the objective of ensuring as generous and as non-means-tested a flat-rate, poverty preventing pension as possible. But despite this focus, the inevitable consequence of the state system reforms we propose, or of any alternative way forward which addresses the current system's problems while coping with changing demography, would in the long-term be either an increase in public expenditure on state pensions as a percentage of GDP, and/or a rise in the State Pension Age (SPA).

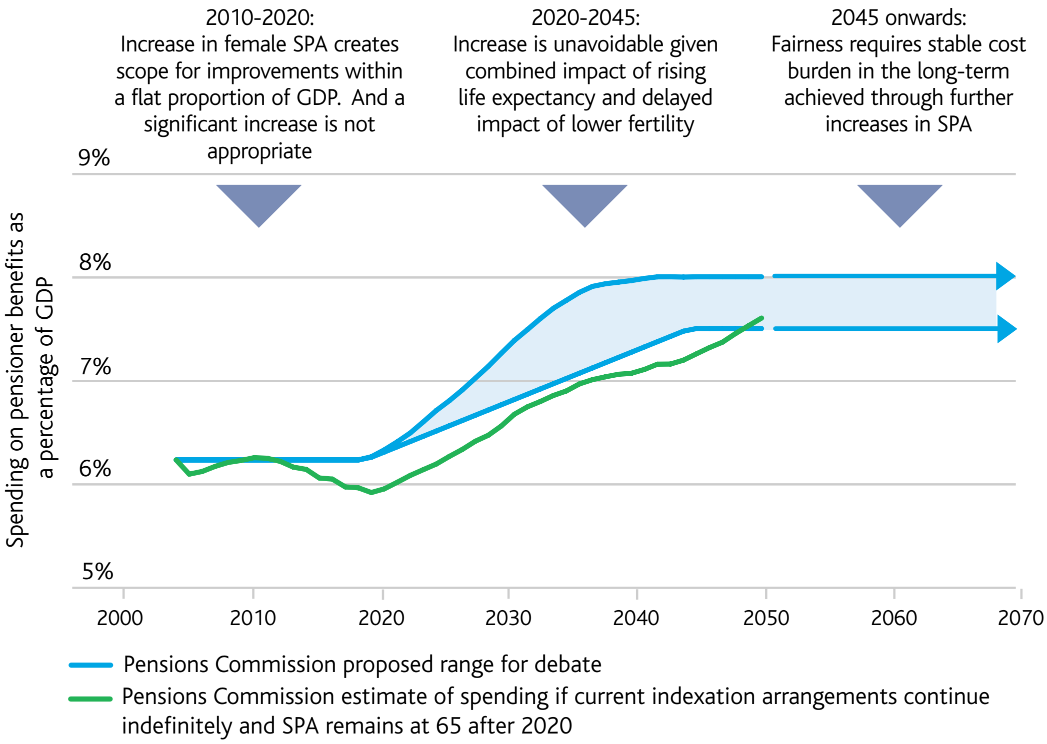
The Pensions Commission believes that a combination of these two will be required:

- We do not believe it is possible to design a coherent state pension system for the UK without some increase in public expenditure on pensions as a percentage of GDP between now and 2050.
- But we believe that increases in the SPA will be essential to keep the increase in public expenditure within limits which are fair between generations and sustainable over the long-term.

In Figure Ex.3 we set out the Pensions Commission's judgement on the range of possible combinations. Key features of that range are that:

- The already planned increase in the SPA for women, to equal the male age of 65 by 2020, creates flexibility for some improvements in the system over the next 15 years without a significant increase in the public expenditure burden as a percentage of GDP and without an additional increase in SPA before 2020. This is because, as Figure Ex.3 shows, expenditure as a percentage of GDP would be likely, on unchanged indexation arrangements, to fall over the next 15 years.
- If the rise in SPA after 2020 was in proportion to rising life expectancy, it would rise to about 66 in 2030 and about 67 by 2050. With this SPA a coherent and less means-tested state pension would probably cost about 8% of GDP, versus today's expenditure of 6.2%. This would impose the costs of falling fertility on taxpayers rather than pensioners.
- If SPA rises after 2020 were more than in proportion to anticipated life expectancy, reaching 69 in 2050, the cost could be limited to 7.5%. This would impose the costs of the fall in fertility on pensioners rather than taxpayers.

Figure Ex.3 Public expenditure on state pensions and pensioner benefits: range proposed for debate



Source: Pensions Commission analysis using Pensim2

Assumptions in the "current indexation arrangements" scenario

In Figure Ex. 3 we show our best estimate of future state pension and pension benefit expenditure "if current indexation arrangements continued indefinitely". Figure Ex. 2 shows how the percentage of pensioner households on Pension Credit would grow under the same scenario. This scenario is referred to at several other points in the Report.

As the title suggests it describes what would occur if the approach to uprating key elements of the pension system followed in recent years continued unchanged. In particular it shows the result of the combination of:

- Keeping the BSP linked to prices;
- Maintaining SPA at 65;
- Raising the level of the Guarantee Credit in line with earnings; and
- Raising the lower threshold for the Savings Credit in line with the BSP (and thus in line with prices).

These were the assumptions used in the government's published long-term expenditure forecasts to which we referred in the First Report. They are not however defined government policy for the long-term since for example the government has only made firm commitments to the Pension Credit indexation regime until 2007/08. Long-term projections of public expenditure and of the extent of means-testing are of course highly sensitive to different assumptions about these indexation regimes.

- Between 2020 and 2045, the increase may have to be frontloaded, rather than a straight line. This reflects the fact, illustrated in Figure Ex.1, that the impact of the retirement of the baby boom generation is concentrated in the years before 2035.

- Beyond 2045, once the one-off adjustment to a lower rate of fertility has been completed, fairness between generations suggests that public expenditure on pensions as a percentage of GDP should stay roughly constant. If life expectancy goes on rising this will require further rises of SPA in proportion with rising life expectancy, allowing each generation to enjoy the same proportion of life spent contributing to and receiving state pensions.

- For the purposes of modelling the cost impact of the options considered, we have assumed that the SPA for both the BSP and the S2P will rise to 66 in 2030, 67 in 2040, and 68 in 2050. The actual policy implemented, however, could at equal cost entail the S2P pension age rising to 69 in 2050, while the BSP rises only to 67 and three months [Figure Ex.4].

- Given uncertainties around future projections of life expectancy, changes in SPA required can only be indicative and need to be determined over time in the light of latest life expectancy estimates. But it will still be possible to follow a policy of significant notice (e.g. at least 15 years) of any change in SPA, and we do not believe that a rapid increase over a short period (e.g. to 70 by 2030 as was suggested in some submissions to us) is required. Changes in SPA, moreover, need to be accompanied by measures to facilitate later working, and to protect the position of lower income individuals with lower life expectancy. These are described in Section 8 of this Executive Summary.

Figure Ex.4 State pension ages assumed in modelling of options for change

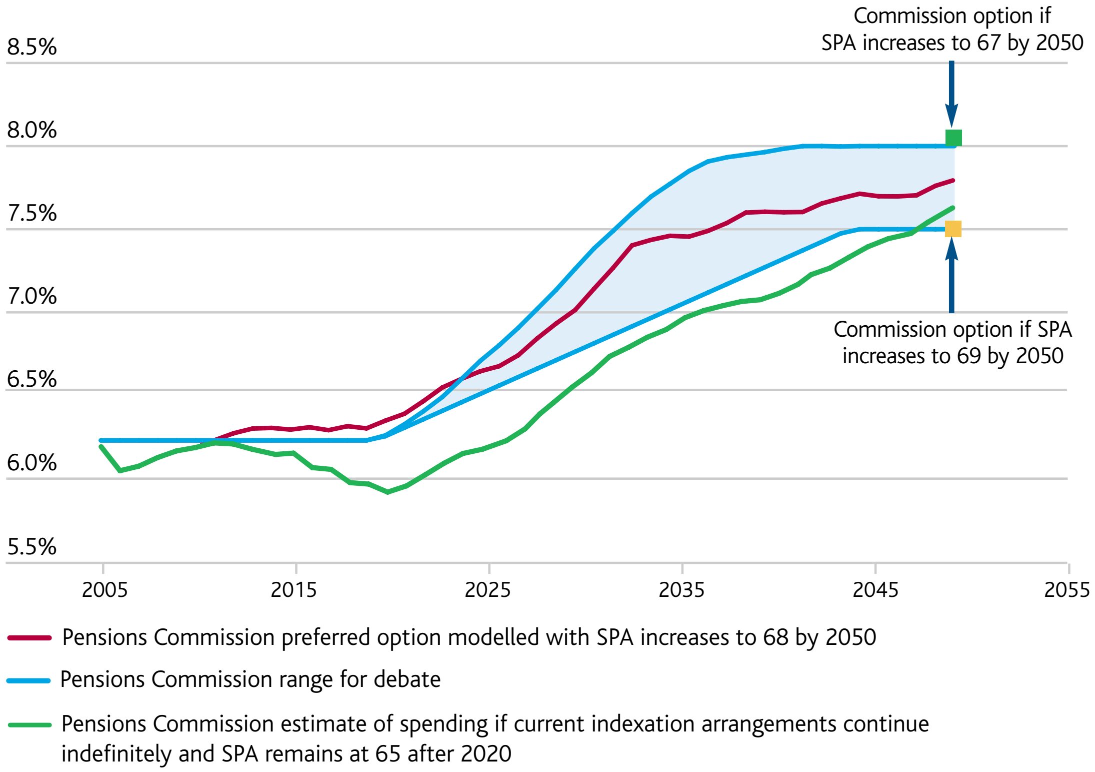
Assumption modelled in all cases	2020	2030	2040	2050	
BSP and S2P	65	66	67	68	Rising gradually over each decade to reach the age shown in the date indicated
Possible equivalent option in the "two-tier" case	**2020**	**2030**	**2040**	**2050**	
BSP	65	65.5	66.25	67.25	Rising gradually over each decade to reach the age shown in the date indicated
S2P	65	67	68	69	Rising gradually over each decade to reach the age shown in the date indicated

Public debate is now essential over the pubic expenditure versus pension age trade-off. The specific proposals we make would result in the public expenditure profile shown in Figure Ex.5, which also shows our best estimate of how public expenditure would evolve on a no change scenario (i.e. no increase in SPA after 2020 and present indexation arrangements continued indefinitely). In 2050 our preferred option would not significantly increase public expenditure versus the "current indexation arrangements" scenario. But it would involve a significantly more generous and less means-tested state pension at a higher SPA.

Different proposals could suggest a different balance between retirement age increases and expenditure increases than Figure Ex.5 shows. But in the face of the UK's changing demography we face the unavoidable choice illustrated in Figure Ex. 6.

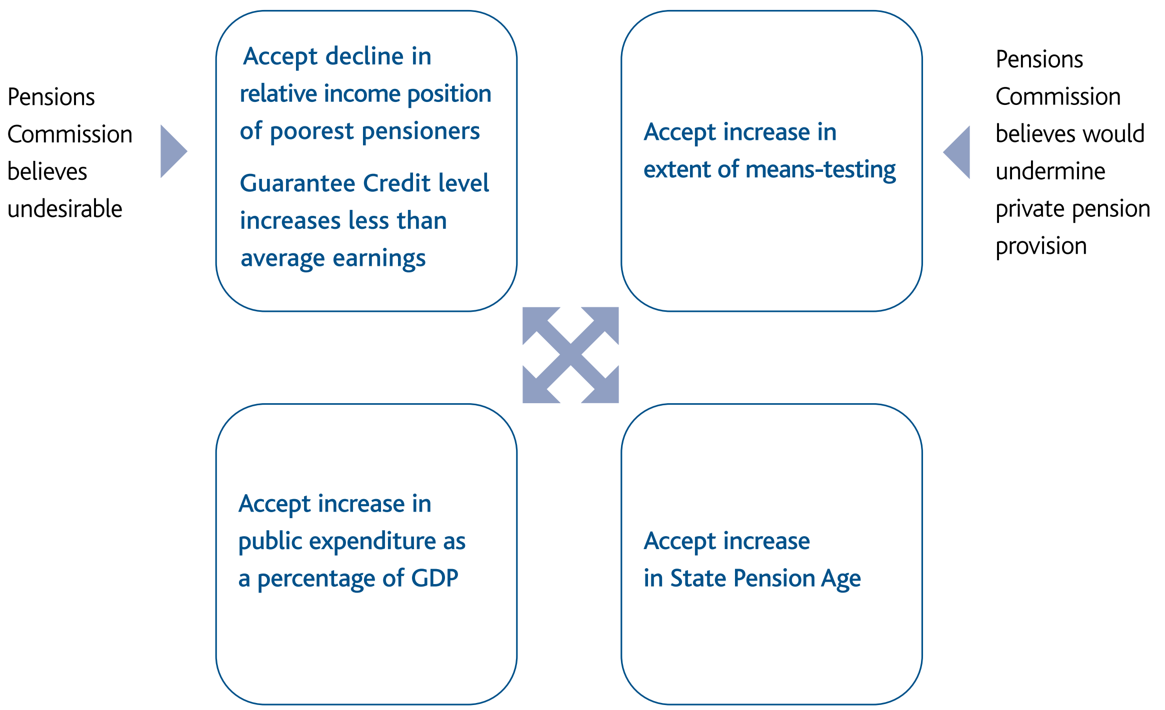
- The future spread of means-testing could be prevented by indexing the Guarantee Credit level to less than average earnings.
- But if this is unacceptable because it would cause a decline in the relative income of the poorest pensioners.
- And if the spread of means-testing has to be limited to avoid undermining private pension saving.
- Then some combination of higher public expenditure and a higher State Pension Age in the long-term is unavoidable.

Figure Ex.5 The public expenditure versus State Pension Age trade off: state pension and pensioner benefit expenditure as a percentage of GDP



Source: Pensions Commission analysis using Pensim 2

Figure Ex.6 State pension provision: the unavoidable trade-off



6. The key recommendations: overall principles and possible ways forward

Detailed design features of the NPSS will need to be decided during implementation planning and in the light of consultation. The objectives of state system reform could be achieved in a number of ways. And the timing of changes to the state system will need to be decided in the light of other demands on public expenditure. But we believe that the overall structure of the pensions system which needs to be built, and the appropriate roles of individuals and of the state, are clear.

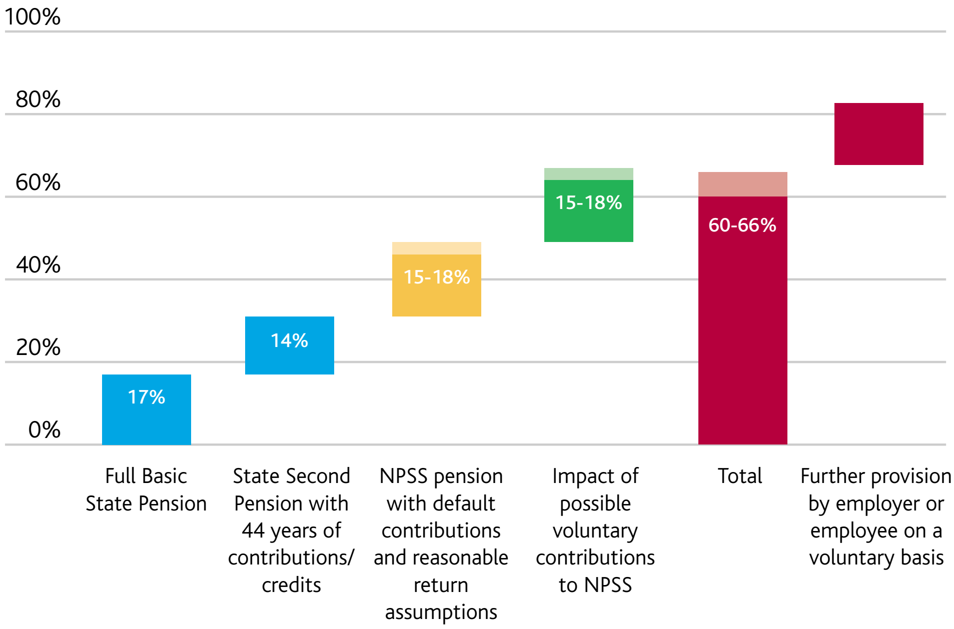
We propose that:

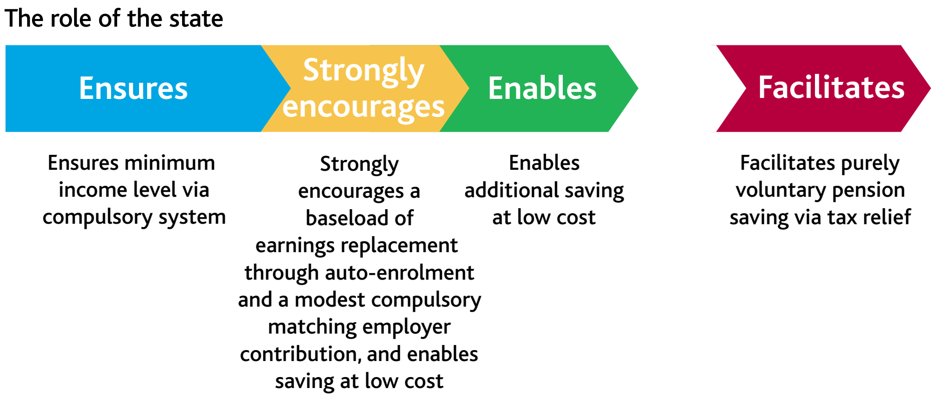
- Earnings-related pension provision should be funded. Individuals in the NPSS should accumulate clearly defined property rights, with accumulated funds directly linked to contribution levels. But the state should play vital roles in:
  - Strongly **encouraging** at least a minimum base load of private provision, via the automatic enrolment of individuals, with a modest level of compulsory matching by employers; and
  - **Enabling** everyone to save their own and their employer's contributions in a highly cost-efficient fashion.
- State Pay As You Go (PAYG) pension provision should, after a transition phase, become flat-rate. The use of constrained tax/National Insurance resources should be focused on:
  - **Ensuring** that all people are kept out of poverty in retirement;
  - Making the system as non-means-tested as possible; and
  - Reducing present problems in the treatment of those with interrupted paid work records and caring responsibilities.

Figure Ex.7 illustrates how the overall system might look for the median earner with a fairly full working life, and defines the relative roles and responsibilities of the state, individuals and employers in securing adequate replacement rates.

Figure Ex.8 summarises our recommendations, distinguishing between the overall essential principles and our specific proposed way forward. It should be noted that our public expenditure forecast in Figure Ex.5 includes the first 5 measures set out under State Reform, which aim to create a sound base on which private saving can build, but not the immediate introduction of a universal BSP for all pensioners over 75. This latter policy is highly desirable, but in a different category since it addresses problems inherited from the past, rather than the system required to underpin private savings in future.

Figure Ex.7 Target pension income as a percentage of earnings for the median earner: at the point of retirement





Source: Pensions Commission analysis

Note: The range of 15-18% shown for the impact of default contributions reflects a range of assumptions about number of years of contribution between 25 and SPA.

Figure Ex.8 Pensions Commission core recommendations

1. Creation of a National Pension Savings Scheme

The objectives in principle:

- Strongly encourage individuals (and their employers) to provide for a pension which will deliver at least a minimum base load of earnings-replacement.
- Enable all people to have the opportunity to save for a pension at low cost.

Recommended way forward:

1. All employees to be automatically enrolled into funded pension saving but with the right to opt-out, and with a modest compulsory matching employer contribution, into either:
   - High quality employer pension schemes; or
   - A newly created National Pension Savings Scheme.

2. Minimum default contributions set at about 8% of the earnings above the Primary Threshold and below the Upper Earnings Limit:
   - 4% out of individual post-tax earnings;
   - 1% paid for by tax relief; and
   - 3% compulsory matching employer contribution.

3. Contributions collected via PAYE or newly created Pension Payment System.

4. Contributions held in individual accounts and invested at the individual's instructions in a range of funds, including some bulk bought from the wholesale fund management industry, with a default fund for those who make no selection.

5. Additional voluntary contributions above the default level by both employees and employers encouraged; and the self-employed allowed to enter the NPSS on a voluntary basis.

6. Target Annual Management Charge of 0.3% or below.

Figure Ex.8 Continued

2. Reforms to the state system to underpin private saving

The objectives in principle:

- Focus constrained tax/NI resources on ensuring as generous and non-means-tested, flat-rate state pension provision as possible (given the creation of an effective NPSS approach to earnings-related provision).
- Improve the treatment of people with interupted paid work records and caring responsibilities.
- Facing the reality of the long-term public expenditure versus State Pension Age trade-off.

Options and issues:

There is a variety of options to achieve these objectives and difficult issues of timing and affordability which now need to be debated, but the Commission's preferred way forward is set out below.

Preferred way forward:

1. Build on the current two-tier system and recent reforms, accelerating the evolution of S2P to a flat-rate pension by freezing the Upper Earnings Limit for S2P accruals in nominal terms.

2. Index the BSP to average earnings growth over the long-term: ideally starting in 2010 or 2011 as the public expenditure benefit of the rise in women's SPA begins to flow through
   ... making this indexation affordable long-term by raising the SPA gradually, broadly in proportion to the increase in life expectancy, for instance to 66 by 2030, 67 by 2040 and 68 by 2050.

3. Maintain the reductions in pensioner poverty achieved by Pension Credit, but limit the spread of means-testing by freezing the maximum level of Savings Credit payments in real terms (which implies that the lower Savings Credit threshold increases faster than in line with average earnings).

4. Base future accruals to the BSP on an individual and universal (i.e. residency) basis, and improve carer credits within S2P.

5. Accept the consequence that public expenditure on state pensions and pensioner benefits must rise from 6.2% of GDP today to between 7.5% and 8.0% by 2045 (depending where SPA reaches in 2050).

6. **Ideally** introduce a universal BSP for pensioners aged over 75.

7. Implications of reform for women and carers

The Pensions Commission has been explicitly asked by government to recommend how pension system reform can help address the problems which people with interrupted paid work records and caring responsibilities (in particular women) have faced in the past and still face to a degree today.

We have developed recommendations that are consistent with the principle laid out in our First Report, that all people, men and women alike, should build up pension entitlements in their own right. Several of our proposals will be particularly beneficial for women and carers.

Specifically:

- The NPSS will provide to low and middle earners the opportunity to save at the low costs currently only available to those with higher incomes or working for large private companies or the public sector.

- And the proposed state system reform will be particularly beneficial to lower paid people and carers in three respects:

  - Indexing the BSP over the long-term, thus halting its decline in value relative to average earnings.

  - Making future accruals of BSP rights on a universal (residence before retirement) basis.

  - Improving the system of credits for the S2P for those with caring responsibilities.

Together these reforms will reduce what would otherwise be the growing dependence on means-tested benefits paid on a household basis, rather than pensions based on individual entitlements. They will increase the ability of people to accrue full state pensions through caring responsibilities rather than paid work.

In addition we suggest that in the shorter-term, the most appropriate solution to inherited problems, and in particular to the limited past ability of some people, particularly women, to build up full state pension rights, would be automatically to pay the full amount of the BSP beyond a specific age, for instance 75, using the residence principle already established through "Category D" rights to the BSP.

8. Facilitating later working and protecting the position of lower socio-economic groups

We have set out two equally unpalatable, but in our view unavoidable, propositions:

- That achieving a coherent state pension system will require, beyond 2020, some increase in public expenditure on pensions as a percentage of GDP; and

- That it will require some rise in State Pension Ages beyond 2020.

The policy of raising State Pension Ages needs to be accompanied by:

- Measures to facilitate later working; and

- Measures to ensure that lower socio-economic groups, with lower life expectancy, are not disproportionately disadvantaged.

(i) Measures to facilitate later working

As pensionable ages increase and as the Guarantee Credit age increases from 60 to 65 between 2010 and 2020, it is vital that jobs are available for those who wish to work longer, both up to pensionable ages and, if they want, beyond. It is also essential that the options available to people are as flexible as possible (e.g. a gradual step-down from full-time work to part-time work to full retirement). Achieving these objectives is a major challenge: government policies to facilitate their achievement are a high priority.

Key policy levers to help achieve this include:

- **Age discrimination legislation**
  This comes into force in October 2006, but with a default retirement age of 65, beyond which it will remain possible to dismiss people for age-related reasons. We recommend that there should be no age limit. We also recommend that the government, in its own employment practices in the public sector, should define and pursue best practice in non-discrimination against older workers.

- **Ensuring good financial incentives for later retirement**
  It is already possible to defer both the BSP and the S2P, receiving a higher pension at a later age or from April 2006 a tax free lump sum. But very few people know this, and at present the choice is inflexible: take the whole value of your BSP and S2P entitlement, or defer the whole pension. We recommend that there should be options to defer part of the pension while receiving part, and that a major publicity campaign should be launched to spread awareness of these options.

- **Considering financial incentives for employers to hire post-SPA workers**
  At present employees working beyond SPA pay no employees' National Insurance (NI) contributions: but employers' NI is still due even though no further rights to state pensions can be accrued. We recommend that government consider whether a reduced rate of employers' NI, on earnings up to a maximum ceiling, should be applied post-SPA.

- **A strong policy focus on occupational health**
  People's ability to work at older ages, and to enjoy work, is heavily influenced by their health, which in turn is strongly determined by their own lifestyle choices but also by occupational health factors earlier in life (such as the ergonomic design of workplaces and levels of stress). The government should help define and encourage best practice, both through its own role as public employer and in collaboration with business.

- **A strong focus on the education and training of older workers**
  At present training expenditure is skewed towards younger workers. Government should ensure that all public programmes which support or encourage training are not age specific, and should work collaboratively with business to encourage best practice in the training of older workers.

(ii) Measures to protect lower life expectancy groups

Latest figures suggest that all socio-economic groups are enjoying life expectancy increases: but they also show a significant gap between socio-economic classes, and that gap is not narrowing. Increases in pension age may therefore affect lower socio-economic groups disproportionately.

The key response should be a strong focus in health service and occupational health policies on measures to reduce the gaps. The long-term aim must be to narrow health inequalities, rather than treating health inequalities as a permanent barrier.

But unless and until those policies are successful, the evolving policy for State Pension Ages should reflect the latest emerging evidence on life expectancies by socio-economic class. Two flexibilities can be exploited:

- The Guarantee Credit could be made available at an earlier age than the BSP. At present the Guarantee Credit is available at 60, but this will rise in line with the SPA for women to reach 65 in 2020. Thereafter however it could remain at 65 even if the SPA was raised. This would have the disadvantage of making some people dependent on means-tested benefits until they reached the SPA. But it will enable people with poor health and low life expectancy to leave the workforce earlier than others, while having only a very small effect on savings and work incentives for the vast majority of people, given the other reforms we suggest.

- It would be possible to set different pension ages for the BSP and the S2P with the BSP age rising more slowly. Thus while, as Figure Ex.4 showed, we have used for modelling purposes the assumption that both pensionable ages reach 68 in 2050, an alternative equal cost approach would be that pension age for S2P reaches 69 by that time, while the pension age for BSP rose only to 67 years and three months. People with low life expectancy would thus be able to receive at least a basic level of state pension earlier than if one age had to be applied to both pensions.

9. Related issues: tax relief and the contracted-out rebate

(i) Tax relief

Saving via a pension attracts significant tax advantages, not only relative to saving in fully taxed vehicles, but also relative to other tax-advantaged routes, such as ISAs. Most people achieve significantly higher rates of return if they make employee contributions into pension policies rather than save via other mechanisms; and the advantage is greater still if their employer makes a contribution on their behalf, even if cash wages are reduced to keep total cost to the employer constant. HM Revenue and Customs estimate that the total cost of tax relief was about £12.3 billion in 2004/05. In addition employers' NI relief on pension contributions cost about £6.8 billion in 2004/05.

At present however, the benefits of pension tax and NI relief are poorly focused and poorly understood. Over half the benefits flow to higher-rate taxpayers, among whom the problems of pension under-saving are least important. Most people have limited understanding of the scale of tax relief benefits, and on average they under-estimate them. And for some low earners, the benefits of tax relief are offset by the impact of means-testing.

Not surprisingly therefore the Pensions Commission received several submissions which argued for a reform of the tax relief system. Many suggested that the rate of tax relief on contributions should be equalised (with higher-rate taxpayers receiving less, and basic or lower-rate taxpayers receiving more). Some also suggested that tax relief should be recast as a government up-front matching contribution.

Our analysis has suggested however that it is extremely difficult to apply such approaches on an across the board and fair basis in an environment where a large element of Defined Benefit (DB) provision remains within the overall system. This is because of the difficulties of calculating each year, and for all DB members, the value of new pension rights accrued. We do not therefore recommend a major reform to the overall system of tax relief in the near future, particularly given the major changes already planned for implementation in April 2006, which have entailed significant implementation complexity.

We do however recommend that the option of creating a scheme specific tax relief regime for the National Pension Savings Scheme, based on a single rate of tax relief and a matching up-front contribution approach, should be considered in detail. And we believe that, whether or not a scheme specific regime is created, the tax treatment of NPSS contributions should mirror the attractive features which currently apply to saving via a Stakeholder Pension, i.e. the fact that starting-rate and non-taxpayers, many of whom will be part-time employees, can receive tax relief at the basic rate.

The launch of the NPSS should also be treated as an opportunity to raise awareness, among both individuals and employers, of the significant advantages of saving via pension contributions, and of the fact that these advantages will, for most people, not be offset by means-testing if our state system proposals are accepted.

(ii) Contracting-out rebate

Our preferred option for reform of the state system has implications for the contracted-out rebate. Since we recommend building on the existing two-tier BSP and S2P system, rebates will continue to be paid to employers and employees contracted-out of the S2P. But since we recommend freezing the Upper Earnings Limit for S2P accruals the importance of these rebates will decline over time. We believe this gradual disappearance of the contracted-out/contracted-in system is the most appropriate policy since:

- The contracted-out/contracting-in choice has added complexity to the UK pension system and is poorly understood. Its application to personal pensions helped generate the pension mis-selling problems of the 1990s. And it requires the government to set a "fair" level of rebate: this is likely to turn out in retrospect to be either too high, in which case government has spent money unnecessarily, or too low, in which case people would have been better to stay contracted-in. It is not a feature of the pension system which we would recommend now if it did not already exist.

- But we believe that its immediate abolition would accelerate still further the decline of employer DB pension provision.

- And the Pensions Commission does not believe it prudent to argue that abolition of contracted-out rebates can provide resources to offset the costs of an immediate increase in state pension generosity. Such a policy would reduce national savings by reducing the pre-funding of pensions at precisely the time when demographic change makes some increase in the national savings rate desirable.

We therefore recommend phase-out and simplification of the contracting-out rules rather than immediate abolition.

- For Defined Contribution (DC) occupational schemes (where contracting-in already dominates) and for personal pension schemes (where many industry experts are already advising customers to contract-in), we recommend that the contracting-out option be removed, with all people not in DB schemes becoming members of the S2P.

- For DB schemes, we recommend the continuation of the contracting-out option for the foreseeable future. But we propose that this option be abolished by at the latest about 2030, the date around which, under our proposals, accruals to the S2P become entirely flat-rate.

Additional government cash flow generated from these changes should be used to increase government's contribution to national saving: this requires either the pay down of debt, the diversion of the money into a national "buffer fund", or its use to promote individual funded savings (e.g. by measures to ensure the success of the NPSS).[1]

10. Securing long-term sustainability and consensus

The effectiveness of the UK's present pension system, both state and private, is undermined by low levels of understanding and trust. Many people do not understand what the state pension system will deliver: many do not believe that the present state promise will be maintained and many do not trust the financial services industry to sell good value products.

These problems have arisen because of:

- Multiple past changes to the state pensions system, in particular to SERPS/S2P, which aimed to reduce the generosity of future promises but in a non-transparent fashion.

[1] In all of our analysis, we have used the GAD's central estimate for the level of contracting-out in future. This implies a gradual decline. Our approach ensures all costs presented for different policy scenarios are on a consistent basis. If contracting-out were abolished for some or all pensions (as we suggest in Chapter 5), this would increase government revenue in the short run and expenditure in the long run with a net present value of zero.

- The failure to explain openly the challenges and implications of changing demography. Since 1981 the UK's BSP has been and is still being adjusted to make it affordable in the face of a rising dependency ratio. The "effective" state pension age for the BSP (i.e. the age at which a BSP at an unchanged value relative to earnings can be claimed) is in a sense being increased rapidly: but this increase is being achieved through the indirect and ill-understood mechanism of price indexation, not by the open and direct route of a commitment to increase pension ages [Figure Ex.9]. People intuitively grasp that the state is going to do less for them, but neither understand nor trust the precise plan.

- The mis-selling scandals of the 1990s, which in return reflected a misguided attempt to extend personal pensions to segments of the market where the economics only appeared to work in periods of exceptional capital return. This attempt has drawn the government into a series of attempts to influence the cost and integrity of selling via increased regulation, but at the cost of further complexity.

It is therefore essential that the new pension settlement is based on an appropriate division of roles, is communicated clearly to people, and that once implemented it is maintained reasonably stable over time.

We believe that our recommendations create a better basis for potential stability since:

- They clearly define the different appropriate roles of the state and of individuals.

  - The state should: i) **Ensure** that all people are kept out poverty in retirement; ii) **Encourage** people to achieve at least a base load of earnings-related pension provision; iii) **Enable** all people to save for a pension at low cost.

  - But individuals should have significant flexibility to make their own trade-offs between retirement age, savings rate, and level of income in retirement, in the light of their diverse preferences and circumstances.

- They deal explicitly with the challenges of increased life expectancy and as a result make possible an understandable state promise: a BSP which is stable in earnings terms but paid at an age which will rise over time with life expectancy.

- They free the state, after establishing and proving the success of the NPSS, from involvement in PAYG earnings-related pensions, thus reducing the risk that unanticipated changes in life expectancy will require ad-hoc changes to policy in order to control public expenditure.

- They provide a low-cost saving option through the NPSS rather than through more regulation of selling processes and prices.

Figure Ex.9 Effective state pension age for the BSP: given price-indexation and formal SPA remaining at 65. Value of pension receivable at different ages in current earnings terms

Age of first claim	2005	2010	2015	2020	2025	2030	2035	2040	2045	2050
65	82	74	67	61	55	50	45	40	37	33
66	91	82	74	67	60	55	49	45	40	36
67	99	90	81	73	66	60	54	49	44	40
68	108	97	88	80	72	65	59	53	48	43
69	116	105	95	86	78	70	63	57	52	47
70	125	113	102	92	83	75	68	61	56	50
71	133	120	109	98	89	80	73	66	59	54
72	142	128	116	105	95	86	77	70	63	57
73	150	136	123	111	100	91	82	74	67	61
74	159	144	130	117	106	96	87	78	71	64
75	167	151	137	124	112	101	91	83	75	67
76	176	159	144	130	117	106	96	87	78	71
77	184	167	151	136	123	111	101	91	82	74
78	193	174	158	143	129	116	105	95	86	78
79	202	182	165	149	135	122	110	99	90	81
80	210	190	172	155	140	127	115	104	94	85
81	219	198	179	161	146	132	119	108	97	88
82	227	205	186	168	152	137	124	112	101	91
83	236	213	193	174	157	142	129	116	105	95
84	244	221	200	180	163	147	133	120	109	98
85	253	228	206	187	169	153	138	125	113	102

Falling earnings equivalent pension receivable at 65

Constant earnings equivalent pension receivable at a rising age

Source: Pensions Commission analysis

Note: Under the present deferral option, pensioners can delay their claim and receive a pension 10.4% higher for each year of delay. The table illustrates the age to which the pension has to be deferred to receive a pension at retirement with the same value as today relative to average earnings.

But while these recommendations provide a potential basis for stability, actually achieving stability over time will also require:

- Full and open debate, in response to this report, about the unavoidable trade-off between increased public expenditure and increased State Pension Age.
- And ideally agreement on two underlying principles:
  - The need for an increase in state pension expenditure as a percentage of GDP between 2020 and 2045.
  - The need, after that gradual but one-off increase, to achieve long-term stability in pension expenditure as a percentage of GDP, secured by the principle of pension ages rising proportionately with life expectancy.

Even agreement on these principles, however, will not remove the need for difficult future decisions about the precise trade-off between state pension generosity, public expenditure and State Pension Age.

Those decisions are likely to be made more effectively if public debate is informed by independent authoritative analysis of the latest demographic and economic facts and latest trends in pension provision, spelling out the unavoidable trade-offs required.

We therefore recommend that a successor body to the Pensions Commission should be established, charged with presenting to Parliament and government every four years a report which spells out the facts and choices required.

11. The timing of reform: challenges and trade-offs; but a new settlement needed soon

The process of debating our recommendations, agreeing a precise way forward, and implementing change will inevitably take some time. We believe that it will be difficult to get the National Pension Savings Scheme fully up and running before about 2010. And there is a trade-off to be struck in deciding the date from which our proposed reforms to the state system should commence. Early implementation would be more costly at a time when public expenditure constraints are tight: later implementation makes it more important that private savings increase to compensate but, by delaying the date from which the spread of means-testing can be halted, may make that increase less likely.

The precise appropriate timing of change can therefore be debated. But it is essential that action is taken as soon as possible. On average, current pensioners are as well provided relative to average earnings as any previous generation, and many will continue to be well provided over the next 15 years. There is therefore no general and immediate crisis. But current trends in voluntary private pension provision, and in state pension provision if current indexation arrangements are continued indefinitely, will result in major and increasing problems after about 2020. To fix these long-term problems requires action now. State pensions paid in 2030 and 2040 will depend on accrual rules now in place. And the private pension income available at that time will depend on the savings behaviour of people now in work, which in turn is influenced by the incentives and the costs which they currently face and by employer engagement in pension provision, which is currently in decline.

The fact that there is not a current crisis for today's average pensioner, or for many of those approaching retirement, should not therefore be taken as justifying a "muddle through" approach. The problems in our pension system will grow increasingly worse unless a new pensions settlement for the 21st century is now debated, agreed, and put in place.

12. Summary of additional recommendations

The Pensions Commission's core recommendations are set out in Figure Ex.8, which distinguishes between the essential objectives which reform must pursue, and our recommended or preferred way forward. We set out below additional recommendations, again distinguishing definitive recommendations from those where further analysis and consultation is appropriate before deciding the way forward.

1. Detailed arrangements relating to the NPSS

The precise working arrangements of the NPSS should be decided in the light of further analysis and consultation, but our current judgement is that the arrangements shown in Figure Ex.10 are likely to be appropriate.

2. Tax Relief

- We do not recommend any major changes to the system of pension tax relief over the short to medium-term, but recommend that the option of creating a scheme specific tax regime for the NPSS, with tax relief expressed as a "government matching contribution" of equal percentage value to all members, should be explored further.

- The launch of the NPSS should be accompanied by a communication campaign to remind employees and employers of the major tax and National Insurance advantages which are enjoyed when employees are remunerated via employer pension contributions rather than cash wages.

3. Contracted-out rebate

- We recommend that contracting-out should be phased-out gradually:

  - For Defined Benefit Schemes, the contracted-out option should be maintained, but phased out, at the latest, by about 2030 (the date at which, under our proposals, accruals to S2P will become entirely flat-rate).

  - The contracted-out rebate system for Defined Contribution pensions (occupational or personal) should be abolished, with all employees not covered by Defined Benefit Schemes becoming members of the State Second Pension for future accrual.

- The improved government cash flow resulting from the abolition of the rebate for DC schemes should not be used to fund current expenditure, but for measures that directly or indirectly increase national savings (e.g. for instance improvements to the tax regime within the NPSS, or measures to mitigate the cost of NPSS employer contributions for very small businesses.)

4. Easing capacity strains in the annuity market

- We recommend that:
  - The ages of first possible and last possible annuitisation should rise over time in line with life expectancy.
  - Government should consider where there is a case for a cash limit to the amount which individuals are required to annuitise at any age (with the benefits of tax relief recovered via the appropriate tax treatment of withdrawals during life or of balances remaining at time of death).
  - Government should investigate whether there are changes to regulation or tax treatment which can encourage the development of a wider market for drawdown products.
  - The government should not be an issuer of longevity bonds on a significant scale. However, **if but only if** it exits from other inappropriate forms of longevity risk absorption via appropriate changes in pension ages in the state and public employee systems, government should consider the issue of longevity bonds which absorb (at an appropriate price) the risks relating to uncertain future mortality rates among very old people (e.g. over 90 year olds).
  - In its debt issuance strategy, government should ensure that there are no artificial constraints on the supply of long-dated and index-linked gilts.

5. The self-employed

- See Figure Ex.10 for recommendation relating to the NPSS.
- In addition we recommend that government investigates the option of allowing the self-employed to join S2P on a voluntary basis, paying age-related contributions on a fair basis.

6. Measures to facilitate later working and flexible retirement

We recommend that:

- There should be no default retirement age beyond which the provisions of the Age Discrimination legislation do not apply.
- The government should consider the option, post 2020, of having a two-tier pension age, higher for the State Second Pension and lower for the BSP.
- The government should more actively publicise the already existing option for people to defer taking the state pensions (both BSP and S2P), receiving a higher pension at a later age, and should increase the flexibility of this option, making it possible for people to take a proportion of the state pensions while deferring receipt of the rest.
- The issue of the appropriate age at which the Guarantee Credit becomes available should be kept under review after its rise to 65 by 2020. The government should consider whether the Guarantee Credit should remain available at 65 even when the SPA rises.
- Government should consider whether there is a case for eliminating or reducing employer's NI contributions for earnings of people aged above the SPA, subject to a maximum absolute reduction.
- Government should review all public policies relating to training and ensure that they are not biased by age.
- Government should ensure that its employment practices within the public sector set a best practice standard in the training of older workers, and in occupational health.
- The planned development of a Health, Work and Well-being Strategy (jointly by the Department of Health and the Department for Work and Pensions) should include a focus on defining the best practices in middle aged and older worker's occupational health which will tend to facilitate active labour market participation up to, and if people wish, beyond the SPA.

7. Ensuring an informed debate over the long-term

- We recommend that government should establish a successor body to the Pensions Commission charged with presenting every 3-4 years a report which sets out:

  (i) Latest trends in life expectancy and implications for the long-term public expenditure/State Pension Age trade-off.

  (ii) Latest trends in private pension saving, and in particular evaluation of the success of the NPSS in stimulating increased participation in pension saving.

  (iii) Latest trend in average retirement ages and in differences in life expectancy by socio-economic class, and latest information on whether ageing is being associated with increased health at specific ages; implications for polices required to support working later and flexible retirement.

Recommendations relating specifically to improvements in the data available to analyse these issues are summarised in the Annex at the end of the Report.

Figure Ex.10 Implementation details relating to the National Pension Savings Scheme

Chapter 10 discusses the detailed implementation issues which need to be resolved before establishing the NPSS. These issues should be the subject of further analysis and consultation before final decisions are made. We set out here, however, our preliminary judgements on the appropriate approach.

Section	Issue	Preliminary recommendation
Contribution rates and covered earnings	Minimum default contribution rate	Combined (employer and employee) default contribution rate of 8% gross earnings between the Primary Threshold and Upper Earnings Limit. Minimum complusory employer contribution of 3% (if individuals stay enrolled).
	Entry age	21
	Cap on contributions	Cash limit of twice the default contribution for the median earner.
Alternative pension arrangements outside NPSS	Employer opt-out	Employers can opt employees out of the NPSS if; ■ they offer a pension scheme which operates auto-enrolment ■ the employer contribution is at least the level of the compulsory match in the NPSS. ■ the combined employer and employee contribution (taking into account charges) is at least what it would be in the NPSS.
	Transfers between NPSS and other pension schemes	These should be allowed but perhaps subject to a maximum transfer allowed into the NPSS.
The mechanics of auto-enrolment	Contributions collection	Contributions should be collected by the employer via payroll deduction and transferred via a newly created Pensions Payment System.
	Individual opt-out	In writing within a month of being auto-enrolled into NPSS. Contributions only taken from earnings after this opt-out window has ended.
Treatment of those who are not employees	The self-employed	Able to join on a voluntary basis. Options to allow simple collection of contributions should be explored.
	Those not in paid work	Should be able to join the NPSS and receive tax relief at the basic rate.
Options for reducing the cost impact on small businesses		Explore options to minimise cost of NPSS for small employers without giving exemptions. This is an appropriate use of cash flow created by the phase out of contracted-out rebates since aimed at increasing funded savings.

Figure Ex.10 Continued

Investment options	Number and type of funds	NPSS to bulk negotiate a range of 6-10 funds and to allow access to a wider range of funds.
	Default fund	Lifestyle smoothed fund with equity exposure at younger ages and with increasing bond allocation as individuals get closer to retirement. Separate government bond fund to provide the only fund which can be described as giving a guaranteed return.
The decumulation phase	Annuitisation rules	Should be subject to the same rules as other pension schemes.
	Types of annuity	Individuals free to purchase level or index linked annuities, but encouraged to consider implications. Individuals free to purchase single or joint life annuities.
	Method of annuity purchase	Individuals free to purchase annuity from any provider. But the NPSS could have reserve powers to bulk negotiate annuity purchases for specific groups if that would mean a better deal for individuals.
	Treatment of fund in case of death before retirement	Part of the deceased person's estate.
Communication with members	Frequency of communication	Annual
	Content of statement	Combined statement of state pension accrued and NPSS capital values accumulated. Indications of possible future pensions at a variety of different ages of annuitisation, given indicative assumptions on rates of return.
The tax regime	Scheme specific tax regime	Government should explore the feasibility of a scheme specific tax regime, with more generous up front match but no tax-free lump sum.
	Tax relief for lower-rate and non-taxpayers	Should at least maintain the current tax relief at basic rate as seen in Stakeholder Pensions.
Operational costs	Target for Annual Management Charges	Desired AMC of 0.3%
Implementation timetable		NPSS in operation by 2010
Governance		Non-departmental public body probably most appropriate. The possibility of a role for the National Savings and Investments (NS&I) organisation and brand should be considered.

Key conclusions of the First Report "Pensions: Challenges and Choices"

Chapter 1: The demographic challenge and unavoidable choices

Life expectancy is increasing rapidly and will continue to do so. This is good news. But combined with a forecast low birth rate this will produce a near doubling in the percentage of the population aged 65 years and over between now and 2050, with further increase thereafter. The baby boom has delayed the effect of underlying long-term trends, but will now produce 30 years of very rapid increase in the dependency ratio. We must now make adjustments to public policy and/or individual behaviour which ideally should have been started in the last 20-30 years.

Faced with the increasing proportion of the population aged over 65, society and individuals must choose between four options. Either:

(i) pensioners will become poorer relative to the rest of society; or

(ii) taxes/National Insurance contributions devoted to pensions must rise; or

(iii) savings must rise; or

(iv) average retirement ages must rise.

But the first option (poorer pensioners) appears unattractive; and there are significant barriers to solving the problem through any one of the other three options alone. Some mix of higher taxes/National Insurance contributions, higher savings and later average retirement is required.

Chapter 2: Average retirement ages: past and possible future trends

Our response to the demographic challenge should include a rise in the average age of retirement. Healthy ageing for many people makes this possible; and an increase in employment rates among older people is now occurring. But the increase needed to make later retirement a sufficient solution alone looks very large; and significant inequalities in life expectancy and health across socio-economic groups may limit the scope for across the board increases. Increases either in taxes/National Insurance contributions and/or in private savings will therefore also be needed to meet the demographic challenge.

Chapter 3: The UK pensions system: position and trends

The UK pensions system appeared in the past to work well because one of the least generous state pension systems in the developed world was complemented by the most developed system of voluntary private funded pensions. This rosy picture always hid multiple inadequacies relating to specific groups of people, but on average the system worked, with the percentage of GDP transferred to pensioners comparable to other countries. But the state plans to provide decreasing support for many people in order to control expenditure in the face of an ageing population and the private system is not developing to offset the state's retreating role. Instead it is in significant decline.

The underlying trend in private sector employer pension contributions has been downwards since the early 1980s, and the total level of funded pension saving is significantly less than official estimates have suggested. But irrational equity markets and delayed appreciation of life expectancy increases enabled many Defined Benefit (DB) schemes to avoid necessary adjustments until the late 1990s. As the fool's paradise has come to an end, schemes have been closed to new members, and a shift to less generous Defined Contribution (DC) schemes has followed. The underlying level of funded pension saving is falling rather than rising to meet the demographic challenge, pension right accrual is becoming still more unequal, and risk is being shifted to individuals sometimes ill-equipped to deal with it.

Chapter 4: Looking forward: pension adequacy if trends unchanged

Given present trends many people will face "inadequate" pensions in retirement, unless they have large non-pension assets or are intending to retire much later than current retirees.

Current government plans and private savings levels imply that total pension income flowing to normal age retirees will rise from today's 9.1% of GDP to a mid-point estimate of 10.8% by 2050, and that there will be no significant shift in the balance of provision from state to private sources. This level of transfer in turn implies either poorer pensioners relative to average earnings or significantly higher average retirement ages.

The burden of adjustment will however be very unequally distributed. We estimate that at least 75% of all DC scheme members have contribution rates below the level likely to be required to provide adequate pensions. Our estimates suggest that around 9 million people may be under-saving, some by a small amount, some severely. But the significant minority of people in still open private sector DB schemes will enjoy more than adequate pensions and most public sector employees will be well provided for, as will some higher paid employees in Senior Executive schemes. The present level of pension right accrual is both deficient in total and increasingly unequal.

The implications of this for pensioner income will be more serious in 20-25 years time than in the next 10. And over that long time span many adjustments, for instance to savings rates and retirement ages, may naturally occur. A muddle-through option does therefore exist. But it is highly likely that the muddle-through option will produce outcomes both less socially equitable and less economically efficient than we could achieve with a consciously planned response to the problems we face.

Chapter 5: Non-pension savings and housing

In addition to occupational and personal pension funds worth £1,300 billion and unfunded public sector pension rights worth about £500 billion, the personal sector owns about £1,150 billion of non-pension financial assets, some of which could also provide resources for retirement income. But the ownership of these assets is very unequally distributed, and for the majority of people they can only provide a modest contribution to their standard of living in retirement.

Housing assets are more significant both because they are much bigger (£2,250 billion net of mortgage debt) and their ownership is more equally distributed. While the liquidation of housing assets during retirement will likely remain limited in scope, the inheritance of housing assets by people who already own a house may play an increasing role in retirement provision for many people. But house ownership does not provide a sufficient solution to the problem of pension provision given (i) uncertainty over future house prices; (ii) other potential claims on housing wealth such as long-term care; and (iii) the fact that housing wealth is not significantly higher among those with least pension rights.

Business assets, meanwhile, are important stores of wealth and potential sources of retirement provision, but for only a small minority of people. The fact that pension saving among the self-employed is not increasing therefore remains concerning.

Chapter 6: Barriers to a voluntarist solution

The present level of pension right accrual, private and state combined, will leave many with inadequate pensions. And there are likely to be limits to solving the problem solely via increased retirement ages. If state system plans are taken as given, a higher level of private saving is required.

There are however big barriers to the success of a voluntary pension saving system, some inherent to any pension system, some specific to the UK. Most people do not make rational decisions about long-term savings without encouragement and advice. But the cost of advice, and of regulating to ensure that it is good advice, in itself significantly reduces the return on saving, particularly for low earners. Reductions in Yield arising from providers' charges can absorb 20-30% of an individual's pension saving, even though they have fallen to a level where provision to lower income groups is unprofitable. This poses a fundamental question: in principle can a voluntary market for pensions work for low income, low premium customers?

But both the behavioural barriers to savings and the costs of provision have been made worse by the bewildering complexity of the UK pension system, state and private combined. This complexity reflects the impact of multiple decisions made over the last several decades, each of which appeared to make sense at the time, but the cumulative effect of which has been to create confusion and mistrust. Means-testing within the state system both increases complexity and reduces, and in some cases reverses, the incentives to save via pensions which the tax system creates. The scope of this means-testing would grow over time if current indexation approaches were continued indefinitely.

Unless new government initiatives can make a major difference to behaviours it is unlikely that the present voluntary private system combined with the present state system will solve the problem of inadequate pension savings.

Chapter 7: Revitalised voluntarism, changes to the state system, or increased compulsion?

To achieve adequacy there are three possible ways forward:

(i) a major revitalisation of the voluntary system; and/or

(ii) significant changes to the state system; and/or

(iii) an increased level of compulsory private pension saving beyond that already implicit within the UK system.

Chapter 8: Women and pensions

Women pensioners in the UK today are significantly poorer than men. This reflects both labour market features (lower employment rates, lower average earnings, and more part-time work) and specific features of the UK's state pension system. These state system features have in the past entailed most women gaining pension income through their husband, and reflected assumptions about family structure which have ceased to be valid. An effective pension system for the future must be one in which the vast majority of women accrue pension entitlements, both state and private, in their own right.

Some progress towards that aim is now occurring, with some labour market trends favourable to women, and some changes in the state system which benefit women. But important issues remain relating to overall equality in the workforce, to state system design, and to low levels of pension provision and take-up in some service sectors in which women's employment is concentrated.