Pensions: Challenges and Choices

The First Report of the Pensions Commission

Response by the

National Pensioners Convention

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19-23 Ironmonger Row
London
EC1V 3QN
Tel: 0207-553-6510
Email: admin@natpencon.org.uk
www.natpencon.org.uk

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Introduction

The National Pensioners Convention is the co-ordinating body for all pensioner organisations within the UK. It represents groups with a total membership of 1.5m retired and older people, and campaigns to improve the welfare, dignity and financial security of Britain's existing and future pensioners.

Summary

- The basic state pension should be raised to £105 a week, linked to average earnings and paid to all men and women.
- The State Second Pension (S2P) should remain earnings-related and based on the SERPS (State Earnings Related Pension Scheme) revalued earnings formula. Survivors' benefits to the state second pension should be increased from 50% to 100%.
- A number of changes should be made to the current qualifying rules surrounding national insurance to benefit women.
- There should be no requirement to join an occupational pension scheme that does not offer a guaranteed return and safeguards against loss of value.
- Consideration should be given to ending the contracting-out of the state second pension and reforming the provision of tax relief.
- There should be no further increase in the state pension age.
- The cost of introducing these recommendations will require additional public expenditure, through increased national insurance contributions, and government grants.

Overview

The Pensions Commission was set up to consider the adequacy of private pension saving in the UK, and to advise on any appropriate policy changes, including whether or not to move beyond the current voluntarist approach.

In undertaking its work, the Commission has concluded that:

- In line with other European countries, the UK has an ageing population
- It also has one of the least generous state pension systems in the developed world, that is hampered by complexity
- In recent years the responsibility for pension provision has shifted from the state, employer and market to the individual
- 12m workers do not currently have sufficient occupational or personal pension provision to obtain an adequate pension by the standard adopted by the Commission
- State and private pension provision amongst women is much lower than for men, and requires special attention

As a result of these main conclusions, the Commission has offered three possible courses of action:

- National insurance/taxes must rise to fund better state pensions
- Personal savings through occupational or personal private pensions must rise
- Average retirement ages must rise

Furthermore, the Commission believes it is unlikely reliance on any one of these options will be feasible.

This paper therefore sets out the Convention's response to these three options, considers the particular issue of women and pensions, and offers some recommendations for future policy changes. The options are explored in more detail by our pensions adviser Tony Lynes, in the Appendix.

Option 1: National insurance/taxes must rise to fund better state pensions

Successive governments have relied on the availability of reasonable occupational and personal private pensions to compensate for a planned decline in the value of the state pension. This has been accompanied by an expansion in the use of means-tested benefits for the over 60s. But the role of the state in ensuring adequate pension provision for all remains crucial if we are to abolish pensioner poverty both now and in the future.

Today there are a number of serious problems with the UK's existing pensions policy, as follows:

- The level of the basic state pension is universally regarded as inadequate
- The widespread use of means-testing to compensate for the level of basic state pension has been ineffective, unpopular and is set to grow under the government's policy of raising the basic state pension by prices and the Pension Credit by average earnings
- Many occupational pensions are changing from defined benefit to defined contributions, and are likely to be less generous
- 11.3m workers currently do not contribute to any private pension scheme and rely entirely on the state system; and, even among those contributing to a private scheme, a substantial proportion can expect to be dependent on means-tested benefits in retirement.
- Women have traditionally been badly served by both the state and occupational pension schemes

These developments are clearly neither desirable nor sustainable and must therefore be addressed.

Since 1980, when the indexation of the basic state pension to average earnings was abolished, the relative value of the pension has continued to fall. At today's current level of £79.60 a week for a single pensioner, official figures

show that this has resulted in one in five older people living below the widely recognised poverty level of 60% of median income.

As a direct result of the removal of earnings indexation and the expansion of means-tested benefits, the Institute for Fiscal Studies estimates that by 2020, 64% of all pensioners will be eligible for the means-tested Pension Credit; rising to 71% by 2050.

The failure of means-testing to eradicate pensioner poverty, the declining relative value of the basic state pension and the recent developments in occupational pension trends (see Option 2 below) – now dictate that the basic and second state pensions are strengthened and improved to provide all older people with an adequate income in retirement.

Option 2: Personal savings through occupational or personal private pensions must rise

Traditionally, the public sector and many large employers in the manufacturing and financial industries have provided their long-serving employees with reasonable occupational pensions. However, millions of workers have never benefited from such arrangements because the nature of their employment or the practices of their employer, denied them such access.

Furthermore, over the last two years, many well known companies have been anxious to phase-out their final salary pensions, in favour of less generous money purchase, defined contribution schemes offering more risk and potentially less return. Even the NHS is considering such changes and some commentators believe that by 2020 the final salary pension will disappear altogether.

The failure of the stakeholder pension, aimed at those earning less than £20,000 a year, has also highlighted the difficulty of saving for many with limited income. Pension saving will always be judged against other and more immediate calls on an individual's finances, such as mortgage repayments, the cost of raising a family, paying off student debts or the cost of caring for an elderly relative in a residential or nursing home.

The attraction of putting money into a private pension scheme when there are many worthy causes demanding a share of your limited income, will inevitably be limited. Furthermore, the recent financial scandals, stories of mis-management and corruption, and the fall in the value of the stock market, have been unlikely to convince many people to put their hard earned salaries into private pensions, offered by companies like Equitable Life.

In future, with the means testing extending further up the income scale and the basic state pension falling in relative terms, a much bigger private pension will be needed to avoid it.

Until now, most people of middle age or younger could also assume that, by

paying regularly into a good second pension scheme for the rest of their working life, they would stand a good chance of retiring with an income above the level of means-tested income support. In future, with the means-test extending further up the income scale and retirement income falling in relative terms, a much bigger pension will be needed to avoid it. According to the actuaries Mercer Human Resource Consulting, people retiring today need a pension fund of at least £75,000 to avoid means-testing.

With such major uncertainties, many younger people may conclude that it is better to spend their money today rather than to save it. Therefore, this option is unlikely to work.

Option 3: Average retirement ages must rise

Over the last few years there have been numerous calls to end age discrimination in the workplace, by ending mandatory age limits on employment. In addition, this has fuelled the suggestion that the age at which the state pension is paid should also rise.

However, whilst tackling age discrimination is an important and worthy goal, it should not be used as a justification for increasing the average working life. The Convention believes that real choice in retirement only comes from having financial security and sufficient pension income that means working beyond 65 becomes a choice rather than a necessity. To address this, in turn, means ensuring that both the state and any occupational pensions are set at a level that is regarded as acceptable.

Furthermore, amongst the clamour for raising the age of retirement and the age at which the state pension is paid, there has been little acknowledgement of a number of serious barriers to its achievement, such as:

- The high rate of unemployment amongst workers aged between 55 and 65, which needs to be addressed as a matter of urgency
- The need to improve the rates of full-time employment amongst women, which will require public expenditure on childcare and flexible working practices
- The need for considerable job creation to accommodate those workers who wish to continue working beyond state pension age
- The aspirations of younger workers who wish to begin a career and find their paths blocked by older workers

A failure to address these issues and that of guaranteed pension income, will mean that any increase in the retirement age and the age at which the state pension is paid will mean that today's poorer workers will end up working longer, drawing their pension for a shorter time and dying sooner. This is not an acceptable option.

Women and pensions

It is widely acknowledged that women are amongst the poorest pensioners in society, with one in four qualifying for means-tested benefits. In the main, this has been due to:

- Fewer opportunities to work full-time and pay national insurance
- The married woman's option to pay reduced contributions
- Lower pay when in work, reducing the possibilities of saving
- Employment in occupations that do not offer occupational pension schemes
- Broken work records due to domestic responsibilities; affecting poorer women the most
- Divorce, separation or widowhood

The failure of the state pension system has been to base entitlement on a traditional male work pattern of 44 years continuous employment, with little serious acknowledgement or safeguards for protecting the vast majority of women whose working life did not conform to this model.

Women have traditionally lost out because less than ten years contributions and low and part-time earnings do not count towards entitlement.

The current system of home responsibilities protection takes off the number of years you have to contribute in order to qualify for a state pension, but even so, individuals are still required to pay National Insurance for a minimum 20 years to get a full pension.

The failure of the private occupational schemes has been to both restrict access for part-time, low paid, mainly women workers and more recently to move towards less generous, defined contribution schemes. However, even those fortunate enough to be members of a final salary scheme, tend to find that the rules favour men and do not take account of a woman's broken work record.

These approaches therefore need revising to relate to modern experience.

Recommendations for policy changes

1. The basic state pension should be immediately increased to at least the level of the Guarantee Credit for all men and women of pensionable age, currently £105.45 a week. This would end the widespread use of means-testing under the Pension Credit, ensure help reached the very poorest in society and start to address the existing problem of pensioner poverty.

2. The basic state pension should be uprated annually in line with average earnings or inflation (Retail Price Index), whichever is the greater, to enable pensioners to share in the growing prosperity of the nation. A single pension is now over £30 a week less than it would have been had the indexation not been broken in 1980.

3. 87% of women do not currently qualify for a full basic state pension in their own right, based on their own national insurance contributions. To widen and enhance the entitlement to a basic state pension for future generations, the system should make the following changes:

    - Any years paying part or whole contributions could count towards entitlement.
    - The lower earnings limit could be lowered so that more low paid workers are brought into the system.
    - The 10 year minimum requirement for contributions could be abolished or lowered.
    - The current number of qualifying years needed to gain a full state pension: 44 (male) 39 (female) could be reduced to 30 years to increase eligibility, particularly amongst women.
    - Home responsibilities protection could be made more generous, to include not only looking after children under 16 years as at present, but also for caring for dependents for less than the current 35 hours a week.

4. The State Second Pension (S2P) should remain earnings-related and based on the SERPS (State Earnings Related Pension Scheme) revalued earnings formula to ensure a fair deal to those employees, particularly women, whose careers do not conform to traditional work patterns.

5. Surviving partners' entitlements to state second pension must be increased from 50% to 100%. This would mainly benefit women who tend to live longer than men, and rely more heavily on their husbands' pension income.

6. There should be no requirement to join an occupational pension scheme that does not offer a guaranteed return and safeguards against loss of value.

7. An estimated £10-14bn is currently given annually in the form of tax relief to occupational/personal pensions. In addition a further £11bn is given in contribution rebates for those contracted out of the state second pension.

    It is widely recognised that the vast majority of this benefit goes to those higher earners who qualify for the top income tax rate and thus receive a 40% rebate, rather than the majority of working people who qualify for just 22%.

    Serious consideration should therefore be given as to whether this public money is best spent in this way, and whether or not contracting–out of the state second pension should be abolished (with the protection of any accrued rights) and tax relief reformed to be more progressive.

8. The age at which the state pension is paid should remain at 65 for both men and women. Serious consideration should be given to find ways of

enabling workers aged between 55 and 65 to continue working. Any proposal to abolish a mandatory retirement age at work should only be considered if both state and occupational pension income can be guaranteed at a reasonable level.

9. The cost of introducing these recommendations will require additional public expenditure, through increased national insurance contributions, and government grants. It should remain the role and responsibility of the state to provide a reasonable and guaranteed income to all older people as the best way of providing dignity and security in retirement.

APPENDIX

Pensions policy – a change of direction?

Comments on the first report of the Pensions Commission by Tony Lynes, Pensions Adviser to the National Pensioners Convention

Summary

The four options

(i) Pensioners becoming poorer. There is no good reason why retired people should have a lower standard of living than the working population. Pensions must not only be adequate at retirement age but, to maintain their adequacy, should rise in line with earnings rather than prices during retirement. Raising the basic state pension to the level of the Guarantee Credit and linking it to average earnings would ensure that at least part of pensioners' income was earnings-indexed.

(ii) Higher taxes/NI contributions devoted to pensions. There is an urgent need to increase the income of the NI Fund to finance greatly improved state pensions. The Treasury supplement should be restored and the Fund should be compensated for the loss of employers' contributions resulting from the introduction of "green" taxes. Future contribution increases would be more acceptable if a National Insurance Commission were set up, including representatives of contributors and pensioners.

(iii) Higher savings. Saving through funded pension schemes has proved much less efficient than a pay-as-you-go state scheme. It should not be compulsory.

(iv) Higher average retirement ages. There is no justification for any further increase in State Pension Age in the foreseeable future, but considerable scope for increasing employment for older people, both under and over State Pension Age.

Risk sharing

(i) Investment risk. DC pensions are a hopelessly inefficient way of providing for retirement, compared with PAYG schemes which involve no investment risk. The state second pension should therefore remain earnings-related and a long-term plan for ensuring its adequacy should be adopted. If contracting out is to continue, it should be limited to DB schemes.

(ii) Longevity risk. A state PAYG scheme has the advantage that contributions can be set at the level required each year, unlike funded DB schemes, in which employees' contributions cannot be increased retrospectively, and DC schemes in which longevity risk is reflected in annuity rates.

(iii) Other risks. People should be able to change jobs without any reduction in the future value of their pension rights and all pensions in payment should

be indexed, ideally in line with earnings but at least with prices.

Adequacy

The benchmark earnings replacement targets proposed by the Commission are reasonable, subject to the requirement that pensions must not only be adequate at the point of retirement but remain so.

Women and pensions

Gender inequalities in private pensions are greater than in the state scheme. Greater reliance on private pensions will therefore lead to more inequality. There are two ways of reducing gender inequality in state pensions. The first is to change the NI rules to remedy the gaps in women's entitlement (incuding those resulting from the lack of provision for backdating HRP and the married women's option to pay reduced contributions). The Government Actuary should be asked to report on the potential effect of such changes, compared with the more radical alternative of a citizen's pension.

The impact of means-testing

If the likely effects of Pension Credit were fully understood, they could seriously affect voluntary savings incentives; but the effects are unpredictable, mainly because of uncertainty as to future policy on indexation and other features of the scheme. Many pensioners are likely to discover too late that saving was a mug's game.

The needs of today's pensioners

The Pensions Commission's first report is to be warmly welcomed as an authoritative and well researched account of the main issues which need to be addressed in planning future pensions policy. The main regret is that the report pays relatively little attention to the situation of existing pensioners and those now approaching pension age, though this is largely due to the Commission's limited terms of reference. The report concedes (page 168) that "many individuals are reaching retirement with minimal private pension savings" and that "increasing numbers are likely to reach retirement age with inadequate resources even over the next 10-15 years"; but it concludes that "the major challenge we face is more concerned with getting the pension system right for those people retiring from, say, 2025 onwards, than fixing problems likely to be reflected in pensioner incomes over the next 10 years." The fact is that no acceptable solution to the long-term problem of inadequate retirement incomes is possible if it fails to address the inadequacy of the incomes of a large proportion of today's pensioners.

The Commission's four options

The Commission asks: "What mix of the 4 possible options: pensioners becoming poorer relative to the rest of society; higher taxes/NI contributions devoted to pensions; higher savings or higher average retirement ages,

should be pursued?”

(i) Pensioners becoming poorer

One can only agree with the Commission’s judgement that this option is “unattractive in respect to the vast majority of pensioners”. There is no good reason why retired people should, in general, have a lower standard of living than the working population. Yet Appendix D of the report shows that, in 2001, 24% of people aged 65 and over in the UK had incomes below 60% of the median income of all households, compared with 15% of the under-65s, and that, comparing the median income of those aged 65 and over with that of the under-65s, the UK had a ratio of 0.76, significantly below the EU average of 0.86. The Appendix also notes that, among the 15 EU countries, “the UK is alone in having a relatively mature pension system and a high proportion of the elderly in low income households.” In the light of these facts, it is impossible to defend the proposition that pensioners should become even poorer relative to the rest of society.

There is another dimension to the question of pensioner poverty: the extent to which poverty increases over the years of retirement. The adequacy of pensioners’ incomes must be judged by comparison with the current incomes of the rest of the population. A person retiring at 65 may well see average real earnings increase by 50% in the course of their retirement. To maintain the same degree of adequacy, their total pension will need to rise by the same proportion. In discussing what level of pension is “adequate”, however, the Commission writes: “Most people will desire their standard of living to be maintained during retirement and the most obvious benchmark is therefore that pensions should maintain the same real value, i.e. rise with prices.” On the contrary, what pensioners want is to share in rising living standards so that they can continue to participate fully in the life of the community as a whole. Tying their pension to a price index will not achieve that aim.

The Commission acknowledges that “older pensioners have significantly lower income than recent retirees” and that “this is bound to be true to a degree if new retiree pensions rise in line with average earnings, while pensions in retirement rise at best with prices”; but, it states, “the empirical data suggests that the decline of relative real income during retirement may be more severe than theory suggests is optimal.” I would argue that the “optimal” rate of decline of relative real income during retirement is *nil*, and I am not aware of any theory that would lead to a different conclusion.

With the exception of the means-tested guarantee credit, the UK pension system at present totally fails to recognise the need to maintain the value of pensions in payment relative to average earnings; indeed, as the Commission notes, private pensions are often not even price-indexed. Hence the importance that the NPC attaches to the restoration of the link between the basic state pension and average earnings, which, until 1980, ensured that at least part of pensioners’ incomes increased in real terms during the years of retirement. Moreover, raising the basic pension to a more adequate level would automatically enhance the effect of the earnings link, since it would mean that a greater proportion of total pension income was earnings-linked.

It is to be hoped, therefore, that the Commission’s final report will strongly

support the NPC's policy that the basic state pension should be raised to the level of the Guarantee Credit element of Pension Credit - at present £105.45 per week for a single pensioner - and increased annually in line with average earnings.

(ii) Higher taxes/NI contributions devoted to pensions

For the reasons explained below, private funded pension schemes cannot offer a satisfactory solution to the problem of providing adequate and secure pensions for the future. Still less can they solve the problems of today's pensioners since, by definition, funding can only provide benefits for the future. There is, therefore, an urgent need to increase the income of the National Insurance Fund in order to finance greatly improved state pensions on a pay-as-you-go basis.

At present, the income of the NI Fund consists entirely of contributions by insured persons and employers. For most of the 20th century, a significant proportion of the Fund's income came from the Treasury. The Social Security Act 1973 fixed the Treasury supplement at 18% of the contribution income, but it was gradually reduced during the 1980s and finally withdrawn altogether. The case for a Treasury contribution, derived from general tax revenue, is very strong. Unlike private pension schemes, the state scheme has a system of contribution credits for periods of incapacity or unemployment and home responsibility protection for carers; and the state second pension is designed to offer benefits to low-paid workers greatly in excess of the value of their contributions. It is right that the benefit entitlements resulting from these features of the scheme, which are not directly related to the individual's contribution record, should be financed by progressive taxes rather than contributions. The Treasury supplement should, therefore, be restored. At its previous rate of 18% it would amount to about £11.2 billion per year.

An additional Treasury contribution should be introduced to compensate the NI Fund for the losses resulting from the introduction of a series of "green" taxes (Landfill Tax, Climate Change Levy and Aggregates Levy) in recent years. Each of these taxes has been accompanied by a corresponding cut in employers' NI contributions, with the result that the Treasury has pocketed most of the proceeds and the burden has fallen mainly on the NI Fund, which is losing over £2 billion a year as a result. Adding that £2 billion to the £11.2 billion Treasury supplement would enable the basic state pension to be raised to the level of the guarantee credit (£105.45 a week) without any immediate increase in NI contribution rates.

In future years, further substantial increases in the Fund's income will be needed as a result of demographic change. It is reasonable that these increases should be derived, at least in part, from higher contributions, including the raising of the upper earnings limit (UEL) if not its abolition. Unlike other taxes, NI contributions are ring-fenced: they can only be used for the purposes specified in the legislation. This is likely to make the increases more acceptable, especially if contributors are convinced that the Fund will not be abused by future governments and that keeping it in a healthy state will therefore be to their long-term advantage. To achieve this will mean removing the Fund from the unfettered control of the Treasury and setting up a separate

body to oversee its finances, possibly on the lines of the National Insurance Commission advocated in the 2003 Catalyst working paper *Better Pensions: The state's responsibility*:

> "To give National Insurance the protection that it deserves there should be a separate and largely autonomous financial institution, with a governing National Insurance Commission consisting largely of representatives of contributors and pensioners which would be responsible for fixing benefit and contribution rates and for proposing structural changes, such as the introduction of new benefits or the modification or abolition of existing benefits.
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> "Structural changes in the pension system would have to be endorsed by the relevant government departments, including the Treasury, and by Parliament. The Commission would also be required to have regard to the financial equilibrium of the system, both short-term and long-term; to the reasonable expectations of contributors as to the benefit rights acquired by their past contributions; to the available evidence as to the benefits and rates of benefit for which contributors would be willing to pay; and to the broader economic implications of its actions. Its primary responsibility would be to ensure both the effectiveness and the financial viability of the social insurance system and to justify its actions and proposals in terms of these objectives.
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> "Should a government ever wish to impose changes in benefits or contributions contrary to the views of the Commission, they would have to lay before Parliament a full statement of their reasons, to which the Commission would have the right of reply. As a result the use of the Fund's resources for purposes unrelated to the proper functioning of National Insurance or the removal of rights based on past contributions would lay the government open to serious and embarrassing criticism."

(iii) Higher savings

Saving for one's retirement is generally regarded as a worthy aim. However, for many reasons, some of which are discussed below, saving through funded pension schemes has proved a much less efficient way of providing for retirement than a state scheme operating on pay-as-you-go principles. There may be a case for encouraging savings in addition, but this should not be regarded as the main way of ensuring an adequate retirement income; nor should it be compulsory. Most people would anyway prefer to save in ways which allow them to access their savings at any time, rather than having to wait until they reach pension age. Separating savings decisions from retirement planning may, therefore, encourage rather than discourage saving.

(iv) Higher average retirement ages

The Commission is right to insist that "an increase in the average retirement age carries no necessary implications for State Pension Age (SPA)." We should also endorse the Commission's warning that an increase in the SPA might (and in my view undoubtedly would) "disproportionately affect socio-economic groups with the lowest life expectancy" - i.e. those who already get

the least favourable return for their pension contributions. Women's pension age is already set to rise from 60 to 65 by 2020 and there is no justification for any further increase in the foreseeable future.

This, however, does not mean that average retirement ages should not rise. There is clearly considerable scope for increasing employment rates for those under 65. We accept, also, that much more needs to be done to counter age discrimination, so that those who wish to continue in paid work beyond SPA are enabled to do so. But the numbers wishing to go on working will depend not only on their state of health but also on the kinds of job available. It is unreasonable to expect that people who have spent the whole of their working lives up to the age of 65 in physically demanding but mentally unsatisfying work at relatively low rates of pay will want to continue working for a day longer than is necessary. A long and comfortable retirement, during which they can find new and satisfying activities, with or without financial reward, is the least that society should offer them.

Risk sharing

(i) Investment risk

The Commission invites views on the appropriate risk-sharing balance between the state, employers, the financial services industry and individuals. It is inevitable that pension planning will involve some risk, if only because of the long time scales involved. It is, however, important to distinguish between the risks inherent in pension provision and extraneous risks which are not directly and necessarily involved in pension provision.

The latter category would include, in particular, investment risk. As the Commission states on page 109 of the report, "the shift of this risk to individuals, which is a key consequence of the DB to DC shift, exposes them to major uncertainty about the value of their future pension, given the volatility of rates of return over periods relevant to pension savings." And, as the Commission also notes, the investment risk borne by the individual has been magnified by the erosion of state pensions, obliging people to rely increasingly on the uncertainties of the private sector.

The fact is that a person investing in a money-purchase (DC) pension payable 10 or 20 (let alone 30 or 40) years hence can have no real idea of its value, its relationship to the general level of incomes at that time, or how this will change while the pension is in payment. This is a hopelessly inefficient way of providing for retirement, since the pension will almost certainly either exceed or fall short of expectations. By contrast, investment risk can be avoided entirely if pensions are financed on a pay-as-you-go basis. As the Commission says, "Essentially a state PAYG promise can be considered as providing a guaranteed rate of return on contributions roughly in line with the rate of growth of GDP. The smaller the role of the state PAYG scheme, the smaller the percentage of peoples' pension that comes in this guaranteed return form." (This statement is qualified by a footnote: "The guarantee of return only holds if the state actually delivers the implicit promise of future PAYG benefits. These promises can however be changed by future governments." This is of course true; but the political risk could be greatly reduced by the appointment of a body such as the National Insurance

Commission advocated in the Catalyst paper to which we have already referred.)

It is essential, therefore, that a state earnings-related pension should remain available to those for whom the only alternative would be a DC scheme. The threat to convert the state second pension into a flat-rate benefit should be removed at once and a long-term plan for ensuring the adequacy of the earnings-related element (including the linking of the upper earnings limit to average earnings) should be adopted. If contracting out is to continue at all, it should be limited to DB schemes in which the investment risk is not borne by the employee.

(ii) Longevity risk

Unlike investment risk, longevity risk is unavoidable in any pension scheme; the only question is who should bear it. Here, too, there are important advantages in a state PAYG scheme, in which contributions for each year can be set at the level needed to pay that year’s pensions, and corresponding disadvantages in private funded schemes, as recent events have shown. The problem for a funded DB scheme is that, if the members live longer than expected, the cost of the pensions increases and there is no obvious source from which the increase can be financed. Employees’ contributions can be increased for the future but they cannot be increased retrospectively and the employer may respond by closing the scheme.

In a DC scheme, where the pension takes the form of an annuity, the post-retirement longevity risk falls on the insurance company, which adjusts its annuity rates accordingly. In a period of rapidly improving mortality rates, however, insurance companies will seek to protect themselves by setting annuity rates at a conservative level, compelling the pensioner to pay a high price for the longevity risk. But even if the longevity risk could be eliminated, annuities would still represent poor value to the pensioner. This is illustrated on page 232 of the report, where a 3.2% real rate of return on pension savings is assumed, resulting from “the combination of a 4% real return during the pension fund accumulation stage ... and a 1.3% return during the annuity phase (the rate implicit in annuity pricing today).” The low rate of return assumed in annuity pricing may be justified by the need to invest in fixed interest securities, but it is an additional disadvantage of funded DC pension schemes.

(iii) Other risks

Chapter 3 of the report lists some of the changes that have led to a reduction in the generosity of employer pension contributions, including the treatment of early leavers and the indexation of pensions in payment. The Commission comments that “some reversal of the unplanned and unanticipated increase in the generosity of DB pension promises was inevitable at some time.” It should, however, be axiomatic that people are able to change jobs without any reduction in the future value of pension rights derived from their past employment. The present preservation requirements do not offer full protection of early leavers’ rights (though the state scheme does) and there

can be no justification for any relaxation of those requirements. There is no good reason why a person's pension prospects should be affected by the number of different employers for whom he or she has worked.

Similarly, the indexation of pensions in payment should be regarded as an indispensable feature of any pension scheme. As we have already indicated, this should ideally mean that the pension rises in line with earnings; but at the very least all pensions should be fully price-indexed.

Adequacy

The adequacy of retirement incomes is clearly a matter of subjective judgement. Whatever level is chosen, however, it is always possible, for those who wish and can afford to do so, to make additional provision. Bearing this in mind, the benchmark earnings replacement targets proposed in chapter 4 of the report - 80% of gross earnings for lowest earners, 67% for median earners and 50% for top earners - seem reasonable. However, it is important to note that people's earnings can fluctuate widely in the course of their working lives and may fall steeply in the period preceding retirement. In these circumstances, it is not unreasonable that total pension income may exceed pre-retirement earnings. And it is relevant to stress here, yet again, that pensions must not only be adequate at the point of retirement but must remain adequate thereafter.

Women and pensions

The Commission's analysis of the reasons why women's pensions are in general greatly inferior to men's is most valuable, though in some respects incomplete. To the extent that pensions are based on earnings, the inequality is a direct reflection of the fact that women are, on average, paid less than men, are more likely to be in part-time employment and spend more of their working lives as unpaid carers. The state pension system partially compensates for these factors by means of contribution credits and home responsibilities protection, by providing a basic pension which is not earnings-related and by paying married women a basic pension based on their husbands' contributions. Nevertheless, as the report says, "the net effect of the historic shape of the UK state pension system, combined with women's past employment patterns, is that 69% of women aged 65-69 who receive BSP receive less than the full amount (compared with 15% of men)."

Gender inequalities in private pensions are even greater. The schemes are nearly all earnings-related (DB pensions directly and DC pensions indirectly since contributions are generally related to earnings); part-time workers (mainly women) are more likely to have been excluded; and, as the Commission notes, the shift to DC schemes has further disadvantaged women because annuity rates are lower for women than for men, while annuities sold to men are usually based on a single life with no provision for inheritance. Finally, unlike the state scheme, private schemes make no allowance for periods of non-earning. It is impossible to avoid the conclusion that greater reliance on private pension schemes will lead to greater pension inequality between men and women.

There is considerable scope for action to improve women's pension rights in the state scheme. National Insurance, originally intended to provide at least a basic minimum income for all those over pension age in exchange for contributions paid during working life, has a number of major gaps which particularly affect women. There are two ways of tackling this situation. The first is to identify the gaps and see whether the rules connecting entitlement with the individual's contribution record can be altered so as to fill them. The second is to reject the contributory basis of the basic state pension altogether and convert it into a citizen's pension with entitlement dependent on a residence test. Which of these courses of action should be adopted depends on the extent to which the needs of women pensioners, including the present generation of pensioners, can be met while preserving the mechanism of National Insurance and the important protection it can offer for future pension rights.

The Commission has identified a number of factors which reduce women's basic state pension entitlement and which could be addressed by changes in the legislation. These include the rule requiring 10 years' contributions (paid or credited) as a condition for a woman receiving even a reduced basic pension on her own insurance; the fact that earnings below the Lower Earnings Limit (£79 per week) in any one job do not count towards pension entitlement; and the fact that home responsibilities protection (HRP) applies only to whole years of caring.

For the present generation of women pensioners, however - and for large numbers of women reaching pension age in the next two decades - two other factors are even more important. The first is that HRP was introduced from 1978 with no provision for backdating it to take account of earlier years of caring. If the evidence required for precise backdating is not available, it should be possible to make an approximate adjustment in respect of pre-1978 periods of parenthood.

The second major factor affecting existing pensioners is the married woman's option to pay reduced NI contributions, which was withdrawn for new entrants in 1978 but continues to have a disastrous effect on women's pension entitlements. It is sometimes suggested that those who exercised the option must accept the consequences but, even if they understood the implications of their choice at the time (and it is certain that a large proportion did not), the resulting loss of pension and other benefits is disproportionate to the reduction in contributions - especially if account is taken of the fact that employers' contributions were payable in full, whether the employee paid full contributions or not. It would, therefore, be possible to award contribution credits for at least a proportion of the years in question, without any unfairness to married women who chose to pay full contributions.

Another change which would mainly benefit women pensioners is the restoration of the right to inherit 100% of a spouse's SERPS entitlement. The reduction to 50% was simply a cost-saving measure, only marginally related to the needs of those concerned.

The information at our disposal does not enable us to say to what extent changes in the contributory state pension system of the kinds discussed above could address existing gender inequalities. The Government Actuary

should be asked to investigate and report on this question, so that a fully informed choice can be made between changes of this kind and the more radical alternative of a citizen's pension.

The impact of means-testing

One of the questions posed by the Commission is: "How important an impediment to save, or to advise people to save, is the impact of means-testing?" The main means-tested benefit available to pensioners at present is Pension Credit. It is clear from the facts presented in chapter 6 of the report that, if the likely effects of Pension Credit were fully understood, they could have a very considerable effect on incentives for voluntary saving, especially when combined with the effect of other means-tested benefits such as Housing Benefit and Council Tax Benefit which are barely mentioned in chapter 6.

It is, however, also clear that, quite apart from the difficulty of understanding the complicated interactions of means-testing, taxation and tax credits, it is at present impossible even for an expert to predict what the actual effects will be at any point in the future. Some degree of uncertainty is inevitable, since we cannot know what changes future governments may make in the tax and benefit systems, but at the very least we should be told what are the present government's long-term intentions, so that firm advice can be given to potential savers on the basis of existing policies, together with a warning that those policies may change in the future.

The greatest uncertainty, at present, surrounds the way in which Pension Credit is likely to develop. This, as the Commission notes, depends on future uprating policy. The illustrations in chapter 6 are based on the continuation of the present policy of increasing the Guarantee Credit in line with average earnings and the basic pension in line with prices, resulting, by 2050, in over 60% of pensioners losing 40p in Pension Credit for every additional £1 of income from savings. But, as the report says, "the Government has no long-term commitment to any particular indexation approach." Moreover, even if the basic pension remains tied to prices, it cannot be assumed that the savings credit threshold (the level of income above which the Savings Credit operates) will remain the same as the basic pension. Nor can it be assumed that the 40% withdrawal rate would continue unchanged in the face of a steep rise in the numbers entitled and the cost of the Pension Credit.

The Commission warns that, if current indexation arrangements were continued indefinitely, savings by low income (and eventually middle income) individuals would likely be depressed, one reason for this being that "IFAs and other pension sellers ... will be wary of selling to people potentially affected by Pension Credit withdrawal for fear of future mis-selling accusations." This would certainly be the effect if it were possible to predict future indexation policy - which may be one reason why the government has given no indication of what that policy might be beyond the end of the current spending round. The present situation, however, is that advisers, however well informed, simply cannot predict the future impact of means-testing. The likelihood is that very large numbers of pensioners will discover too late that saving for their retirement was a mug's game. The only way to avoid that outcome is to

ensure that all pensioners have an income above the level at which the main means-tested benefits operate, in particular by raising the basic pension to the level of the Guarantee Credit and restoring the earnings link.

January 2005 **Tony Lynes**