House of Commons

Work and Pensions Committee

Pension Reform

Fourth Report of Session 2005–06

Volume I

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Report, together with formal minutes

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The Work and Pensions Committee

The Work and Pensions Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department for Work and Pensions and its associated public bodies.

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Committee staff

The current staff of the Committee are Sarah Davies (Clerk), Gosia McBride (Second Clerk), Maxine Hill and Djuna Thurley (Committee Specialists), Luke Robinson (Committee Media Advisor), Louise Whitley (Committee Assistant), Sarah Verrinder (Committee Secretary) and John Kittle (Senior Office Clerk).

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Summary

The Government has proposed significant reform to the UK pension system in its recent White Paper *Security in retirement: towards a new pensions system*. This report sets out the Committee's detailed response to the proposals.

We conclude that on the whole the Government's measures are the right way forward. They do not represent the wholesale simplification some were seeking, but they have other advantages and appear to be feasible. They form a sound basis for a political consensus. Other stakeholders – including businesses and unions - are broadly signed up to these measures, recognising the trade offs but viewing them as a significant improvement on the present system. It is essential to rebuild trust in pensions, and we are hopeful that these proposals will begin to do that.

The new system has a number of different elements with the most ambitious being the Government's plan to introduce a new system of personal accounts for pension saving. Employees who are not in an occupational scheme will be opted-in, unless they make an express decision otherwise. The Government has not yet decided who will run the scheme, but it has stressed that charges should be kept low to maximise the pension pot savers can anticipate when they reach retirement.

There is no opt-out for employers, who will have to contribute if their employees opt in. There is concern among businesses on affordability and future pressure on wage negotiations. We recommend that the Government make an early announcement on a support package to ensure a smooth introduction. There is worrying research suggesting that some employers may try to persuade employees to opt out. This is totally unacceptable.

We have asked for more information on how the new scheme will interact with means-tested benefits since people need to be confident that they will benefit from saving. We have asked for pre-legislative scrutiny of the legislation relating to personal accounts to assess how these matters have been addressed.

The proposed reforms to the State Pension system to recognise the contribution of people with caring responsibilities received a warm welcome. The remaining proposals take a gradual approach to reform which do not go as far as some organisations wanted. We asked four questions:

- Will they go far enough in reducing means-testing?
- Are the arrangements to re-link the Basic State Pension to earnings right?
- What are the implications of the proposed measures to increase the coverage of state pensions?
- Was it right to reject alternative proposals to move more quickly to a simpler, flat-rate pension?

We welcome the recognition that growth in the extent of means-testing over time should

be restricted. While the Pension Credit has lifted many pensioners out of poverty, retaining the present system as it stands would mean an unacceptable increase in the proportion of people on means-testing. The evidence we received confirmed that the proposals should reduce means-testing but there is uncertainty about the long term projections.

The Government's decision to re-link the Basic State Pension to earnings is also commendable. The White Paper does not guarantee the date when this will take place – it states that it will be 2012, or at the end of the next Parliament, subject to affordability. We questioned the Secretary of State hard on this point, as we think such equivocation is unhelpful and a firm commitment would be welcome. The additional delay beyond 2010-11 will defer the benefits of the reforms for current and future pensioners.

We welcome the Government's proposals to increase dramatically the number of women and carers who receive a full Basic State Pension. The qualifying years will reduce to 30 in April 2010 and crediting arrangements will be improved. These are important steps which will make a real impact on the retirement incomes of women and carers. We welcome them, although we have concerns about those who will miss out on the new entitlement by days or months.

The Government is retaining a State Second Pension (S2P) with different qualifying arrangements to the Basic State Pension. The gradual move to a 'flat-rate' system means that the first completely 'flat-rate' pensions will be paid to people retiring in around 2080 and, even then, those with more years of contributions and credits will get more S2P. We are concerned that gaps remain in entitlement to the State Second Pension compared to the Basic State Pension, particularly for the self-employed. We recommend that the Government set a date for re-examining the feasibility of moving to a single flat-rate state pension.

The Government has also proposed that the State Pension Age should increase in three steps – to 66 from 2024, to 67 from 2034 and to 68 from 2044. We conclude this is a justifiable step, but have concerns about the impact on poorer people and those in manual jobs. We recommend that any increase be demonstrably linked to measures to reduce health inequalities and increasing access to training and jobs for older workers.

Lastly, we discuss the importance of giving people clear financial advice and support to make the decisions they need about their financial future. We recommend that the Government issues better pensions forecasts, building on the work it has already done with Combined Pensions Forecasting. We also suggest that resources should be put into making face-to-face financial advice available locally, especially for those on low incomes.

1 Introduction

Illuminating pension reform: the Committee's inquiry

1. Pension reform is a curious subject. Curious because while having a decent income in retirement is important for everyone, the system itself seems often to inspire only apathy and confusion. People find the issues highly complex at an individual level and can, some suggest, fail to behave in their own economic interest. Designing pensions systems involves genuinely difficult challenges – constructing institutions which are durable over decades, dealing with inherited structures which are hard to change and ensuring that savings are secure.

2. This report – which we hope will be illuminating rather than confusing - forms the Committee's response to the Government's White Paper on Pensions Reform, *Security in retirement: towards a new pensions system*,[1] which was published in May 2006. That White Paper, in turn, followed a Green Paper[2] on which our predecessor Committee reported in 2003,[3] and the three reports of the Pensions Commission, chaired by Lord Turner of Ecchinswell.

3. We were clear from the outset that we did not wish to duplicate the work done by Lord Turner and the other Commissioners. Where we saw our inquiry adding value was in its consideration of the Government's reaction to the Pensions Commission proposals from a political as well as an analytical point of view.

4. We have tried to explain key issues clearly and simply, to enable readers who are unfamiliar with the complexities of the pensions system to get an idea of how small policy changes could have a significant impact on pension provision. We also saw our role as a select committee to listen to those involved and affected, reproduce it here, and extract key sections for the report. We hope that this will provide a clear picture of the state of debate, for Members of the House, the Government, experts and, particularly importantly, the wider public.

5. We decided to launch our inquiry well before publication of the White Paper to ensure that we could publish our report within the consultation period, and announced the following terms of reference in February 2006: "to consider whether the proposals contained in the Pensions Commission's Second Report and the forthcoming Government White Paper provide the basis for enduring pension reform." The detailed terms of reference are set out in Appendix A.

6. We initially received written evidence from over 50 interested organisations and individuals. The Committee began its programme of oral evidence sessions in April and May, and held further hearings in June after the White Paper was published. The

1 Department for Work and Pensions, Cm 6841, May 2006, (referred to throughout this report as the "White Paper").

2 Department for Work and Pensions, Simplicity, security and choice: working and saving for retirement, Cm 5672, December 2002

3 Work and Pensions Committee, Third Report of Session 2002-03, The Future of UK Pensions, HC 92

transcripts of these hearings are published in a separate volume. We issued a call for further written evidence on the Government's proposals, and are grateful for the 17 further memoranda received, particularly as we had to impose a tight deadline for submissions.

7. Our sister Committee, the Treasury Committee, published a report on the *Design of the National Pension Savings Scheme and the role of financial services regulation* in May, shortly before the White Paper was published, and we have used evidence submitted to that inquiry, and the report's analysis and conclusions, during our own work.[4]

8. As part of its process of inquiry, the Committee visited Sweden in early May to discuss the significant initiatives that have happened there over the last 20 years. We were able to meet politicians, academics, civil servants and those involved in Sweden's 'Premium Pension Authority', which is similar in some ways to the Pensions Commission's proposed National Pension Savings Scheme. We are very grateful to all those who met with us and those who helped organise the visit.

9. The Committee also had an opportunity to learn the views of a wider audience through a special "select committee session" on the Radio 4 programme 'You and Yours', held on 27 June. The calls and emails received have been reflected in this report, and a summary of the views expressed is printed in the volume of written evidence. We are grateful to all those involved in the programme, and to those members of the public who called or emailed.

10. We would like to thank our three Specialist Advisers for their assistance and expertise: Carl Emmerson, from the Institute for Fiscal Studies, Ruth Hancock, Professor of non-clinical Gerontology at Essex University and Anthony Neuberger, Professor of Finance, Warwick Business School.

11. As Members of Parliament, through our constituency work and our surgeries, we recognise and understand the problems many people have faced in connection with their pension provision. We hope that the recommendations in this report, and the Government's proposals, will mark a way forward that will enable people to maintain a decent quality of life in their retirement.

The Pensions Commission analysis and proposals

12. The Pensions Commission's First and Second Reports analysed current UK pension provision in depth. We could not, and do not intend to, replicate that analysis here. The Commission did not seek to raise alarmist headlines of a "pensions crisis" but rather to set out the trends that, without change, would cause increasing problems over time. It set out four options from which "society and individuals have to choose:[5]

- pensioners will become poorer relative to the rest of society; or

4 Treasury Committee, Fifth Report of Session 2005-06, The Design of the National Pension Savings Scheme and the Role of Financial Services Regulation, HC 1074-I

5 Pensions Commission, First Report, October 2004, p 1

- taxes/National Insurance contributions devoted to pensions must rise; or
- the savings rate must rise; or
- average retirement ages must rise."

13. The Commission proposed two key elements of reform:[6]

- "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." The Commission proposed relinking the Basic State Pension to earnings ideally in "2010 or 2011 as the public expenditure benefit of the rise in women's SPA begins to flow through."[7]

14. In its Final Report in April 2006 the Commission stated that "wide-ranging debate" on its Second Report had "revealed a high degree of consensus on the direction of policy reform now required." In particular:[8]

- "There is almost universal acceptance that the combination of the present state pension system and the present voluntary system of private pension saving is not fit for purpose and will result in pension provision which is increasingly inadequate and unequal.
- There is a significant degree of consensus that the solution must and should entail some combination of higher private pension saving, higher average retirement ages, and an increased percentage of national income spent on state pensions. The fourth option considered in our Reports (pensioners' incomes falling relative to average earnings) is clearly seen as unattractive.
- And there is therefore general acceptance that future policy needs to be based both on significant reforms to the state system and on a new approach to private pension saving which goes beyond a wholly voluntary approach."

15. Witnesses to our inquiry, and the Government's White Paper, broadly agreed with the Commission's analysis, although witnesses identified some gaps and did not agree with all of its recommendations.[9] Overall, that analysis has provided the basis for a robust debate on future policy. **We applaud the Pensions Commission for its assessment of pension**

6 Pensions Commission, Second Report, November 2005, p 6

7 Pensions Commission, Second Report, November 2005, p 21

8 Pensions Commission, Final Report, April 2006

9 See, for example, Q 1 [Professor David Miles and Alison O'Connell]

provision and recommend that it be regarded as a model of how to utilise expertise in the policy process.

The Government's proposed reforms

16. When the Secretary of State appeared before us he described the reforms proposed by the Government in its White Paper as "a radical reform and the most important since Beveridge",[10] although this analogy was hotly disputed by three historians from the group 'History and Policy'.[11] The proposals followed those made by the Pensions Commission in certain respects, but with some key differences:

- The final choice of the model to be used for the proposed system of "personal accounts" (equivalent to the Commission's National Pension Savings Scheme, the NPSS), and whether there should be a single provider (as the Commission recommended) is left open for further consultation.[12]
- The objective for the reintroduction of the earnings link for the Basic State Pension is set at 2012 "subject to affordability and the fiscal position … in any event by the end of the Parliament at the latest", rather than 2010-11 as the Pensions Commission had recommended.[13]
- The White Paper does not propose introducing a residency test for future Basic State Pension accruals. Instead, it proposes reforms to the contributory system and the arrangements to credit people into the system, in order to make both the Basic State Pension (BSP) and the State Second Pension (S2P) more generous for those with interrupted work records. Neither does it adopt the recommendation that the BSP should be awarded on a universal basis for pensioners over a certain age, say 75.[14]
- The White Paper does not specifically propose separate State Pension Ages for the BSP and the S2P, an option suggested by the Pensions Commission,[15] and
- The White Paper does not propose a permanent 'Pensions Advisory Commission'. Instead, in the context of increases in the State Pension Age, the Government proposes "to periodically commission reviews drawing on a range of independent expert advice in the light of emerging evidence on demographic change."[16]

17. In a press release timed to coincide with publication of the White Paper, the Pensions Commissioners "welcomed" the Government's proposals and said that they "represented a

10 Q 248

11 Ev 424, para 23

12 White Paper, p 50

13 White Paper, para 37

14 White Paper, p 126-7

15 Pensions Commission, Second Report, November 2005, p 9

16 White Paper, para 39

major opportunity to build consensus around a new pensions settlement which could last."[17]

18. The Government has set five tests for the reforms:

- promoting personal responsibility;
- being fair;
- being simple;
- being affordable, and
- being sustainable.[18]

Taking reform forward: the importance of consensus

19. Witnesses giving evidence to the Committee were clear about the importance of reaching consensus on a settlement both within Parliament and with the public. This was also emphasised during our visit to Sweden.

20. We were told by the Secretary of State for Work and Pensions, the Rt Hon John Hutton MP:[19]

> "Fundamentally we have to get a consensus in Parliament about these reforms because otherwise it will not stick. The main architecture will collapse if there is a sense that it is going to be revisited five years, ten years, fifteen years from now. The party consensus around pensions reform is a fundamental building block to making sure that this system does last."

21. The Public and Commercial Services Union described in its written evidence the "absolute need for the country as a whole to come to an understanding and we would encourage the Government and industry to work hard to find that consensus which will be sustainable for the next few generations."[20] Teresa Perchard from Citizens Advice took the view that a start had already been made, describing the "political and cross-sectoral consensus about the shape of reform" that had been developed in the light of the Pensions Commission report as "astonishingly important."[21]

22. **No reform of the pensions system will succeed unless it is able to transform individual savings and retirement behaviour, and employer and state contributions. For this to be achieved a political and then a public consensus must be reached. A consistent political commitment will then be required to make it stick.**

17 "The Pensions Commissioners welcome White Paper", Pensions Commission press release, 25 May 2006

18 White Paper, p 15

19 Q 249

20 Ev 331, para 30

21 Q 501

The timetable for reform

Follow-up reviews and pre-legislative scrutiny

23. There is much work still to be done. As well as the consultation period on the White Paper itself, which ends on 11 September 2006, commitments for further reviews and work include:

- A rolling deregulatory review of the rules governing pensions, which will feed into the DWP simplification plan to be published "later this year"[22] and a pilot Pensions Law Rewrite Project;
- An assessment of the overall welfare impact of personal accounts;[23]
- Further work on personal accounts, including a final decision on the choice of single- or multi-provider model;[24]
- Legislation to enable the conversion of Guaranteed Minimum Pension Rights into scheme benefits[25] - "the Government intends to bring forward legislation to enable this change as soon as a suitable opportunity arises";
- A review of the organisations set up by the Pensions Act 2004, including the Pension Protection Fund and the Pensions Regulator;[26]
- A formal review of the default retirement age in 2011;[27]
- Further consideration of "the potential gains from greater tax and benefit integration in terms of improving financial incentives to work and save and providing greater simplicity for pensioners";[28] and
- A review of protected rights and contracting out. [29]

24. When the Secretary of State gave evidence to us he explained that there would be a "flagship Pensions Bill" in the 2006-07 Parliamentary Session but that there might also need to be a second Bill in the 2007-08 Session, adding that "the big question mark is about the personal accounts." [30]

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22 White Paper, p 87

23 White Paper, Volume 2, paras 1.72, 2.75 and 2.176 and p 148

24 White Paper, para 1.141

25 White Paper, para 2.33

26 White Paper, para 2.55

27 White Paper, para 4.13

28 White Paper, para 3.68

29 White Paper, Volume 2, para 3.82 and 3.86

30 Q 250

25. We asked the Secretary of State whether he would consider submitting a pensions bill (or bills) to pre-legislative scrutiny. He replied:[31]

> "We are not planning pre-legislative scrutiny of the Bill at this stage for a number of reasons, first and foremost because of the work the Turner Commission themselves have done over several years in presenting a package of reforms to us which we have then broadly carried forward. There has been a very extensive programme of work in consultation and deliberation that preceded the White Paper, and we are very anxious to get on and do the business now".

26. It will be of considerable interest to see what balance the Government strikes between setting down policy in primary legislation to lock in consensus, and what is left to Ministers to change through statutory instruments and codes of practice, particularly on personal accounts where most of the detail is not yet available. Further careful scrutiny will therefore be required, in our view.

27. **We understand the Secretary of State's argument that there may not be time for the flagship Pensions Bill to be subject to pre-legislative scrutiny. We regret that the timing would appear to preclude this. We ask for a firm commitment that any follow-up bill on personal accounts, where much of the detail has yet to be finalised, will be made available for pre-legislative scrutiny.**

A Pensions Advisory Commission?

28. The Pensions Commission proposed the establishment of a successor body, a Pensions Advisory Commission, "charged with monitoring developments and laying before Parliament every three to four years a report "describing relevant trends and spelling out the unavoidable trade offs which result." Its Final Report noted that the key issues for the Pensions Advisory Commission to consider would be:[32]

- Latest best estimates of future life expectancy and thus of the unavoidable future trade-off between increased public expenditure and increased State Pension Ages. Including analysis of:
    - Whether gaps in life expectancy by socio-economic group are closing, widening or staying constant;
    - Evidence on whether ageing is on average 'healthy' (more years of active life) or 'unhealthy' (more years of frail dependent life);
- Latest trends in private pension provision, and of participation and contribution rates within the NPSS, and thus of the overall coverage and adequacy of pension provision;
- Analysis of trends in average retirement ages, and in employment rates among older people.

31 Q 250

32 Pensions Commission, Final Report, April 2006, p 43

29. Contributors to the inquiry supporting some form of follow-on Commission included Which?,[33] the Society of Pension Consultants,[34] the TUC,[35] EEF,[36] ABI,[37] Age Concern,[38] the NASUWT,[39] Citizens Advice[40] and the National Association of Pension Funds.[41]

30. Richard Saunders of the Investment Management Association took a different view: [42]

> "In terms of a standing Commission, I would be a little bit cautious. I think one would have to define its function very carefully. One of the dangers I see in having a standing Commission is that it might be tempted to tinker."

31. Responding to this point, Stephen Haddrill of the Association of British Insurers said:

> "I would say that there are always lots of good ideas for change on pensions; having an independent body that can resist that is just as important."

32. The White Paper stated that the Government, instead of creating a new Commission, had decided to "periodically commission reviews drawing on a range of independent expert advice in the light of emerging evidence on demographic change."[43] The Secretary of State explained to us in evidence that there was an issue of timing:[44]

> "The Pensions Review Body that he [Lord Turner] wanted to set up was going to be tasked principally with overseeing that aspect of the policy agenda [State Pension Age]. It is nearly 20 years before we actually have to make those changes, and I do not want to set up a quango that does not have much of a job to do for 20 years."

33. In response, the Pensions Commissioners said "the timings of these reviews should be set in advance."[45] When this point was put to the Secretary of State he said that this was something he was prepared to consider.[46]

34. We note the point made by the Secretary of State that with regard to the State Pension Age the task is such a long term one that a standing body might not be necessary. However,

33 Ev 154, para 44

34 Ev 172, para 21

35 Ev 196, para 1.6

36 Ev 210, para 23

37 Ev 229, para 4.10

38 Ev 317, para 2.23

39 Ev 417, para 20

40 Q 501

41 Q 458

42 Q 458

43 White Paper, para 2.52

44 Q 251

45 "The Pensions Commissioners welcome White Paper", Pensions Commission press release, 25 May 2006

46 Q 357

projections of life expectancy are subject to a great deal of uncertainty, and in some circumstances can go down.[47]

35. **We ask the Government to set out what form its periodically commissioned pension reviews will take and what their remit will be. We recommend that they be held regularly, the timings set in advance, and that they result in reports which are laid before Parliament. We also recommend that by the end of the next Parliament the Government commissions an independent review to analyse how implementation is progressing, broadly along the lines of the Pensions Commission.**

36. The Pensions Commission envisaged a wider role for the new Advisory body, including the monitoring of employment rates of older people and pensions provision.[48] It linked its recommendation to the need to secure and maintain consensus over time, to which we have already referred and will return throughout this report.[49]

37. **We recommend that the Government consider alternative ways of building additional stability into its proposed pensions reforms, to allow the new system to absorb external shocks and changes in political opinion more effectively over time. These could include predefined calculations akin to the Swedish 'balancing mechanism', to allow for changes in key variables such as longevity, rather than politically-based reviews, establishing an additional duty for the proposed personal accounts scheme trustees to analyse and comment on future proposed changes to the pensions system (from the point of view of maintaining the Government's published criteria for success over time) and enshrining any variables which may prove vulnerable to future political fiddling in primary legislation.**

Undersaving and lack of consumer confidence: a poisonous combination

38. The Government's White Paper and the Pensions Commission report described the nature of the 'pensions problem' in detail. We would highlight two issues in particular: undersaving and consumer confidence.

39. The White Paper described the current situation in grave terms:[50]

> "Millions of people are not currently saving enough to meet their expectations for income once they retire. There are persistent and powerful barriers to people taking the long-term savings decisions that would be needed to address this problem. These include inertia, financial myopia, the cost of pension saving and the complexity of the decisions involved."

47 Q 229

48 Pensions Commission, Final Report, April 2006, p 43

49 Part of the Swedish Pension System has an 'automatic balancing mechanism' built into it. This is designed to enable the pension system to adjust automatically to demographic and economic change. For more information, see Sunden A, 'The Swedish Experience with Pension Reform', Oxford Review of Economic Policy, Volume 22, No. 1, Spring 2006, p 139

50 White Paper, p 31

40. The Pensions Commission's Second Report noted that between 9 million and 12 million people were not saving enough for their retirement.[51] The White Paper queried this overall figure, but commented that on the basis of its current modelling there was likely to be "a significant amount of undersaving across most income groups"[52] and concluded that there were 7 million people undersaving for retirement.[53]

41. Whether the actual figure is seven, nine or 12 million people, this level of undersaving potentially has a massive impact on people's quality of life in retirement. It contributes to high poverty levels and dependence on means-tested benefits. Addressing it is rightly a matter of priority for the Government.

42. One of the reasons for undersaving is undoubtedly low levels of confidence in, and understanding of, the current system. As Which? put in its written evidence to this inquiry, "one of the key causes of the pensions crisis in the UK is this low trust and confidence in pensions"[54] and the British Bankers' Association commented that "the anxieties surrounding pensions and other mis-selling scandals, for both customers and financial advisers, run deep."[55]

43. The series of problems and scandals have included the mis-selling of endowments and the closure of Equitable Life to new business and cuts in policy values. Falls in the stock market, changes in the tax regime and accounting treatment have increased the cost of company schemes and made them more likely to close.

44. Some final salary occupational pension schemes, in particular, wound up without sufficient funds to enable the schemes to pay pensions as expected. The Parliamentary Ombudsman published a report in March 2006 on this issue, *Trusting in the pensions promise*.[56] The Ombudsman made three findings of Government maladministration and concluded that the maladministration "was a significant contributory factor in the creation of the financial losses suffered by individuals, along with other systemic factors." She added that it caused injustice "in the forms of a sense of outrage, lost opportunities to make informed choices or to take remedial action and distress, anxiety and uncertainty."[57]

45. The Government published its response to the report in June. It stated that it did "not believe that the information issued by the Government can be regarded as having caused the losses described in the report."[58]

46. The Public Administration Committee, which leads on matters relating to the work of the Ombudsman, held a number of oral evidence sessions on the Ombudsman's report at the same time as we were conducting our inquiry. It is to publish a report shortly. We

51 Pensions Commission, First Report, October 2004, p 159

52 White Paper, Annex A, para A10

53 White Paper, Annex A, para A7

54 Ev 151, para 9

55 Ev 218, para 1.1

56 Parliamentary and Health Service Ombudsman, Sixth Report of Session 2005-06, HC 984

57 Parliamentary and Health Service Ombudsman, Sixth Report of Session 2005-06, HC 984, paras 5.245 and 5.246

58 Department for Work and Pensions, Response to Ombudsman's Report, para 57

take an interest in this issue and took evidence in June from James Purnell MP, Minister for Pensions Reform, on the Financial Assistance Scheme. We await with interest the conclusions of the Public Administration Committee.

47. This is, therefore, a challenging environment within which to launch reform of the pension system. Measures to engage the public and build trust highlighted in this report will be critical to ensuring reform achieves its objectives. **We recommend that the Government consults on what proactive measures it could take to rebuild confidence in the pensions system and savings generally.**

2 Personal Accounts

48. The Pensions Commission recommended reforms to the state pension system "to make it more understandable and less means-tested" and thereby improve the effectiveness of voluntary private pension saving. However, it did not think that this would in itself "remove barriers to adequate private pension provision."[59] It therefore recommended the introduction of a new National Pension Savings Scheme. The White Paper adopts this proposal, referring to it as a "new low-cost scheme of personal accounts."[60] The key objectives of the scheme are to:[61]

- *Overcome inertia and greatly increase participation in pension savings* by means of auto-enrolment of employees and modest compulsory matching contributions by employers;
- *Aim for a 'base load' of earnings replacement* through minimum contributions of 8% of a band of earnings.
- *Encourage the maintenance of existing high quality pension provision* by allowing employers already providing more generous provision to auto-enrol employees into those arrangements.
- *Ensure the low cost of operations* (e.g. an Annual Management Charge of 0.3% per year or less) by using a national payment collection system and providing members with the option of investment in very low cost funds bulk bought from the fund management industry.

49. As proposed by the Commission, eligible employees would be automatically enrolled into the scheme but would be able to opt out.[62] They will contribute 8% of a band of earnings of between around £5,000 and £33,000 a year. 4% will come from the employee, 3% in the form of a compulsory contribution from the employer and a further 1% from Government in the form of normal tax relief.[63] The Government intends to bring forward "proposals on the approach to administration in personal accounts later this year."[64]

Participation in the scheme

50. The Commission considered that most people at lower earnings levels - below about £8,000 - would rely primarily or entirely on state provision in retirement. For them, the state would "ensure earnings replacement rates of over 80%."[65] For median earners

59 Pensions Commission, Second Report, November 2005, p 7

60 White Paper, para 1.46

61 Pensions Commission, Second Report, November 2005, p 7

62 White Paper, para 1.46-48

63 White Paper para 1.106. 1% represents basic rate tax relief on individuals' contributions – in addition, individuals may be entitled to higher-rate tax relief and neither employers nor employees pay tax or National Insurance contributions on employer contributions.

64 White Paper, para 1.72

65 Pensions Commission, Second Report, November 2005, p 282

(around £23,000), the Commission considered it a "reasonable aim of public policy" that they achieve a replacement rate of at least 45%. 30% would be provided by the state pension (Basic State Pension and State Second Pension) and 15% from participation in the new system of personal accounts, from about age 30.[66] The Pensions Policy Institute commented that this 15% "sets a very high standard" for the scheme.[67]

51. In the White Paper, the Government accepts the Commission's analysis that a minimum contribution of 8% of the proposed band of earnings is capable of delivering, with the state pension, "a replacement rate of around 45% of earnings for a median earner with a full working life." It emphasises, however, that this should not be taken "as implying certainty about replacement rate outcomes." "Actual replacement rates can vary substantially" depending on a range of factors such as earnings, the age at which saving starts, investment returns and annuity choices.[68]

52. The White Paper does underline, however, the importance of the scheme as part of its package of pension reform proposals. A median earner who does not save would be less well off in retirement in 2053 than if current policies continued.[69] A median earner who does save, on the other hand, should be better off in retirement.

53. **The success of the new system of personal accounts will be critical to encouraging saving and delivering 'adequate' retirement incomes in the future for those on median earnings. This will need careful monitoring.**

The decision to opt out

54. The White Paper explained that "conventional economics suggests people will try to smooth their spending over their lifetime", for example, choosing to borrow when they are younger to fund education or buy a house and starting to save when they are older. It noted, however that "actual spending tends to track income more closely than these theories would suggest." An explanation is offered by behavioural economics, which identifies a number of reasons why people do not save for retirement, even when it is in their interest to do so – due to procrastination and inertia.[70] It was to address this problem that the Pensions Commission recommended automatically enrolling people into a pension savings scheme.[71] It considered 'auto-enrolment' preferable to compulsion because it left individuals free to make decisions "in the light of their preferences and circumstances."[72] They could choose to opt out if participation was not in their interests

66 Pensions Commission, Second Report, November 2005, p 18-19 – this was to be assumed through savings starting at age 30, an average rate of return before Annual Management Charges of about 3.5% (p 274).

67 Ev 399, para 69

68 White Paper, para 1.102

69 White Paper, p 197, figure E.v

70 White Paper, p 42, box 1a

71 Pensions Commission, Second Report, November 2005, p 7

72 Pensions Commission, Second Report, November 2005, p 157

because, for example, they were going to inherit significant housing assets, or if they had high interest rate debt outstanding.[73]

55. Some witnesses expressed doubt about the extent to which undersaving was due to inertia. Deborah Cooper, of the Actuarial Profession, suggested that some people would be better advised to pay off debt, or save money in a form where they can access it:[74]

> "if something unforeseeable happened - your roof caves in or whatever - if all your savings are in a pension you do have to borrow in order to get that right and over your life cycle that can make you worse off. Sure, retirement saving makes you better off in retirement, but only at a cost during your working lifetime […] The impression that comes away from not just the Pensions Commission but a lot of economic research is that people behave irrationally by not saving, but I think often we underestimate them […] I think often people are making quite rational decisions by not saving, particularly low-income families with children."

56. Alison O'Connell of the Pensions Policy Institute argued that for these people, "auto-enrolment does not help, it just makes the decision more acute".[75] They can opt out, but by doing this may risk inadequate retirement incomes (see para 50). It is difficult to know how many people this would apply to. The Secretary of State said he had not seen a breakdown of reasons "why people do not save into specifically hard and fast areas."[76]

57. An individual's decision to participate in the scheme or to opt out, therefore, has ramifications for their income in working life and in retirement. This raises the question as to whether people need advice to help them make the right decision. In evidence to the Treasury Committee, Lord Turner argued that people were already making these decisions without individual advice in the occupational pension scheme environment.[77] In the context of personal accounts, he said:[78]

> "We believe that the generic advice to people, categories of advice in the literature through citizens' advice bureaux, which says, "For the vast majority of people this savings scheme will make sense. If, however, you are a high APR credit card debtor you should consider not joining", is something which we believe people are capable of doing without individual advice."

58. Teresa Perchard of Citizens Advice, however, argued that the decision could be more complicated than this suggests:[79]

73 Pensions Commission, Final Report, April 2006, p 17

74 Q 194-5

75 Q 69

76 Q 254

77 Treasury Committee, Fifth Report of Session 2005-06, The Design of the National Pension Savings Scheme and the Role of Financial Services Regulation, HC 1074-II, Q 211

78Treasury Committee, Fifth Report of Session 2005-06, The Design of the National Pension Savings Scheme and the Role of Financial Services Regulation, HC 1074-II, Q 210

79 Q 507

"This is actually quite a complicated concept; what it is, just the rate of interest you are paying, or the amount of debt you have got relative to your income, whether it is secured or not, what other assets you have got, whether you have got some insurance against the risk of not paying those debts."

59. She argued that some people would need face-to-face advice from someone able to look at all their financial circumstances and help them make an informed decision:[80]

"It is not quite as simple as just putting out a leaflet saying, 'If you have this amount of interest that you are paying on any credit card, or loan, you should not take this out at the present time' […] It might well be, for students, if their only debts were those that had been accrued through the student loan system, that the interest payable by them on their debt was far outweighed by the benefit of being within a National Pension Savings Scheme."

60. The Resolution Foundation argued that the model proposed for the personal accounts system would still leave people with "complex and important decisions to make about their pensions".[81] It identified a range of circumstances where people would benefit from advice:[82]

- "People at the lower end of the income scale for whom means-testing would act as a disincentive;[83]
- When deciding whether to contribute more than the minimum (see para 84);[84]
- On retirement (for example, as to the type of annuity to purchase);[85]
- Self-employed people – who may need advice as to whether their business will provide security for retirement;[86]
- Those working for small employers who may prefer to reach an informal agreement, for example, accepting a cash payment in lieu of the employer contribution.[87]

61. In evidence to the Treasury Select Committee, the Financial Services Authority acknowledged "the centrality of removing the requirement for individual suitability advice, and therefore regulation of such advice" from the personal accounts scheme.[88] However,

80 Q 507

81 Ev 273, para 15

82 Ev 273

83 Ev 273, para 17

84 Ev 273, para 18

85 Ev 273, para 21

86 Ev 273, para 23

87 Ev 273, para 24

88 Treasury Committee, Fifth Report of Session 2005-06, The Design of the National Pension Savings Scheme and the Role of Financial Services Regulation, HC 1074-I, para 38

Which?, Citizens Advice and the Resolution Foundation argued that generic financial advice was needed.[89] Teresa Perchard of Citizens Advice explained the difference:[90]

> "In the debate about pensions, people talk about advice but they are talking about advice in order to make the sale, or a pension product, not advice in the round, about you, your money, your future prospects, your family, how to manage that money effectively and then keeping that under review. I think that is where we need to shift to, to look at advice in the round for individuals, which also helps people to deal with concepts and choices more effectively than they have done in the past."

62. Generic advice is information, advice and guidance that does not involve recommending a course of action in relation to a specific provider's product. It is defined by the Financial Services Authority as "Services and tools that use information about individuals' circumstances to help them to identify and understand their financial needs and to plan their finances."[91] The Treasury Committee is considering these issues in the context of its current inquiry into financial inclusion.[92]

63. We were surprised to learn from Lord Turner that he had not discussed his proposals with the Financial Services Authority,[93] in particular in the light of the history of mis-selling charges in the pensions sector. It is important to minimise the risk of mis-selling obligations against the Government encouraging saving among those who would be better advised to opt out.

64. **The target group for the new system of personal accounts includes those on low to median incomes, many of whom do not currently have access to financial advice. For some people deciding to save for a pension will involve complex decisions regarding, for example, how to deal with existing financial commitments. Generic financial advice would assist people in doing this effectively (see para 453).**

Will people be better off by saving?

65. Also linked to the decision whether or not to opt out is the issue of means-testing. The combination of the compulsory employer contribution and the projected reduction in means-testing as a result of the state pension reforms is designed to make the decision to participate straightforward for most – they could be fairly confident that they would be better off in retirement as a result.[94] This is of particular importance because it will be Government policy to auto-enrol them – and thereby give them a strong steer towards participation.

89 Ev 265, para 820; Ev 273, para 15; Q 506

90 Q 508

91 Financial Services Authority (July 2004), 'Building financial capability in the UK: the role of advice'

92 Treasury Committee, Fifth Report of Session 2005-06, The Design of the National Pension Savings Scheme and the Role of Financial Services Regulation, HC 1074-I, para 51

93 Oral Evidence taken before the Work and Pensions Committee on 14 December 2005, HC (2005-06) 815, Q 27

94 Pensions Commission, Final Report, April 2006, p 20; Q 254 [Nigel Stanley]; Q 455 [Richard Saunders]; Treasury Committee, Fifth Report of Session 2005-06, The Design of the National Pension Savings Scheme and the Role of Financial Services Regulation, HC 1074-I, para 38

66. The Secretary of State spoke of the importance of "being absolutely sure that it will be safe automatically to enrol people in it [the personal accounts scheme], so that they will always be better off inside it than remaining outside it and relying on means-tested support from the State."[95]

67. Those at risk of being no better off despite having saved are those who end up eligible for Guarantee Credit in retirement.[96] Some 6% of pensioner households are expected to be eligible for Guarantee Credit only in 2050.[97] The Government acknowledges, however, that there is an element of uncertainty in such long-term projections (see para 287). As we note in paragraph 293, it would be useful, to aid individual decision-making, for DWP to provide details of the types of individuals who might expect to be eligible for Guarantee Credit in the future, for whom generic advice will be appropriate.

Participation rates

68. The Government estimates that "a fully rolled-out personal accounts scheme would have between 6 and 10 million members at any time, with a central estimate of 8 million members out of a total working-age population of 37.1 million."[98] The Government estimates that opt-out rates will be between 20% and 50%, with a central estimate of 30%.[99] The Secretary of State made it clear that such estimates came with "something of a health warning attached to them. It is immensely difficult to be absolutely precise about prophesying future behaviour."[100] The Department assumes that opt-out rates will be higher than those in existing occupational pension schemes with auto-enrolment and an employer contribution because the "group targeted includes many who are less likely to save." [101]

69. The Department's analysis indicates that those likely to opt out include:

- people aged under 25;
- those who do 'not believe in saving', and
- those reported to be struggling with debt; and after that:
- people aged over 55;
- with children under 10, and

95 HC Deb, 8 May 2006, col 7

96 Those on Savings Credit see 40 pence of their benefit withdrawn for every pound of pension income above a threshold level but are roughly compensated for this by the fact that their employer contributes about 40% of the 8% minimum contribution. See Ev 399

97 Ev 380

98 White Paper, Volume 2, para 2.59

99 White Paper, Figure 1.xiv

100 Q 256

101 Ev 375

- the self employed. [102]

70. The Pensions Commission report considered that opt-out rates were likely to be higher for those on lower earnings (e.g. 35% for those with earnings between around £5,500 and £12,500; and 20% for those with earnings over £12,500). [103]

71. High rates of opt-out would be a cause for concern because those opting out would be at risk of inadequate incomes in retirement. On the other hand, it is possible that participation rates might be higher than DWP's estimates expect. In this case, the new system would need to be able to manage the higher than expected workload. The Secretary of State told the Committee that it was possible that there would be targets for up-take of personal accounts by different groups:[104]

> "Whether they would be a PSA type target has not been resolved. I think it is very likely that it would be necessary I think in relation to setting up NPSS or anything like it that there are some milestones or operational objectives set up for the provider delivering that service, and I imagine that would be at least governed in part by contractual processes."

72. **In response to this report, the Department should outline its strategy for maximising participation in the new system of personal accounts, explain what targets it intends to set for participation in personal accounts, identify a level of participation below which it will review the policy of auto-enrolment and consider whether people should be compelled to participate, and outline contingency plans for coping with the work-load if participation is higher than expected.**

Who is in the target group for the scheme?

73. Lord Turner described the target group as those earning around £10,000 to £30,000 a year who are increasingly not making any provision on top of the state pension: "That is the core problem that we are trying to fix."[105] The Commission's analysis suggested that those currently unlikely to be contributing to a pension included: many self-employed people; many employees in small firms; and employees in particular sectors such as the retail sector. Women have in the past accrued on average significantly less occupational pension than men and there are also significant differences by ethnic group.[106]

Employees in small and micro businesses

74. The Pensions Commission found that only around 30% of employees in firms with fewer than 50 employees participated in an employer-sponsored pension scheme.[107] The

102 Ev 375

103 Pensions Commission, Second Report, November 2005, p 287

104 Uncorrected transcript of oral evidence taken before the Work and Pensions Committee, 3 July 2006, HC (2005-06) 1389, Q 47

105 Treasury Committee, Fifth Report of Session 2005-06, The Design of the National Pension Savings Scheme and the Role of Financial Services Regulation, HC 1074-II, Q 195

106 Pensions Commission First Report, October 2004, p 62

107 Pensions Commission, First Report, October 2004, p 62

White Paper found that of nearly one million (980,000) employers in the private sector who offer no pension provision and/or make no contribution, two-thirds (650,000) have fewer than five staff and just under a third (310,000) have 5 to 49 staff.[108]

75. The success of the personal accounts scheme will be of critical importance for their employees. The Commission warned that "moderate income earners, particularly those employed by small and medium-sized employers, would be worse off" if the personal accounts scheme were not a success, "as over time they would not have any element of earnings-related pension provision.[109] It identified employees in micro-businesses as a "key group of undersavers".[110]

76. Because of the low levels of pension provision by small employers, the Pensions Commission conducted focus groups to look at how they would respond to reform proposals. Participants from micro-businesses (with fewer than five employees) were "profoundly concerned" by the prospect of an increased obligation to "provide, administer or contribute to employee's pensions."[111] The research found that reform options which imposed additional costs would "not only be highly unpopular, but also likely to have a range of negative effects on SMEs [Small and Medium Sized Enterprises]". Some participants "suggested that they would revise their growth aspirations, and some claimed that they might seek to avoid meeting new obligations – a strategy that could result in distortions to the labour market".[112] DWP research with micro-employers found that participants felt little, if any, responsibility for their staff's pensions and usually believed that their staff would prefer higher wages over pension contributions. Compulsion for micro-employers was rejected "because they did not feel that they had a responsibility in this area, and because they felt the extra costs would be too much of a burden on their business." [113]

77. In evidence to the Committee, Mike Cherry of the Federation of Small Businesses said of the compulsory employer contribution:[114]

> "This is going to be yet another burden which, quite honestly, could be the straw that breaks the camel's back. 3% does not sound an awful lot, obviously, but I can assure you, where it is a break-even line already, it could be the bit that just tips the business over."

78. A survey from the Association of Consulting Actuaries found that "firms expect opt-out rates to be quite high…with the incidence of opt-outs at this level rising to over 60% among the smallest firms."[115]

108 White Paper, Volume 2, figure 2.vi

109 Pensions Commission Final Report, April 2006, p 22

110 Pensions Commission Final Report, April 2006, p 22

111 Pensions Commission, Second Report, November 2005, Appendix F, p 151-3

112 Pensions Commission, Second Report, November 2005, Appendix F, p 151-3

113 Pensions Commission, Second Report, November 2005, Appendix F, p 154

114 Q 432

115 Association of Consulting Actuaries, Placard, Issue 23, April 2006, p 14

79. **Small employers are more likely than large ones to offer no pension provision and there is concern among this group at the prospect of being obliged to administer and contribute to employees' pensions. The Government should outline its strategy for maximising participation among employees in small businesses.**

Self-employed

80. The Pensions Commission said that a "disproportionate percentage of the self-employed appeared in danger of inadequate pension income in retirement." This reflected the fact that they cannot be members of the State Second Pension and only 38% had private pensions compared to 56% of employees.[116] The Federation of Small Businesses was concerned that many of the issues facing the self-employed had been overlooked in the current debate.[117]

81. The White Paper stated that the "self-employed make up a key segment of our target group". However, while it recognised that "participation rates for personal accounts could be affected if the self-employed are not able to join the scheme easily", after detailed consideration it concluded that there was no way of providing an automatic enrolment process for this group.[118]

82. **The White Paper does not provide the self-employed either with access to the State Second Pension or with an automatic enrolment process to the personal accounts system. This will make a strategy to maximise participation in personal accounts by this group critical.**

Those not in paid work

83. The White Paper proposes allowing those not in paid work to contribute to personal accounts.[119] It estimates that if around 5% of those who are unemployed, economically inactive or earning below the income threshold (about £5,000) chose to participate, this would give between 0.3 million and 0.9 million members.[120] The Department has not, however, adopted a suggestion made by the Equal Opportunities Commission that additional contributions should be made for groups such as carers: "The tax relief system, which costs the Government up to £21 billion each year, still gives far greater benefits to higher rate tax payers. We would like to see greater redistribution, with the Government giving greatest support to those least able to save more."[121] Lord Turner said that he did not think Government contributions on behalf of such groups should necessarily be excluded, although it should be "real, up-front money, ie, this must be a funded scheme."[122] In the

116 Pensions Commission, Second Report, November 2005, p 278

117 Ev 353

118 White Paper, para 1.94-95

119 White Paper, para 1.96

120 White Paper, volume 2, para 2.58

121 Ev 128, para 39

122 Treasury Committee, Fifth Report of Session 2005-06, The Design of the National Pension Savings Scheme and the Role of Financial Services Regulation, HC 1074-II, Q 198

absence of any Government contribution, it seems likely that participation from those not in paid work is likely to be low.

Additional contributions

84. Once an individual is participating in the scheme, the next question is how much they need to contribute to achieve an 'adequate' income in retirement. In its First Report, the Pensions Commission found that there was "no clear definition of pension adequacy". It looked at the retirement incomes people actually achieved and at survey evidence of their preferences and concluded a reasonable "benchmark" was a replacement rate[123] of 80% for the lowest earners; 67% for median earners and 50% for top earners.[124] In its Second Report it recommended that the role of the state should be to:

- Ensure through the state pension a replacement rate equal to about 30% of median earnings at the point of retirement;
- Strongly encourage and enable a further 15% through participation in the personal accounts scheme, contributing at the minimum 8% level from about age 30 (or slightly more - 18% - if they maintain continuous saving from 25)[125]; and
- Enable additional low cost saving which might deliver a further 15-18%.[126]

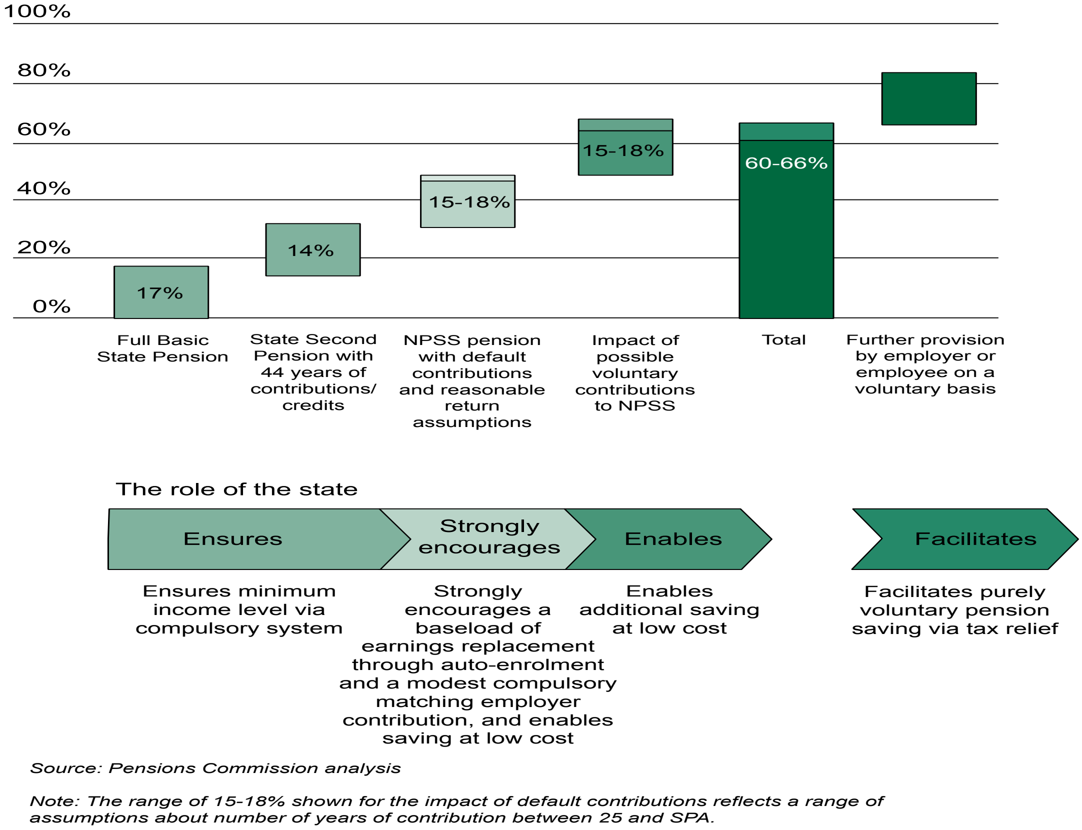
123 Income just after retirement as a percentage of income just before. Pensions Commission, First Report, October 2004, p 138

124 Pensions Commission, First Report, October 2004, p 142

125 Pensions Commission Second Report, November 2005, p 274

126 Pensions Commission, Second Report, November 2005, p 282

Figure 1: Target pension income as a percentage of earnings for the median earner: at the point of retirement



Source: Pensions Commission, Second Report, p 18

85. If a median earner wants to achieve a replacement rate of some 67%, they will need to contribute more than the minimum. Others who might be advised to make additional contributions could include moderate and higher earners and those starting to save later in life. It is unclear how additional contributions are to be encouraged, however. Norwich Union was concerned that the 8% minimum contribution would "create a false illusion that this will provide a comfortable retirement" and argued that a "large scale Government campaign needs to address this and promote the benefits of savings above this level."[127]

86. The White Paper acknowledges that "even with good quality information, all too often member contributions tend to remain at the minimum contribution level."[128] It suggests that one option is for employees "to save more by pre-committing to increase their contributions from each pay rise."[129] The Secretary of State said he was "less convinced" when asked whether the scheme should set targets for additional contributions.[130] **The Department should set targets for additional contributions above the minimum 8% and publish a strategy to deliver, and closely monitor, progress.**

127 Ev 238

128 White Paper para 1.132

129 White Paper, p 77, Box 1

130 Uncorrected transcript of Oral evidence taken before the Work and Pensions Committee on 3 July 2006, HC (2005-06) 1389, Q 49

The implications for employers

87. Auto-enrolment has not been tested at a national level where the employer has to make a compulsory contribution.[131] The way in which employers deal with the new obligations imposed on them will be critical in ensuring the personal accounts scheme is a success. Evidence to the inquiry suggested that there were concerns about the administrative burden and about the compulsory employer contribution, although employer representatives differed in their views: EEF supported the proposal for auto-enrolment and the compulsory employer contribution;[132] the CBI argued that employers should be "offered the same opt-out that employees will enjoy";[133] and the Federation of Small Businesses opposed "the principle of employers being responsible for their employees' pension savings".[134]

88. The Government has estimated that, as a result of the compulsory contribution, "on average, firms would face an increase of their labour cost of 0.6%." David Yeandle of EEF thought it was important to "put a bit of realism" into the debate:[135]

> "There has been too much talk about 3%, assuming it is 3% of all earnings; it is only 3% of a band of earnings, never more than 2½% and, in many instances, will be only 1½% of earnings. If we implement it on a phased basis, with some financial support for small employers, I do think then it is something that we can achieve without causing major problems."

89. Some firms, however, will experience a greater increase in costs than others. The White Paper acknowledged that for micro and small employers these costs will represent a higher proportion of the total labour costs (0.9% compared to 0.6% for all firms) once the accounts are fully phased in. This is because they are "more likely to have no current provision."[136] The Pensions Commission acknowledged that it seemed likely that some small businesses would be "profoundly affected."[137]

90. The White Paper explains that there are several mechanisms employers could use to manage the cost of contributions to personal accounts – in particular passing them on to employees in the form of lower wage increases. The other possibilities it listed were: passing the increase in costs on to consumers via higher prices; reducing investment; or 'levelling down' current pension contributions towards 3%. To the extent that these were not feasible, "firm profits would fall, or employment would adjust". The majority of firms are expected to use the mechanisms. [138]

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131 Q 45 [Alison O'Connell]

132 Ev 207, para 8

133 Ev 357, para 22

134 Ev 353

135 Q 433

136 White Paper, Volume 2 para 294-5

137 Pensions Commission, Second Report, November 2005, Appendix F, p 151

138 White Paper, Volume 2, para 2.100-02

91. Witnesses suggested that it was difficult to make a judgement at this stage as to what proportion of employers would adopt what mechanisms. David Yeandle of EEF explained that “a lot will depend on the state of the economic environment and the state of the labour market at the point that it comes into effect”.[139]

92. Critics of the proposals are concerned that it may amount to a tax on jobs. For example, Susan Anderson of the CBI commented that some employers could offset the costs against future pay increases, but this would not be possible for all:[140]

> “in a large firm […] with heavy unionisation, the union is going to be looking to the employer to make good the employee contribution, never mind accepting a pay reduction.”

93. The White Paper also recognised that while there was limited scope for lowering wages where employees were on the National Minimum Wage (NMW), the Low Pay Commission would take account of the cost of compulsory contributions to a pension when making recommendations about the appropriate level of NMW.[141]

Levelling down

94. Levelling down refers to the risk that employers with more generous occupational schemes will reduce their contributions to the level of the new personal accounts scheme. We heard differing evidence on whether this risk would materialise. Susan Anderson of the CBI told us:[142]

> “Employers have got only so much money they can put into pensions, so I think we have to face the fact that if you have got only a 50% take-up rate and you are contributing at 10%, you may well have to level down to 5% for all. It is as much a political decision; if it is felt that is the right thing to do then that is what employers will have to do. There is another option, of course, which is that employers might take the opportunity to move down to 3%, on the basis they have to make hay while the sun shines.”

95. Philip Davis, Professor of Finance and Economics, Brunel Business School, said “in a sense it is almost going with the grain of the way employers are cutting contributions anyway. Certainly it is desirable that they do not get levelled down, but there is a risk of that.”[143] He saw it as a problem which would primarily affect Defined Contribution schemes.[144]

139 Q 433

140 Q 432

141 White Paper, para 1.128

142 Q 430

143 Q 73

144 Q 73

96. On the other hand, the Chartered Institute of Personnel Directors, on the basis of research conducted with HR professionals, concluded:[145]

> "the introduction of a National Pension Savings Scheme (NPSS) would neither lead to a levelling down nor a cancellation of existing pensions arrangements. More than four fifths of employers, with a few still undecided, say that they would continue with their existing arrangements if Lord Turner's proposals were implemented. Meanwhile only 1% say that they would level down."

97. The Pensions Commission acknowledged and confronted the levelling down risk, noting that an increasing number of companies believed they gained "limited labour market advantage from paying people via pensions rather than cash wages."[146] In its Final Report, it warned that "if the risk of levelling down to the NPSS minimum is severe, there must be a significant danger that employer pension provision will in any case decline […] Indeed in the absence of an NPSS minimum this levelling down could be to a floor of 0% rather than 3%."[147]

98. In evidence to the Treasury Committee, Lord Turner said that "We have 56% of the private sector workforce who are in no non-state pension scheme whatsoever. So is the social priority to bring that 56% up to a minimum or to guard against a levelling down among the 44% who do already get something? I think actually the social priority is to get people up to a minimum."[148]

99. The Secretary of State acknowledged that "Rational economic theory would suggest there will have to be some levelling down" but stressed that "The evidence we have seen suggests that levelling down is likely to be small." [149] He continued:[150]

> "that this was one of the principal concerns that Ministers had studying the Second Report of the Turner Commission preparing ourselves for the White Paper. We did look very, very carefully at the impact of this and the evidence, such as it is, suggests that it is small. This is something we have to watch very carefully in the future."

100. **We agree that the Government will need to monitor closely the impact of the new personal accounts scheme on existing occupational provision and guard against levelling down. This will need to be a key aspect of consideration in the regular reviews of the system and the further independent study that we have recommended (see para 35) should be instigated before the end of the next Parliament.**

145 Ev 337

146 Pensions Commission, Second Report, November 2005, p 54

147 Pensions Commission, Final Report, April 2006, p 38

148 Treasury Committee, Fifth Report of Session 2005-06, The Design of the National Pension Savings Scheme and the Role of Financial Services Regulation, HC 1074-II, Q 222

149 Q 261

150 Q 261

Transitional support

101. The Pensions Commission Final Report stated that even if some of the extra costs were absorbed over time by adjustments in cash wages, there was "at least a transitional burden". It opposed an exemption for small employers but argued that the Government should "consider ways in which the costs for small employers could be mitigated, for instance via subsidies which are fixed as an amount per employer."[151]

102. The White Paper explained that to support employers with the new obligations, contributions, both for employers and employees would be phased in over a three year period, at the rate of 1% per year. In designing the scheme and the transition phase, the priority would be to minimise the burden on employers. The Government continues to consult on transitional support for the smallest businesses and whether a longer phasing period is needed. Furthermore, to allay concerns that the amount of the employer contribution might be ratcheted up over time, the rate is to be placed in primary legislation. [152]

103. Those measures announced so far received support from both employer and employee representatives.[153] As regards the phasing in of the compulsory contribution, for example, Kay Carberry of the TUC said:[154]

> "I do not think that it would be possible to prepare people to the degree that we would not need any phasing in. I think that people, certainly who are beginning from a standing start, would find it difficult, and that goes both for some employers and a lot of employees."

104. Employer representatives had argued strongly that the amount of the employer contribution should be placed in primary legislation. While the TUC had been opposed to setting the amount in primary legislation, the need to achieve consensus had "concentrated.. minds."[155]

105. Discussions between Government and employer representatives about additional transitional support were ongoing. EEF had come up with a suggestion which it thought needed to be discussed with small businesses.[156]

Monitoring and compliance

106. The system of personal accounts proposed in the White Paper would give employees new rights regarding auto-enrolment and access to an employer contribution. The Pensions Commission said on the basis of its focus group work that it seemed likely that " a general level of hostility would persist; some businesses would be profoundly affected; and

151 Pensions Commission, Final Report, April 2006, p 22

152 White Paper, paras 1.129 and 1.130

153 Q 374- 9; Ev 207, para 7

154 Q 374

155 Q 379 [Kay Carberry]

156 Q 434 [David Yeandle]

some businesses at least, would seek to resist any new obligations."[157] The White Paper acknowledged that there would need to be "an effective compliance regime which remains light-touch, risk-based and proportionate." This would include a "range of enforcement powers" for "the minority of cases where non-compliant employers do not respond to initial light-touch approaches."[158]

107. Citizens Advice said that "the introduction of auto-enrolment would need to be carefully monitored to ensure that people are making rational decisions, that they understand the consequences of doing so and are not put under any pressure to opt out by employers."[159] Nigel Stanley of the TUC said that "a clear signal" needed to be sent out to employers that encouraging employees to opt out was "unacceptable behaviour":[160]

> "The comparison which is sometimes made is with the Working Time regulations, in which employees can opt out of that. Frankly, the Working Time regulations probably are the least understood, the least enforced, the most ineffective bit of labour market regulation we have in the UK, and this has to be the exact opposite, it has to be very, very clear. The Minimum Wage is enforced properly, the Inland Revenue are very tough with people who breach it; it does get breached, but clearly it is not acceptable, it is not something that if found out it is cracked down on."

108. Mr Stanley argued that there needed to be ways that employees could "shop employers", investigations of unusual patterns of opting out in workplaces and effective penalties.

109. **The Committee welcomes the measures announced in the White Paper to support employers with the new requirements imposed on them by the personal accounts scheme. The Committee is concerned that employers should not encourage employees to opt out and recommends that the Government outline its proposed arrangements for monitoring and enforcing compliance with these requirements, the mechanisms for reporting breaches with compliance and the proposed penalty regime.**

How auto-enrolment will work

110. The White Paper explained that once the personal accounts scheme is up and running auto-enrolment will apply at age 22; on changing employer; when an individual's earnings reach the lower earnings threshold; and for those who initially chose to opt out but continue to work for the same employer, every three years.[161] Details of exactly how this will operate are still being worked out.[162] The Committee considered that important questions included: when people are asked to decide whether to opt out; when they are

157 Pensions Commission, Second Report, November 2005, Appendix F, p 151

158 White Paper, para 1.58-61

159 Ev 263, para 7.7

160 Q 380

161 White Paper, para 1.89-90

162 White Paper, para 1.141

given a choice of funds (and how many choices they are given); and whether they are asked to choose providers (see para 123).

111. Employer representatives argued that "there should be a six-month deferment, which would take out the short-term and seasonal workers and also save the small businesses some considerable administrative and burdensome work to be done on that."[163] Doug Taylor of Which? said:[164]

> "I think the danger of creating a long period from starting employment to actually being in the system is that will exclude people who are on a series of short-term contracts, it will have problems for seasonal workers, and so on and so forth. I think the answer is, people should be able to get into the system as quickly as practical, but the actual period that amounts to will not be clear to designate until the system's structure is actually in place. As a principle, I think getting into there as quickly as possible should be our objective."

112. The Pensions Commission suggested that employees might (as in New Zealand) be required to inform the NPSS in their first four weeks if they did not wish to join. Payments would then commence only at the end of the second month.[165]

113. A further question is whether people are asked to decide on which fund they want to invest in at the same time. David Yeandle of EEF outlined what he explained were initial thoughts:[166]

> "We think the choices that individuals have, at the very point when they make that decision whether to auto-enrol or not, should be kept to a minimum. For example, […] at the point of making a decision whether or not to auto-enrol, that is the only decision they have to make. Once they have decided that, we would suggest that the money is put into a holding fund, and then, maybe two or three months later, the organisation that is running a pension scheme would approach the individuals, without the involvement of their employer whatsoever, and give them the option of whether they want to invest that money actively or whether they want to have that invested into a default fund."

114. Further down the line they could be asked whether they wish to choose to invest in a particular type of fund (the Commission envisages between 6-10 choices, with different risk and return combinations),[167] or to invest in the default fund. In the Swedish Premium Pension Scheme (PPM), 90.6% of all individuals now invest in the default fund.[168] This appears to be in part due to the very large number of choices in the PPM (over 700).[169]

163 Q 422 [Mike Cherry]

164 Q 253

165 Pensions Commission, Second Report, November 2005, p 369

166 Q 419

167 Pensions Commission Second Report, p 373-6

168 Pensions Commission, Second Report, p 200

169 Q 72 [Nicholas Barr]; Pensions Commission Second Report, p 373

Nonetheless, an effectively managed default fund, for those who do not wish to exercise this choice, will be essential.

115. Separating the two decisions in this way could also help to allay concerns among employers that they might be asked to be involved with the choice of funds. David Yeandle said that EEF members “feel very, very strongly that the provision of advice is not something that they should be involved in, either directly or indirectly.”[170]

116. It seems likely that administering the scheme will be particularly complicated for some employers, for example, those using a manual payroll, employing people on short-term contracts or people with a number of low-paid jobs. Mike Cherry of the Federation of Small Businesses said that “there were some very considerable administrative and practical problems which could arise”:[171]

> “Where you have got a manual payroll and somebody is actually having to work it out then you have got issues surrounding that. You have also got problems, of course, where you have got an employee who may be working for two or three employers; it is then a question of, if one is a fairly low payer, or earnings, who actually pays the pension contribution and at what stage that pension contribution is paid.”

117. **Participating in the new personal accounts scheme should be as simple as possible. We believe that employees should be opted-in within three months of beginning employment. Care will need to be taken to ensure that arrangements for auto-enrolment are workable for firms with employees on ‘non-standard’ work patterns, for example, temporary contracts or more than one job.**

Charges

118. A key objective for the system of personal accounts is to ensure the low cost of operations. The Pensions Commission recommended that the scheme should aim for an Annual Management Charge of 0.3% per year or less.[172] The Committee’s visit to Sweden confirmed the importance of keeping charges low. Figures provided by the Premium Pension Authority showed that compared to having no charges at all, an annual management charge of 0.25% led to an 8% reduction in the value of a pension; a charge of 0.5% to a reduction of 15% and a charge of 1% to a reduction of 28%.[173] Charges in the PPM amounted to 0.6% of managed assets in 2005.[174] The PPM is aiming for charges of 0.33% or lower once mature.[175]

170 Q 42

171 Q 414 [Mr Cherry]

172 Pensions Commission, Second Report, November 2005, p 8

173 Presentation to Committee by the PPM on 9 May 2006

174 Review of the Swedish PPM http://www.regeringen.se/content/1/c6/05/19/48/72712aef.pdf

175 Pensions Commission Second Report, Appendix F, p 238

119. The Government agrees that it is “critical that charges for personal accounts are maintained at as low a level as possible. Under a 1.5% management charge, an individual saving for 40 years will lose around 20% of their pension compared with a charge of 0.5%.”[176] In the White Paper it stated that in the long term, it was confident that it could achieve low charges, although in the short-term “charges will need to reflect the choice of delivery mechanism, funds under management, contract specification and financing arrangements.” [177]

120. The Pensions Commission had noted that “Large occupational schemes face these complexities and those with over 5,000 members often operate with total costs at or below 0.3% [...] Very large occupational scheme costs therefore represent a reasonable benchmark for NPSS.”[178] However, the Association of British Insurers argued that the primary determinant of costs would be the “level of take-up, and with the Government predicting a range of between 50% and 80% take-up, a wide degree of uncertainty remains.”[179]

121. The Government has said it will consider other funding structures for personal accounts.[180] Intelligent Money says people are put off saving because they do not understand the charging system and has therefore recommended a fixed administration fee, rather than one based on fund size.[181] Asked about this, Richard Saunders of the Investment Management Association said it was “essentially a contractual issue to be settled at the time when the administrators are being hired and the competition is being run. [182] Stephen Haddrill of the Association of British Insurers said:

> “It is worth looking at, but I think it is quite a difficult proposition, because the annual management charge approach basically subsidises the poor, or the lower contributor. If we are talking about very low levels of contribution, I think that cross-subsidy is probably going to be necessary, and particularly in the early years. I think people could find the flat fee was actually going to come out at really quite a high level, so I am not sure it is going to work, particularly at the beginning.”

122. **The Committee agrees with the Pensions Commission that the focus should be on keeping Annual Management Charges as low as possible in order to increase retirement incomes. The Committee notes that if charges cannot be driven towards or below 0.3% over time it would substantially erode the value of people’s pensions. We believe that the option of fixed administrative fees should be considered but note that the impact of such a charging structure on those saving small amounts would have to be considered as part of that review.**

176 White Paper, para 1.78

177 White Paper, para 1.79

178 Pensions Commission, Second Report, November 2005, p 396

179 Ev 231, para 3.10

180 White Paper, para 1.78

181 Ev 413

182 Q 470

Competition for contracts, or through branded providers?

123. The White Paper proposes two alternative delivery models for the provision of a system of personal accounts:

- The Pensions Commission approach, in which there is competition for contracts. There is one provider organisation, with the day-to-day running of the scheme outsourced to a number of pension administrators and investment managers.

- An alternative approach in which there is competition for branded providers. This would "build on existing pension provision". The White Paper noted that "a model in which individuals have a choice of provider is likely to be more expensive to administer [...] However, the advantage of this approach is that it would rely to a greater extent on the existing infrastructure, and could therefore have advantages when coming to implementation."[183]

124. The Department's "initial analysis suggests that the best delivery model is that proposed by the Pensions Commission."[184] It will judge the options against eleven criteria which include: the level of charges; value for money for the taxpayer; the appropriate type of consumer choice; simplicity for employers and individuals; the promotion of personal responsibility; and maximising effective competition.[185]

125. Of these criteria, two seemed particularly important to the Committee – charges and simplicity for employers and individuals. The Pensions Commissioners continue to argue that "a single national scheme, rather than a multi-provider model, will deliver the lowest cost and thus the highest possible pensions to savers."[186]

126. As regards simplicity for employees and individuals, evidence to the Committee suggested that, again, this was another advantage of the single-provider model. Doug Taylor of Which? argued that it was important that the scheme was "clearly understood, with a brand that is clearly identified". He suggested that having a "universal" system would be important in helping to engage people moving from one employer to another and in particular seasonal workers and people on short-term contracts.[187] David Yeandle of EEF argued that the single-provider model would also work better for employers in that it would minimise administrative burdens, result in lower costs and "minimise the choices that employers would have to make."[188] On the other hand, the Association of British Insurers stressed that a limited range of choices could be provided, giving "employers the opportunity – but, importantly, not the duty – to pick a default provider for their

183 White Paper, p 52

184 White Paper, para 1.71

185 White Paper, para 1.71

186 "The Pensions Commissioners welcome White Paper", Pensions Commission press release, 25 May 2006

187 Q 520

188 Q 491

workforce, increasing employers' engagement in the system and sense of control over the process."[189]

127. **The Government has set out a list of eleven criteria against which it intends to assess the two proposed alternative delivery models. We believe that two of these are particularly important: achieving a lower level of charges and simplicity for employers and individuals. For this reason, the Committee accepts the Government's initial view that this can be achieved through the delivery model proposed by the Pensions Commission. However, we await with interest the outcome of further work to establish whether similar objectives could be achieved through a limited multi-provider model.**

Investment risk

128. A number of organisations suggested the policy of auto-enrolling employees into a Defined Contribution scheme, where the investment risk is borne by the individual, could be problematic if people did not understand the risks they were taking and the inevitable 'risk/return trade-off.' Doug Taylor said that research by Which? showed that people prefer a low-risk, low return product to a higher-risk , higher return product and that the features of pensions people valued most are "the levels of guarantee and certainty that may exist."[190]

129. Richard Saunders of the Investment Management Association argued that it would be "irresponsible not to put people into high risk assets when they do not have to get at those assets for decades." He argued that risk can be managed through a 'lifestyle-smoothing' approach,[191] which involves relatively high exposure to higher risk investment at early ages, and a gradual shift to very low risk investment as people approach retirement. This is the Commission's recommended approach for the 'default' fund for the personal accounts scheme.[192]

130. However, as Richard Saunders acknowledged, even if risk can be managed, it "can never be taken out."[193] A number of witnesses raised the question of how individuals might react if they were disappointed with the returns received. The Pension Reform Group, for example, was sceptical that future Governments would be able to avoid the risk of being accused of "mis-directing savings into schemes which perform differently for members of each scheme over time, depending when in the equity/bond cycle members draw out their savings".[194] Referring to the recent report of the Parliamentary and Health Service Ombudsman, the Rt Hon Frank Field MP said that:[195]

> "Now if we can have a huge fuss over a form which almost nobody has seen, which is the Government form telling us to save in occupational schemes, what are the

189 Ev 229

190 Q 510

191 Q 473

192 Pensions Commission, Second Report, November 2005, p 200

193 Q 473 [Richard Saunders]

194 Ev 142, para 3

195 Q 150

> charges going to be of a scheme that is set up by the Government and which, to some extent, the Government is regulating, given that Lord Turner says there will be three funds in this scheme and, therefore, at any one time the funds are bound to be performing differently? So the charges that 'I was misinformed' are going to be great, but they are going to say: 'Well, there wasn't any money there for giving you advice.'"

131. In oral evidence, the Secretary of State said:[196]

> "There is a risk associated with all forms of investment and we have made that absolutely explicit in the White Paper. There is no question of any Government underwriting the value of people's savings in personal accounts. That simply is not possible. There needs to be the appropriate regulatory arrangements in place, and there will be. There needs to be safeguards, and there will be. There will be legislation dealing with all of these matters in terms of governance, but in terms of the investment risk itself that is clearly there. It just needs to be identified and people need to be clear about it."

132. Ensuring people are informed about risk, while at the same time encouraging them to save will be a difficult balancing act. Lord Turner told the Public Administration Committee that: [197]

> "There is always a risk; nothing is absolutely cast iron. That point is not very often made and it should be. However, there is obviously a need to encourage and get more people to save for their pensions, and so this is a difficult area to get right."

133. The Parliamentary Ombudsman, in her recent report, *Trusting in the Pensions Promise* argued that to empower people in the choices they have to make, it is important that they "should be as clear as possible about what citizens can expect from others and what their own responsibilities are." She concluded that "ensuring that the information provided to the public is accurate and complete while being accessible remains a challenge for DWP."[198]

134. **The Government has a responsibility for the running of the macro-economy and the regulatory framework for pensions. It does not have a responsibility for investment risk in the new system of personal accounts, but Government and regulators will have an obligation to communicate the risks and benefits clearly while still encouraging participation in the scheme. In response to this report, the Government should set out how it proposes to do this. We agree with the Pensions Commission that the default fund should be a 'lifestyle-smoothing' fund with a relatively high equity weight at early ages, and a gradual shift to bonds as people approach retirement.**

196 Q 269

197 Uncorrected transcript of oral evidence taken before the Public Administration Committee on 22 June 2006, HC (2005-06) 756-iv, Q 360

198 Parliamentary and Health Service Ombudsman, Sixth Report of Session 2005-06, Trusting in the Pensions Promise, HC 984, para 8.7-20

Governance arrangements

135. Organisations such as IMA and Which? argued that appropriate governance arrangements needed to be put in place to reduce risk. The IMA identified the need for "independent governance" as a gap in the Pensions Commission's proposal. It argued that the personal accounts scheme needed "to be set up in a way which operates in the interests of members and minimises political risk. This requires that:

- The scheme should be independent of Government and accountable to Parliament, with functions akin to those of a board of trustees in an occupational Defined Contribution scheme.
- The scheme would have an overriding duty of care to its members."

136. Which? also argued that the scheme should be managed by an "independent board consisting of consumer, employee and employer representatives with an explicit legal duty to look after the interests of scheme members and be legally accountable to the public." It argued that, in contrast, "the retail pensions model has weak systems of governance and major conflicts of interest. Under UK company law, directors of firms have a primary legal duty to shareholders balanced with what we think is a fairly weak regulatory duty to 'treat customers fairly.'"

137. **The Committee agrees with Which? and the IMA that governance arrangements – ensuring the scheme is overseen by trustees which are independent of Government and have an overriding duty of care to protect the interests of savers – will be critical to the scheme's success. Independence will also be vital to ensure that corporate governance standards are not compromised. Political interference in investment strategy and on how the voting rights of the personal accounts scheme investments are exercised would be unacceptable.**

Setting up the new scheme

138. The Pensions Commission noted that the establishment of the new scheme would involve "significant operational set-up risks." In oral evidence, the Secretary of State said:[199]

> "There are the obvious operational risks associated with setting up and managing a new scheme like this that could have 6, 7 or 8 million people paying into it on a regular basis. It is a major operational undertaking and comes clearly with a risk of operational failure which we have to deal with. There is IT. Let us get that out on the table now."

139. The White Paper includes details of the features and functions that would need to be centralised for delivering a personal accounts scheme. There is to be a "simple, low-cost payment collection system" and further centralised functions are to include the allocation of a default provider or fund and ensuring contributions are made to a single account, and

199 Q 269

providing information from a central point.[200] It argues that "Government involvement in delivery should be minimised".[201] The Treasury Committee concluded that there was "a possibility of effective public sector purchase of relevant administrative services from the private sector, provided that the purchasers on behalf of the NPSS or any similar national scheme have the relevant skills, whether acquired in the public or private sectors. It is important that overall administrative costs are minimised and that an appropriate balance of risk between public and private sector is achieved."[202]

140. Christine Farnish of the National Association of Pension Funds argued that setting up a new clearing house to deal with the new accounts was a "big, new challenge, I think, for the Government to make sure that is set up properly. I cannot see who else is going to set it up." [203]

141. Richard Saunders of the Investment Management Association commented ideally one would want to "piggy-back on PAYE and National Insurance, because essentially they are in the business of collecting and verifying contributions from employers." However, he understood from HMRC that there were "significant technical issues in using the existing PAYE system for this purpose."[204] He added that the industry was in a good position to gear up for delivering other core activities – account administration and investment - that would be required for the new scheme:[205]

> "Within the UK mutual fund industry currently there are 18 million accounts and there are a number of very large providers of administration services to mutual fund companies. The largest has, I believe, already more than five million accounts. The functionality of the systems that these people use is very close to that which will be required by the NPSS, so that, in that situation, it would be logical for the board of the NPSS to run a competition to find a provider of administration services. I can think of at least half a dozen firms which might be interested in competing for that business; in fact, I know of three who are examining it actively, even today"

Stephen Haddrill of the ABI was more cautious on the basis that the proposals covered a different target group from that served by industry at present:[206]

> "Firstly, this new system is designed to reach people on relatively low incomes, it is designed to reach people who may well be quite financially illiterate… Also it needs to reach employers down to the corner shop level. It is a much harder task, I think, than reaching the current market, and there will be new problems that emerge.. we need people with a great deal of expertise and that expertise will need to be built up over time."

200 White Paper, p 48-49

201 White Paper, para 1.50

202 Treasury Committee, Fifth Report of Session 2005-06, The Design of the National Pension Savings Scheme and the Role of Financial Services Regulation, HC 1074-I, para 68

203 Q 466

204 Q 466

205 Implementing a National Pension Savings Scheme, Paper by IMA, February 2006; Q 461

206 Q 466

142. The Government argued that one of the potential advantages of the multi-provider model is that it "would rely to a greater extent on the existing infrastructure and could therefore have advantages when coming to implementation."[207] However, Which? argued that "the critical point is that the necessary time should be taken to implement the reforms properly." [208]

143. **The Government and Pensions Commission have rightly recognised that establishing the infrastructure for the new system of personal accounts will be a challenge. We strongly recommend that Government involvement in the development of any necessary IT system is based on a clear understanding of lessons learned from previous government IT systems failures.**

Conclusion

144. One of the questions in the remit for our inquiry was whether the new system of personal accounts was the right way forward. Witnesses identified a number of risks with the proposals – the risk of establishing a large new operational infrastructure, for example, and the risk that the Government will be subject to claims of mis-selling in the future. The Committee agrees that these are genuine concerns that the Government will have to guard against as the proposals are implemented.

145. We recognise, however, that the White Paper reforms are a package and that the success of the personal accounts scheme will be critical if people on median incomes, in particular, are to have adequate retirement incomes in the future. In evidence to the Committee on 7 June, the Secretary of State said: [209]

> "The question for us is how much more and how many more people we can get to save. This is going to be the acid test for these reforms, and I accept that. The whole balance between what we were doing on personal accounts and then the complementary reforms for the State Pension are designed fundamentally to generate more savings, to provide people with the peace of mind to know that it is worth their while to save. That is what we have to do."

146. The key target group - people on around £10,000 to £30,000 who are not saving for a pension – include the self-employed and those in small businesses. Maximising their participation will be a significant challenge: there is to be no automatic enrolment process for the self-employed and small businesses have expressed profound concerns about the new obligations the scheme will impose on them.

147. We believe that the provision of generic advice will be important in maximising participation – ensuring that people are able to make informed decisions as to whether to prioritise more immediate financial commitments, for example, and ensuring that where people opt out, they understand the implications of doing so. It will also be important in

207 White Paper, para 1.69

208 Ev 156, 67-68

209 Q271

helping people make decisions about whether to contribute more than the minimum. The way in which auto-enrolment operates and the choices people are given will be critical to the scheme's success.

148. As the Pensions Commission said, the success of the personal accounts scheme "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."[210]

210 Pensions Commission, Second Report, November 2005, p 9

3 Existing occupational and private pensions

The future of Defined Benefit schemes

149. When our predecessor Committee completed its inquiry into the future of UK pensions in 2003 it reported that most witnesses were clear that "a transition was occurring" from occupational Defined Benefit (DB) to Defined Contribution (DC) Schemes.[211] DB schemes are pension schemes where the pension is related to the members' salary or some other value fixed in advance; DC schemes are schemes where the individual receives a pension based on the contributions made and the investment return that they have produced.[212]

150. This trend has continued. The Pensions Commission considered that it was "difficult to see private sector DB provision, certainly in final salary form, playing more than a minimal role in the future UK pension system."[213] It considered that a number of factors had led to the decline of such schemes, including increased life expectancy estimates, more realistic equity return expectations, lower real bond returns, and tighter accounting standards.[214]

151. When giving evidence to the Committee, Kay Carberry, from the TUC, expressed concern about this trend, suggesting that when DB schemes closed and were replaced by DC schemes "in most instances the employer contribution goes down"[215]. However, even if the contribution were maintained, she pointed out that DB schemes provided more certainty in retirement, as in DC schemes "the risk falls onto the shoulders of the employee."[216]

152. On the other hand, it is argued that DC schemes are capable of producing high returns[217] and also that it is possible to 'manage' investment risk through a 'lifestyle-smoothing' approach.[218] The problem is that the shift to a Defined Contribution scheme is often accompanied by a reduction in the employer contribution.[219]

211 Work and Pensions Committee, Third Report of Session 2002-03, The Future of UK Pensions, HC 92, para 69

212 Pensions Commission, Second Report, November 2005

213 Pensions Commission, Second Report, November 2005, p 48

214 Pensions Commission, First Report, October 2004, p 92-3

215 Q 386

216 Q 387

217 Q 473 [Mr Saunders]

218 Q 474 [Mr Saunders]; Q371 [Mr Stanley]

219 Ev 192; Q 69

Contracting out

153. Contracting out is the system by which individuals can choose to forego all or part of their State Second Pension entitlement, and in return pay lower rate National Insurance contributions, and/or receive payments into their pension scheme. These reductions and payments are known as the contracted-out rebate.[220]

154. The White Paper explains that contracting out provides "a private sector alternative to the State Second Pension, but in doing so adds significant complexity to the pensions system."[221]

155. The Pensions Commission recommended "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."[222]

156. The Government broadly followed the Pensions Commission's recommendations in this area.[223] Contracting out is to be abolished for DC schemes "at the same time as the basic State Pension is uprated in line with earnings."[224] However, it considered: [225]

> "For DB schemes, unless changes are made to scheme benefits or to contribution levels, the reduction in the rebate would gradually increase employer's payroll costs and reduce employees' take-home pay. For a number of reasons, the decision to contract out is not so easily reversed in DB as in DC schemes. This is mainly because of the long-term nature of decisions made on contribution and benefit structures as well as funding levels. These considerations mean that a longer lead-in time is required to introduce any changes to contracting out for DB schemes. Also, as the Pensions Commission recognised, a sudden and significant change affecting DB provision is more likely to prompt scheme closure than to spur additional savings."

157. It did not intend at this stage to "bring forward additional proposals to abolish DB contracting out in the longer term". Instead, the long-term future of contracting out for DB schemes would be "subject to ongoing review."[226]

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220 White Paper, Volume 2, para 3.7

221 White Paper, Volume 2, para 3.7

222 Pensions Commission, Second Report, November 2005, p 26-7

223 White Paper, para 2.16

224 White Paper, para 2.21

225 White Paper, Volume 2, para 3.21

Contracting out and the future of DB schemes

158. Both the written and oral evidence submitted to the Committee suggested widespread support for the abolition of contracting out for Defined Contribution schemes, with some arguing that the Government could have gone further and also removed it for Defined Benefit schemes.

159. The Pensions Policy Institute (PPI) commented that, as "acknowledged by the Pensions Commission, there is no evidence for how the removal of contracting-out would impact on DB provision."[227] The CBI said that "members believe abolishing contracting-out would lead to a serious shortfall in funding at a time when Defined Benefit schemes are already under significant pressure. Funding for most Defined Benefit schemes takes account of the fact that money received from the contracting-out rebate provides a significant proportion of the funds needed to pay promised benefits (15% of contributions to Defined Benefit schemes come through the NI rebate)."[228] On the other hand Christine Farnish, from the National Association of Pension Funds described contracting out as "a source of cost and complexity for people who run pension schemes, particularly occupational pension schemes." She continued:[229]

> "One of the things we are disappointed in in the White Paper, is that the Government have not picked up the Pension Commission's recommendation that DB contracting out should cease by a certain point in time. I think Adair Turner recommended 2030, but we cannot see any point in future where the Government is committing actually to wind down and eliminate contracting out altogether, which we feel would be a very good place to be."

160. However, she made the point that in order for the abolition of the DB rebate to be effective schemes would need to be able to adjust the level of benefits so it was cost-neutral to them: "That would actually help to de-risk what is left of DB schemes in this country and make them more sustainable, and not less sustainable, in future, but also make the whole deal much simpler."[230]

161. Stephen Haddrill, from the Association of British Insurers took the view that "it is a bit odd to do one thing for DB and the other thing for DC."[231] Deborah Cooper, from the Actuarial Profession, told that Committee that the Profession "would have no objection to contracting out being phased over a shorter period of time."[232]

162. The Secretary of State emphasised when he gave evidence to us that he agreed with the conclusion the Pensions Commission had reached:[233]

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226 White Paper, para 2.23

227 Pension Policy Institute (2006), Transition Trade-Offs: Options for State Pension Reform, p 43-4

228 Ev 356, para 16

229 Q 476

230 Q 478

231 Q 477

232 Q 172

233 Q 299

> "I think it would be too destabilising for DB to take away the rebate at this moment in time, and that is why Turner did not recommend it and why we have agreed with him."

163. He continued that the Pensions Commission "did not recommend we did anything before 2030 on this, and I think that is where we are."[234]

164. Christine Farnish, while maintaining the NAPF's support for abolition of the DB rebate in order to fund a Citizens' Pension, told the Committee "Our preferred position would still be that; although, in the interests of building a consensus, we are not lobbying strongly on that point at the moment."[235]

165. **We recommend that the Government should set a date when the future of contracting out for DB schemes is to be reviewed. This could form part of the further independent review we recommend should be commissioned by the end of the next Parliament.**

A rolling deregulatory review

166. The White Paper proposed a "rolling deregulatory review of pensions regulation, which will feed into DWP's simplification plan, to be published later this year" possibly including a re-examination of matters such as mandatory indexation of pensions in payment, member-nominated trustees, administrative and internal control requirements, restrictions on changes to accrued rights, payments to employers where surplus funds exist, deemed buy-back and internal dispute resolution.[236]

167. It noted that "Reforms in some of these areas (for example, further reform of the requirement to apply price indexation to pensions in payment) could have the scope to make a significant difference to the costs of running an occupational pension scheme."[237]

168. We agree that in the current climate of DB decline such a review is prudent, but some aspects of reform could be particularly sensitive and must be dealt in a way which is fair to those involved. Giving oral evidence to the Committee, Christine Farnish from the NAPF agreed with the Government's list, commenting:[238]

> "The sorts of things that we have suggested could be looked at are exactly the same things that are in Chapter 2 of the Government's White Paper … We are not talking about robbing people and taking away their benefits, we are talking about trying to get back to a saner regime for the future, because I fear, if we do not, these things are going to become of historic interest only."

234 Q 300

235 Q 478

236 White Paper, para 2.42

237 White Paper, para 2.43

238 Q 479

169. She added:[239]

> "I think there is a big issue as to whether we want a world in future where the majority of people might be able to benefit from a good pension scheme provided by their company, or whether just a tiny minority might get a wonderful pension benefit but everybody else gets nothing more than 8%."

170. The Occupational Pensioners' Alliance was concerned about the possible implication of further reform of the requirement to apply price indexation to pensions in payment for existing occupational pensioners. It said that a "further reform" that diminished the value of retirees' pensions in payment generally would not be merely an adjustment to what has gone before. "It would be a U-turn, a break with principle and justice."[240]

171. Asked about the scope for reducing the pressures on Defined Benefit schemes, David Norgrove, the Pensions Regulator, told the Committee:[241]

> "That would be a matter for Government to decide. To do it retrospectively is always extremely difficult, both in principle and socially. Whether prospectively that would be a sensible thing to do is a matter for the Government; but clearly, yes, one of the factors here has been the way in which, for what seemed sensible reasons at the time, the safety valves around DB schemes have been shut."

172. James Purnell MP, Minister for Pensions Reform, gave the Committee additional details of the review on 28 June, stressing that it would seek to strike a balance between cost and protection. He added that a group would be formed to make recommendations to Government, involving representatives from Which? and the TUC, as well as employers.[242]

173. **While we welcome the Government's decision to set up a rolling deregulatory review of pensions regulation, we note that it will have to maintain fairness to those who have already accrued pension rights and effectiveness in terms of ensuring that DB schemes do not close because of unnecessary costs and provision. We welcome the fact that a group has been established to make recommendations to the Government, including employer and employee representatives. We ask the Government to outline the timetable for this review including interim progress updates.**

Review of role of Pensions Regulator

174. The White Paper also states that the Pensions Regulator and the Pension Protection Fund are considering how they might contribute to the simplification process. It gives the example of the Regulator "reviewing its information and data requirements in the widest

239 Q 479

240 Ev 418

241 Oral evidence taken before the Work and Pensions Committee on 22 March 2006, HC (2005-06) 1008, Q 12

242 Uncorrected transcript of oral evidence taken before the Work and Pensions Committee on 28 June 2006, HC (2005-06) 1362, Q 108

sense and looking at where it can use information already gathered by other organisations – government or commercial – rather than requiring schemes to submit it”.[243]

175. David Norgrove, the Pensions Regulator, told the Committee that:[244]

> “The trouble is, as the last year or two has shown, pensions are a data free zone. It is astonishing how little we all know about the true situation with pensions, and it looks as though the investment banks and the actuaries have an industry of adding up the numbers – every other day a different number comes out [...] So as scheme funding comes in over the course of the next few years we will start to get a better handle on what the true level of deficit is.”

176. Evidence to the Committee by the Pensions Regulator suggests that the new information being gathered through scheme returns is needed to improve understanding of the current situation regarding occupational pensions.

Risk-sharing schemes

177. Adrian Waddingham, of the Association of Consulting Actuaries (ACA) stated that the ACA “would very much like to see encouragement, support, help for new types of schemes, rather better than NPSS, which would allow the employee and the employer to share the retirement risks.”[245] Lawrence Churchill, Chairman of the Pension Protection Fund, said when giving evidence to the Committee in March that he was hopeful that more of these type of schemes would come forward.[246]

178. In a speech to the ACA in 2003, Lord Turner said that: "The big problem with DC schemes is the irrational volatility of return [...] If we want to maintain an element of private provision which is Defined Benefit at least in the sense of not being exposed to equity price volatility, we are going to have to think flexibly and creatively about the precise risk-sharing balance between employers and the individual."[247]

179. Kay Carberry from the TUC told us:[248]

> “Unions have been talking to employers to try to maintain DB schemes, or at least maintain them to existing members, where it is not possible to keep them open to new accruals, and clearly it is better for some sort of hybrid scheme to replace a DB scheme where there is a sharing of risk than to go completely to a DC scheme where the employee is going to bear all the risk.”

243 White Paper, para 2.38

244 Oral evidence taken before the Work and Pensions Committee on 22 March 2006, HC (2005-06) 1008, Q 23

245 Q 158

246 Oral evidence taken before the Work and Pensions Committee on 22 March 2006, HC (2005-06) 1008, Q 10

247 Lord Turner, speech to the Actuarial Profession on The Macro-economics of Pensions, 2 September 2003, reproduced in ACA response to Pensions Commission Second Report.

248 Q 389

180. However, several employers groups, such as the CBI and EEF described such schemes as a “minority sport”.[249] David Yeandle explained that it was possible for only the:[250]

> “larger, more sophisticated companies, with a lot of resources, both internally and externally, to communicate the change and to implement, because these are quite complex messages to get across to individual employees, and indeed sometimes quite complex changes to be made.”

181. Any employer setting up a new risk-sharing pension scheme will be concerned about future liabilities. Employees will need reassurance that they are fairly treated and that what is essentially a deferred wage is properly protected and managed. **We recommend that the Government considers whether more needs to be done to create an overall level playing field in which risk-sharing schemes, as well as DC and DB schemes, can all develop to their full potential, and encourage higher levels of contribution to whichever form of scheme is chosen.**

249 Q 440

250 Q 440

4 State Pension reform: the Basic State Pension

Introduction

182. When the Pensions Commission was set up in 2002, it was with the remit of keeping the "regime for UK private pensions and long-term savings" under review and to recommend whether there was a "case for moving beyond the current voluntarist approach."[251] However, the Commission determined that the "bewildering complexity of the UK pension system" acted as a barrier, among other things, to the success of a voluntary pension saving system. In particular, it concluded "means-testing within the state system both increases complexity and reduces, and in some cases reverses, the incentives to save via pensions."[252]

183. The Commission's Second Report, therefore, recommended that "reforms to the state system [were] 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."[253] In evidence to the Committee, the Secretary of State endorsed this approach.[254]

184. The Commission suggested that the state pension (BSP and S2P) should ensure a minimum income level. Earnings-related provision, on top of this, would be encouraged through auto-enrolment in the new system of personal accounts. Its view was that the introduction of the State Earnings Related Pension Scheme had not been accompanied by a "consensus in favour of the significant growth in public expenditure" which would inevitably result.[255]

185. The Pensions Policy Institute commented that the broad construct of the Commission's approach was in line with "the consensus among pensions experts that has emerged in the last year or so."[256] The majority view of pensions experts was that the "currently muddled view of the state's role in pension provision should be clearly delineated", so that it had two distinct responsibilities: "to deliver better on the one role that only the state can do – poverty prevention" and "to enable and incentivise the private sector to do what it does best – provide earnings-related pensions on a voluntary basis."[257]

251 Pensions Commission, First Report, October 2004, p ix

252 Pensions Commission, First Report, October 2004, p 205

253 Pensions Commission, Second Report, November 2005, p 2

254 Q 248

255 Pensions Commission Second Report, November 2005, p 118

256 Ev 390, para 8

257 Ev 390, p 6

186. Support for this approach is not, however, universal. Tony Lynes, in recent years adviser to the National Pensioners Convention and pensioners' groups in Southwark, argued that "the Commission has failed to produce convincing arguments for abolishing state earnings-related pensions, to explain why the earnings-related S2P cannot or should not be maintained and improved, or to compare the cost with that of the alternative it proposes."[258]

The Pension Commission's proposals

187. In order to meet its proposed objectives, the Commission recommended:[259]

- Accelerating the evolution of the State Second Pension (S2P) to a flat-rate system (in order to concentrate resources on "the provision of as generous and non-means-tested, flat-rate provision as possible."
- Over the long-term, linking the value of the Basic State Pension (BSP) to earnings and freezing 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."
- Moving accrual of future Basic State Pension rights onto a residency basis. "This would 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."

The Government's proposals

188. The Government's White Paper followed the Commission's broad approach to state pension reform, although there are differences in the details of the proposals (see, for example, paragraph 16).[260] We decided that the key questions to consider regarding the state pension reform proposals set out in the White Paper were:

- whether they went far enough in reducing means-testing;
- arrangements to re-link the Basic State Pension to average earnings;
- the implications of the proposed measures to improve coverage of state pensions; and
- whether it was right to reject alternative proposals to move more quickly to a simpler, flat-rate pension.

258 Ev 349

259 Pensions Commission, Second Report, November 2005, p 10

260 White Paper executive summary

The level of the Basic State Pension and restoring the link to earnings

189. The White Paper proposed that the level of the Basic State Pension should in future be re-linked to earnings. As a result, by 2050, it "could be worth twice as much as if it had been linked to prices."[261]

190. The principle that the level of the Basic State Pension should be linked to earnings received widespread support.[262] As the White Paper stated, it will help people to "predict with confidence what they are likely to receive from the State when they retire."[263]

191. However, it was also pointed out that the level of the Basic State Pension would remain low. Sally West of Age Concern told us that "when you talk about a more or less generous system, we have to be aware that we are not talking about a very high level of basic pension."[264] In evidence to the Treasury Select Committee, Lord Turner commented that "our proposals for the state pension, whatever the debates about affordability, would still leave the UK with one of the meanest and most Basic State Pension systems in the OECD."[265] A number of witnesses argued that, as well as restoring the earnings link, a significant increase in the Basic State Pension was needed.[266]

192. Moreover, the White Paper proposes restoring the link to earnings at a later date than the Commission. While the Commission said this should ideally be in "2010 or 2011 as the public expenditure benefit of the rise in women's SPA begins to flow through,"[267] the White Paper says that: [268]

> "Our objective, subject to affordability and the fiscal position, is to do this in 2012, but in any event by the end of the Parliament at the latest. We will make a statement on the precise date at the beginning of the next Parliament."

193. There was some support for this sort of flexibility, with the CBI arguing that "any link with average earnings must be reviewed in the light of economic circumstances."[269] A number of witnesses, however, expressed concern at both the delay and the element of uncertainty. Age Concern said: [270]

> "we are concerned that the link will not be restored for at least 6 years. The intention is that this will happen in 2012 but as the commitment is to do this by the end of the next parliament in theory this could be as late as 2015. Every year the pension is not

261 White Paper, para 20

262 Ev 135; Ev 187, para 4.1; Ev 196, para 1.3; Ev 256, para 2.3; Ev 316, para 2.8

263 White Paper, para 3.21

264 Q 97

265 Treasury Committee, Fifth Report of Session 2005-06, The Design of the National Pension Savings Scheme and the Role of Financial Services Regulation, HC 1074-I, Q 194

266 Ev 135; Ev 389, para 4.1; Ev 282

267 Pensions Commission, Second Report, November 2005, p 21

268 White Paper, p 17

269 Ev 350, para 5

270 Ev 326, para 2.1

linked to earnings it will continue to lose its relative value. For future pensioners the platform on which to build up savings will be lowered while current older people will see the value of their pension fall each year."

194. The Secretary of State explained the reasons for the Government's position: [271]

"on affordability grounds it saves extra money for the taxpayer, and we should not discount that […] Secondly, I think it does make sense, as far as possible, to tie the restoration of the earnings link with the introduction of the National Pension Saving Scheme, the personal accounts. Turner thought we could do personal accounts in 2010. I think that is very optimistic."

195. The Pensions Commissioners considered that "the delay to 2012 represents an acceptable compromise given affordability concerns. But a longer delay could undermine the balance of the overall policy package"[272] because "the less progress that is made towards the abolition of means-testing, the higher the minimum employer contribution would need to be."[273]

196. The Secretary of State agreed that a delay beyond 2012 was "not desirable."[274] However, he added "it is only sensible and reasonable for the Chancellor, nearer the time, to make an express judgment about the timing of this change, because I think that is the only sensible way that any government can manage public spending, looking ahead over six years."[275]

197. The Committee questioned, however, what action the Government would take if, having assessed the position, it considered the re-link to earnings to be unaffordable at the end of the next Parliament. Which would come first, "the affordability question or the importance of making sure these reforms are not put at risk?"[276] The Secretary of State said that "affordability" would come first[277] but added: [278]

"It is not going to be unaffordable and we have made it very clear […] We believe it is going to be affordable in the next Parliament; so the premise on which your question is based simply does not arise."

198. In response to a request from the Committee, the Department provided figures to explain the cost of restoring the earnings-uprating of BSP from 2010, 2012 and 2015 (see Table 1).

271 Q 307

272 "The Pensions Commissioners welcome White Paper", Pensions Commission press release, 25 May 2006

273 Pensions Commission, Final Report, April 2006, p 40

274 Q 329

275 Q 322

276 Q 326 [Justine Greening MP]

277 Q 326 [Secretary of State]

278 Q 327 [Secretary of State]

Table 1: Cost of earnings-uprating the BSP from…

	2008	2009	2010	2011	2012	2013	2014	2015	2020	2030	2040	2050
… 2010	0.0	0.0	0.5	1.1	1.8	2.4	3.0	3.7	7.1	19.9	36.3	50.3
… 2012	0.0	0.0	0.0	0.0	0.6	1.2	1.8	2.4	5.6	17.7	33.3	47.0
… 2015	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.5	3.5	14.5	29.1	42.1

Source: Department for Work and Pensions

All figures in £ billion, 06/07 price terms.

The table contains the additional costs of reforms to the Basic State Pension over and above the current (price-uprated) system. It includes earnings-uprating the BSP, coverage measures from 2010, and abolition of ADIs from 2010. Savings from increasing State Pension Age are excluded.

The reforms proposed in the White Paper are a complete package, and varying one aspect may require others to change too.

These costs assume that the only change is the date of earnings-uprating the BSP, with everything else held constant.

All other footnotes as per Figure 9 of the White Paper apply.

199. Restoring the BSP earnings link (together with measures to increase coverage of the State Pension and the abolition of Adult Dependency Increases) in 2010 would cost £50.3 billion in 2050 in 2006-07 prices, compared to £47 billion if it was restored in 2012. Delaying the restoration of the link to 2015 would cost £42.1 billion. There is a relatively modest impact on the proportion of pensioners entitled to Pension Credit in 2050: 28% if the link is restored in 2010, 29% if it is restored in 2012 and 32% if it is restored in 2015.[279]

200. **The Committee welcomes the decision to re-link the Basic State Pension to earnings but is concerned by the inconsistency between the unequivocal statement that the link will be re-established by the end of the next Parliament "in any event" and the Secretary of State's statement that affordability will come first. We ask the Government to clarify this. In our view, the link should be restored as soon as possible, and certainly no later than April 2012.**

Increasing coverage

201. A previous Secretary of State, the Rt Hon Alan Johnson MP, commented to our predecessor Committee that "My enthusiasm has not waned for tackling a real and substantial problem which is that women's pensions are, in a sense, a national scandal."[280]

202. The Pensions Commission recommended "moving BSP accruals looking forward onto a universal basis, with a residency test."[281] The aim was to address the fact that women will, for many years, "be less likely than men to enjoy a full BSP in their own right." While

279 Ev 383, 380 and 383

280 Oral evidence taken before the Work and Pensions Committee on 20 October 2004, HC (2003-04) 1171, Q 35

281 Pensions Commission, Second Report, November 2005, p 270

it considered that some of the "problems and gaps" could be addressed by making "changes to the current system", others could not. One key problem, for example, was where a person earned "less than the Lower Earnings Limit (LEL)) on any one job" and therefore did not accrue BSP entitlement. This was "difficult to fix without more significant system changes."[282]

A residence test?

203. Witnesses to the inquiry were divided on the merits of a residence test. Those who supported it stressed its role in providing certainty as regards what people could expect from the state in the future. The Equal Opportunities Commission and Help the Aged, for example, stressed its importance in giving women, in particular, confidence in being able to accrue "a full BSP, and thus have a strong and secure platform upon which to build their private saving."[283] IPPR stressed its potential to simplify the pensions system.[284] Others emphasised the importance of improving coverage for those already retired and suggested this might be easier to achieve through a residence test.[285]

204. As noted in the White Paper, a residence test does not necessarily provide universal coverage. A long-term residency test (for example, where pension entitlement is pro rata to a working life of 45 years) would minimise the entitlement of those with "little connection to the UK" but would "not necessarily improve outcomes."[286] The White Paper set out the Government's reasons for preferring to retain the contributory system.

205. The Secretary of State said in oral evidence "I believe very, very strongly, and the Government does, that the contributory principle, which has always been at the heart of the State Pension system in this country, is the right one. It is the one that commands overwhelming public support and we should stick with it."[287]

206. However, as the National Association of Pension Funds pointed out, at the National Pensions Day organised by DWP, "half of the participants agreed that years living in the UK, regardless of what the individual was doing (i.e. working or not), should count towards the Basic State Pension. Just over one third (35%) disagreed with this." [288] Mervyn Kohler of Help the Aged said that "you generally get the impression that the contributory principle is important for men and you very seldom get it from women."[289]

207. It could be argued that the 'contributory principle' is weakened by the reduction in the number of years required to qualify for a Basic State Pension to 30 years, out of a possible 49 years of working life.

282 Pensions Commission, Second Report, November 2005, p 206

283 Ev 131; Ev 163

284 Ev 125, para 8

285 Ev 304, para 63, Q 111

286 White Paper, p 126

287 Q 282

288 Ev 305, para 36

289 Q 106

208. As the Pensions Commission noted, the UK does not have "an established population register."[290] It concluded that the absence of a UK population register meant the test would be "very hard if not impossible to apply retrospectively". For this reason, it proposed that the residence test should apply to future accruals only.[291]

209. The Secretary of State was clear when giving evidence that the "proxy indicators" which were available - tax and NI records – were "not as robust as many people would think."[292] This, in the Government's view, was a further reason for rejecting the residence test.

210. IPPR agreed that any such register "would have to be built up over several years before such a scheme could go ahead. Nonetheless, the Citizen's Pension is a potential option for reform in the medium to long term (say, 2020 or later)."[293]

The White Paper proposals

211. The Department provided the Committee with a breakdown of the impact of the different measures to extend state pension coverage, as follows:[294]

- *The reduction to 30 in the number of qualifying years needed for a full Basic State Pension.* This is expected to deliver "a step change" in BSP entitlement, with around 70% of women expected to reach SPA in 2010 with a full BSP (compared to around 50% without the reform);

- *Replacing Home Responsibilities Protection with weekly credits.* This "does not significantly alter" the estimate that around 70% of women reaching SPA in 2010 will be entitled to a full Basic State Pension. The new weekly credits are to apply to people with care of a child up to 12 (compared to 16 for BSP and 6 for S2P.) While this means that people caring for children aged between 12 and 16 will no longer get credits for BSP, the effect of this is "offset by the reduction in the number of qualifying years needed."

- *Abolishing the requirement to have gained at least one qualifying year through paid contributions and to be entitled to at least 25% of the full BSP.* Up to 100,000 a year reaching SPA could benefit.

- *Introducing credits for people who undertake care for 20 hours or more for people with severe disabilities.* Around 70,000 people a year could gain a credit for Basic State Pension from this proposal (half of these will be women.) 110,000 more women and 50,000 more men will be accruing entitlements to the State Second Pension.

290 Pensions Commission, Second Report, November 2005, p 206-7

291 Pensions Commission, Second Report, November 2005, p 209, White Paper, para 1.26

292 Q 280

293 Ev 282, para 8

294 Ev 377

212. A further measure is the phasing-out of 'auto-credits' currently awarded to men aged between 60 and 64 so they do not have to 'sign on as unemployed' to gain credits for their pension (and to be extended to women as their State Pension Age increased). This "has the effect of marginally lowering" the proportion of women reaching SPA in 2010 entitled to a full BSP.

213. As a result, from April 2010, around 70% of women reaching State Pension Age (SPA) would be entitled to a full Basic State Pension, compared with around 50% under the current system.[295] From 2025, the proportion will be over 90% of men and women, compared with around 80% under the current system.[296] Under the Pensions Commission's proposals, "the same outcomes would not be achieved much before 2050."[297]

214. **The Committee agrees that the focus should be on the outcome of increasing the numbers of people entitled to a full Basic State Pension. The Government has said that it is more practical to do this, with greater effect on outcomes, through changes to the current system of contributions and credits than through the introduction of a residence test. The reduction to 30 in the number of years required for a full BSP should go some way to providing people with more confidence about what they can expect from the state in the future. We therefore welcome the Government's proposals.**

Who are the missing 10%?

215. The Committee was interested to probe further who would be among the 10% still "left out" of full BSP entitlement by 2025. Analysis conducted by DWP for its 'Women and Pensions: The Evidence' report, indicated that those not engaging in an activity likely to qualify them for BSP tended to be those with low family income and included people describing themselves as sick or disabled but not in receipt of a qualifying benefit and women who described themselves as "looking after the home" but were without children.[298]

216. It seems likely that many of these people will be helped by the reduction in the number of qualifying years needed for a full BSP to 30 (which the Secretary of State explained "by far and away has the biggest effect on outcomes of all of the changes."[299]) However, it is unclear who will be among the 10% still excluded from full BSP entitlement and, therefore, whether there is a good justification for this. The Secretary of State explained that DWP would be doing further analysis to establish who fell into this group.[300] This should help to clarify whether the Government has got the balance right with its proposed package of reforms. Help the Aged, for example, asked "what rationale is there for 30 years as against, say, 25?"[301]

295 White Paper, Volume 2, para 4.29

296 White Paper, Volume 2, para 4.21

297 White Paper, para 3.79

298 DWP 2005, Women and Pensions: The Evidence, p 76-7

299 Q 285

300 Q 273

301 Ev 168

217. **We welcome the Secretary of State's undertaking that the DWP will do further analysis to establish which groups reaching State Pension Age after 2025 will not be entitled to a full BSP. We recommend that the analysis covers entitlement for those reaching SPA in 2010, and includes an assessment of the amount by which people will fall short of full entitlement.**

The 2010 cliff edge

218. The changes to increase coverage are to be implemented on 6 April 2010 and will not apply to women reaching State Pension Age before that date. Not only does this mean that current pensioners will not benefit but, as Help the Aged pointed out, it will introduce a "cliff-edge" between those reaching State Pension Age before and after 6 April 2010. The Secretary of State explained that there were a number of reasons for this:

- *It would be difficult to make the proposed carer's credit retrospective.* "You would have to do that on a self-certified basis because there would be no other way of doing it and that is not a very sensible thing to do." [302]
- *It would maximise its impact.* "In 2010 we will go from around 45% to about 70% on April 6. On that one day it will be a huge change [...] Phasing the changes in by definition would minimise the impact of these changes, and they are big."[303]
- *Up until 2010, women have the opportunity to retire at age 60.* After that, "the more generous contributory principle will kick in then, and will kick in at the same time the State Pension Age for women begins to rise. Is that a perfect equilibrium? Maybe not."[304]

219. The Secretary of State explained that women would not be able to bring themselves within the scope of the new rules by deferring claiming their Basic State Pension entitlement and retiring after 5 April 2010. [305]

220. Other witnesses stressed the difficulties that might arise from this. Teresa Perchard of Citizens Advice said there might be a group of people "who feel particularly unfairly treated" as a result.[306] She added that it was possible that some of the cost would be offset against Pension Credit entitlement and that it would be useful to see analysis from the Department on this point. One advantage of this would be that those who were not claiming Pension Credit would benefit.

221. **The Committee accepts that it might be difficult to apply the carer's credit retrospectively, but is concerned about those with interrupted work records reaching State Pension Age between now and April 2010 who will not benefit from the proposals to increase coverage. We recommend that consideration be given to mitigating the gap**

302 Q 275

303 Q 275, 279

304 Q 275

305 Q 279

306 Q 531

in entitlement of those born before April 1950 compared with those reaching SPA under the new rules.

Adult Dependency Increases

222. The White Paper proposes removing Adult Dependency Increases (ADI) from 2010. These are additional allowances paid in respect of certain other financially 'dependent' adults who can be below pension age. The rate of the ADI in 2006-07 is £50.50 - 60% of the recipient's entitlement to the BSP. ADIs were to have been extended to women in respect of their husbands and to civil partnerships in 2010.[307] However, the White Paper proposes to abolish them from 6 April 2010. The Government's "conclusion is that the concept of 'dependency' on which the ADI provisions are based has little relevance in today's society in which partnerships of equals are the norm." The net cost of Adult Dependency Increases in 2015 would be £0.5 billion. By 2020, the cost would be expected to rise to £1.2 billion as the increase in women's State Pension Age meant more women would qualify.[308]

223. In its report on Incapacity Benefit and Pathways to Work, the Committee noted that "the abolition of the dependency and age allowances was felt by some who gave evidence to be particularly harsh as they provide a valuable source of income for disabled people". The Committee urged the Government to "work closely with disability organisations to ensure a proper assessment is made of the structure of the new benefit."[309] The Committee did not take evidence on this issue in the course of its current inquiry.

307 White Paper, Annex B

308 HL Deb, 6 July 2006, col WA 73

309 Work and Pensions Committee, Third Report of Session 2005-06, Incapacity Benefits and Pathways to Work, HC 616-I, para 146- 50

5 The State Second Pension

224. Employees earning more than the lower earnings limit pay into the "Additional Pension" (unless they are "contracted-out" and contributing to an occupational or personal pension instead.) Between April 1978 and April 2002, this was built up under the State Earnings-Related Pension Scheme (SERPS). From April 2002, SERPS was replaced by the State Second Pension (S2P).

225. DWP's 2005 *Women and Pensions* report described S2P as "one of the key changes to the State Pension system to give women with low earnings or time out of the workplace a better State Pension record."[310]

The Government's proposals for S2P

226. S2P formed an important part of the retirement income package envisaged by the Pensions Commission. The Commission envisaged the state providing a "replacement rate equal to about 30% of median earnings at the point of retirement" – 17% Basic State Pension and 14% State Second Pension (based on 44 years of contributions or credits).[311]

227. As a result of measures in the White Paper S2P entitlement is to be extended:

- More generous crediting arrangements are proposed for those with caring responsibilities, which will mean that "up to 1 million more individuals (around 90% of which are women) will be accruing State Second Pension entitlements in retirement."[312]
- The contracted-out option for DC schemes is to be abolished in around 2012.[313] At this point around 3 million personal pension policy holders and around 500,000 members of occupational DC schemes will start to accrue S2P rights.[314]

The move to a flat-rate S2P

228. S2P is already becoming more flat-rate in nature over time. This is because it is calculated on earnings between two earnings thresholds (with lower earners and certain carers and people with disabilities credited in).[315] Under current indexation arrangements, these thresholds are converging, with accruals expected to become flat-rate in around 2055.[316] From that date, accruals would be unrelated to an individual's earnings.

310 DWP (2005), 'Women and Pensions: the Evidence', p 73, para 26

311 Pensions Commission, Second Report, November 2005, p 19

312 White Paper, para 3.95

313 White Paper Volume 2, para 3.38. This is to happen at the same time as the BSP is linked to earnings

314 White Paper Volume 2, para 3.56

315 For a fuller description, see Pensions Commission, First Report, October 2004, Appendix F, Section 5,

316 Pensions Commission, First Report, October 2004, Appendix F p 156. Pensions Commission, Second Report, November 2005, p 159. Under current indexation arrangements, the Lower Earnings Threshold is linked to earnings and the Lower and Upper Earnings Limit are expected to be linked to prices

229. Like the Pensions Commission, the Government considers this move towards a flat-rate second pension to be desirable: the White Paper states that the "introduction of the new personal accounts scheme will mean that for the first time everyone will have access to a genuinely low-cost private savings vehicle. We do not want the State Second Pension to duplicate this, which is why we are able to reinforce and speed up its change in focus to a flat-rate top-up benefit."[317]

230. The Pensions Commission recommended that this process should be accelerated by freezing the Upper Earnings Limit for S2P accruals in nominal terms.[318] In line with this, the White Paper introduces measures to result in accruals becoming flat-rate by around 2030. At this point a year of contributions or credits will be worth around £1.40 a week of S2P (in constant earnings terms).[319] The result should be that, as the White Paper puts it:[320]

> "after 40 years of work or credits, a low earner can expect to build up an additional top-up of around £60 a week. Coupled with their Basic State Pension entitlement, this will give a total State Pension at retirement of around £135 a week in today's earnings terms."

231. The Pensions Policy Institute pointed out that "unequal outcomes" in pension provision "favouring the better off, will persist for decades." One of the reasons for this was "because the flattening of S2P is slow."[321]

232. The Department provided information to show illustrative S2P outcomes for low, median and high earners over the period 2005 to 2053. It assumes that a person works or is credited into the system from the age of 25 i.e. 40 years of work/crediting (increasing as State Pension Age rises.)

Table 2: Weekly S2P outcomes for working from age 25 – State Pension Age

	Weekly earnings	**Retiring in**					
		2005	2010	2020	2031	2042	2053
Low	£230	£35.86	£37.67	£38.78	£44.24	£54.74	£60.95
Median	£440	£84.97	£79.27	£78.62	£62.66	£64.83	£66.19
High	£630	£129.28	£118.26	£115.79	£76.70	£71.32	£67.31

Source: Department for Work and Pensions

317 White Paper, para 3.47

318 Pensions Commission, Second Report, November 2005, p 220

319 The value of the flat-rate element of S2P increases year on year – for instance it will be worth around £1.20 a week in 2010 but around £1.55 a week in 2050 in constant earnings terms. White Paper, para 3.50. White Paper, Volume 2, para 4.25.

320 White Paper, para 3.52

321 Ev 406, para 4

233. The Department explained that:

- "People earning higher amounts will still see higher S2P outcomes as earnings-related rights accrued prior to 2030 will be honoured. Eventually, outcomes for all earners will be the same as pre-2030 amounts disappear – the first completely flat rate S2P will be paid to people in around 2080."

- "The theoretical maximum overall S2P for someone retiring in 2052 is £86.50. However, to achieve this outcome, a contributor would need to work from age 16 to age 68 and during the period up to 2030 (when earnings relation is still in place) would need to have consistent annual earnings of over £30,000."[322]

234. The result is that the more years of contributions or credits you have, the more S2P you qualify for. In the context of BSP, the White Paper argued that a reduction in the number of qualifying years was needed to help those with interrupted work records get full BSP entitlement.[323] It does not explain why the same rationale should not apply to S2P. The Secretary of State explained that "for the State Second Pension, it literally depends on how many years you have been contributing. That is what you get out. You can contribute for 40 years, but for each of those years you get more when it comes to your retirement."[324] People will be able to accrue more S2P as SPA increases.[325]

S2P: a source of complexity

235. It is difficult, however, to be sure what proportion of people will reach these levels of S2P entitlement. This is partly because of the complexity of the system, the way it has changed over time and the length of time over which entitlement is accrued. As DWP has commented, it takes many years for the changes to feed through to S2P entitlement. [326]

236. S2P continues, therefore, to remain a source of complexity. Citizens Advice noted that "the erosion of SERPS benefits, and the difficulty of evaluating contracting out options has left many people unclear and wary about second tier state pensions."[327] In oral evidence, Teresa Perchard said:[328]

> "As those people come through the system, they will be coming out with different things, so it will make advising people, either what to expect or whether what they have got is right, quite challenging, because it will be a moving level down to flat rate.

322 Ev 379

323 White Paper, para 3.78. The way in which the entitlement to the additional state pension is calculated is difficult to explain, partly because it has changed over the years, with the State Earnings Related Pension being replaced by the State Second Pension in April 2002. Very broadly speaking, State Second Pension entitlement is calculated on the basis of percentage of earnings between different earnings thresholds for each year between 16 and State Pension Age (although the exact number of years depends on a person's date of birth). Certain people - such as carers, and lower earners - are treated as if they were at the lower earnings threshold (£12,500 in 2006/07 prices). For a fuller explanation, see Pensions Commission First Report, Appendix F, p 150.

324 Q 287

325 Ev 379

326 DWP (2005), 'Women and Pensions: the Evidence', p 75, para 30

327 Ev 256, para 2.1

328 Q 593

> It is an area that is quite difficult to advise people on now and it will become more difficult because the rate will be changing."

237. The Secretary of State himself acknowledged this, describing the S2P as having "a built-in element of complexity that no amount of reform is ever going to remove, but, I think, moving to a flat rate more quickly is going to speed up the simplification of the State Pension system."[329]

Gaps in S2P entitlement

238. The proposed changes to credits bring S2P and BSP entitlement more into line, for example, in both cases:

- Credits for childcare would be available until the youngest child is aged 12 (currently it is up to age 6 for S2P and 16 for BSP);
- A new weekly credit would protect the Basic and State Second Pension record of carers who provide 20 hours or more care for someone receiving a disability benefit.[330]

239. There are 19 activities that can credit someone in to the Basic State Pension and, of these, only seven also qualify the individual for the State Second Pension. Those that do not qualify an individual for S2P include periods of unemployment, receiving Maternity Allowance, Statutory Adoption Pay or Statutory Sick Pay.[331] It is clear that more gaps remain in the system of credits and contributions for S2P than the Basic State Pension, particularly for the self-employed and those who are sick and disabled.

The self-employed

240. The Government has decided not to extend S2P to the self-employed. A number of reasons are given for this: complexities with the Commission's suggestion that the self-employed might be included by means of age-related NI contributions; "reluctance to commit taxpayer's money to a speculative scheme where enrolment may be low"; the new opportunities to save in personal accounts; and the fact that the average duration of employment was an average of eight years.[332]

Those who are long-term sick or disabled

241. While the White Paper proposes removing the Labour Market Attachment Test to ensure fair treatment for those who are long-term sick or disabled[333] it also raises the

329 Q 248

330 White Paper, Volume 2, p 114

331 HL Deb 26 June 2006, col 63W. The following circumstances currently qualify people for credits to BSP but not S2P: starting credits for 16-18 year olds; approved training courses; jury service; former prisoners with quashed convictions; men aged 60-64; Jobseekers Allowance; short-term Incapacity Benefit; short-term Incapacity Benefit; Statutory Sick Pay; Statutory Adoption Pay; Working Tax Credit; Maternity Allowance; Unemployability Supplement; unemployed and actively seeking work.

332 White Paper, p 119-120

333 White Paper, Volume 2, p 114

question as to whether credits to S2P should begin after 52 weeks, after the 13 week assessment phase, or be restricted to those on the Support component of the new Employment and Support Allowance (ie. to those with the most severe illnesses and disabilities).[334] Asked what the rationale for restricting entitlement to those on the Support component only would be, the Secretary of State said: [335]

> "Off the top of my head, I do not think there probably would be one, but it is one of the things that we are looking at as a possible option, because it is there on the table in front of us if we wanted to go down that road."

242. Teresa Perchard of Citizens Advice took the view that such a measure would simply create "a new group of future disadvantaged poor pensioners with an insufficient NI contributions record." [336]

243. **The Committee believes that those on the Employment and Support Allowance should be credited into the State Second Pension after the 13 week assessment phase.**

244. As a result of such gaps (or potential gaps) in the contribution and credit arrangements for S2P, inequalities in S2P provision, compared to BSP, will continue. The Pensions Policy Institute's initial analysis was that "many people - more than a third - will receive less than £135 a week"[337] (the amount of state pension - BSP and S2P - the White Paper says a person could expect who has been in employment or caring throughout their working life).[338]

245. **The Committee welcomes measures in the White Paper to improve coverage of S2P for carers and the simplification that would arise in the long term from moving to flat rate accrual. However, we note that inequalities in S2P provision are set to continue and the fact that, as the Secretary of State acknowledged, S2P will continue to be a source of complexity. DWP should provide estimates of how many people it expects to receive less than £135 a week in BSP and S2P in 2030 and in 2050.**

334 White Paper, para 3.108. For more details of the Employment Support Allowance and the conditions of entitlement, see Work and Pensions Committee, Third Report of Session 2005-06, Incapacity Benefits and Pathways to Work, HC 616-I, para 139

335 Q 297

336 Q 534

337 Ev 394

338 White Paper, Volume 2, para 4.21: figures in 2005-06 earnings terms

6 Should the state pension remain two-tier?

246. The Pensions Commission considered that a "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)."[339]

247. Having considered the options, the Commission recommended retaining a two-tier state pension – with the Basic State Pension and State Second Pension. It explained that "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." In addition, it argued that the gradual and evolutionary approach it proposed would have the advantage of reducing transitional complexity and allowing flexibility, for example, to have different pension ages for S2P and BSP. [340]

248. A number of memoranda questioned the proposal to retain two separate tiers, arguing that it did not go far enough in simplifying the system. The Pensions Policy Institute argued that "the gradual transition approach for state pension reform preferred by the Commission has three significant problems: complexity, risk of constant fiddling and distributional inefficiency." [341]

249. Other memoranda, however, were supportive. Age Concern, on balance, favoured two tiers on the grounds that it had "scope to provide certain groups, such as carers, more generous provision from the state" and "given we have to start from where we are, reform to the existing two tier system is likely to be easier and quicker to achieve than moving to a single tier system."[342] The Equal Opportunities Commission strongly supported "the concept of maintaining and extending the second state pension (S2P)" and proposed a "revised and tightly targeted supplementary state pension, designed to deliver combined income of up to £160 from BSP and S2P to those spending their lives in low paid employment (under the middle threshold of £12,116p.a.) or in unpaid parenting or caring roles." [343]

339 Pensions Commission, Second Report, November 2005, p 8

340 Pensions Commission Second Report, November 2005, Executive Summary, p 9

341 See Ev 394, para 32; Ev 122

342 Ev 318, para 6.1

343 Ev 126, para 19

Alternative proposals – the Pensions Policy Institute

250. The Government, as outlined in the White Paper, followed the Pensions Commission in deciding to take a gradual approach to state pension reform, building on the existing two tiers. In oral evidence on 7 June, the Secretary of State warned: [344]

> "I do not think this idea, this Holy Grail that people have searched for, of merging the two is anything like as straightforward or as simple or necessarily as sensible as people suggest, and that is why Turner did not propose it. He took a very long, careful look at it and said, "Do not go there. It is too complicated."

251. The Pensions Policy Institute, however, has consistently argued that "a faster transition to a simpler state system is both possible and affordable, could have a better distributional outcome, and could reduce reliance on means-testing still further".[345] It set out three alternative means for arriving at this objective. In each case, it argued, the end result was:

- "Single-tier" and so simplifies the pensions system. Accruals to S2P stop and the level of the first tier is increased.
- Set at Guarantee Credit level (£114 a week for single pensioners in 2006/07) "and so reduces means-testing".
- Wider coverage than the Basic State Pension. "For the sake of modelling, we have assumed that the single-tier pension would be universal." [346]

252. PPI proposed three options for arriving at this result – a short, medium and longer term transition. PPI explained that the short transition – under which the flat-rate pension would be introduced immediately by increasing the BSP to the new level – could be achieved using the 'offset' method. This "targets gains on those with a state pension income of less than the new pension level of £114 a week." Those with state pension income of less than £114 a week are brought up to that level. Those with more do not gain immediately, but lose nothing. All accrued rights are honoured. The White Paper, broadly following the Pensions Commission, outlined a number of reasons for rejecting the PPI's transition proposal for a short-term transition. Like the Commission, the Government concluded that under the more gradual transitional approaches, "the prize of simplicity is lost."[347]

Transitional complexity

253. The Pensions Commission's Second Report described the calculation required "as complex and administratively burdensome particularly because the different benefits have different indexation regimes (ESP to earnings, SERPS/S2P price-indexed in retirement,

344 Q 349

345 Ev 389

346 Ev 394, para 33

347 White Paper, p 117-8, Box 3a

BSP to prices) requiring the calculation to be done separately each year for each individual. The arrangements would be 'possible (though complex)'"[348]

254. Alison O'Connell said that the Pensions Policy Institute had talked "to officials in the Inland Revenue who administer this stuff and we felt that it was quite straightforward, because all the information exists" [349] The Secretary of State explained that it was not just a question of administrative complexity, he was "sure it could be done"[350], it was also a problem for individuals, with people having "no clear idea of what the state would provide."[351]

255. However, as evidence to the inquiry indicated, lack of clarity is a problem with the present system, particularly as regards the State Second Pension (see para 236 above). Christine Farnish of the National Association of Pension Funds thought it was more of a political judgement: [352]

> "Clearly, there are transition issues and it would be complicated to achieve, but I would set against that the huge risk and the complexity and length of the transition that we are going to go through now, in moving forward with the reforms set out in the White Paper. I think it is some pain for a very big gain, if you have more of a 'big bang' approach, but clearly these are political judgments that politicians need to make."

256. As previously explained, an element of complexity continues under the present system. Pension forecasts, however, could assist people in understanding what they could expect from the state. Administrative complexity should not be a reason for rejecting the proposals.

Cost

257. The White Paper explained that the offset method would "still result in a considerable immediate increase in expenditure. Costs using the offset arrangements would be an additional £10 billion in 2010, and £8 billion in 2015. Costs would peak at around 0.9% of GDP around 2040, falling back to 0.3% of GDP by 2050."[353]

258. PPI, on the other hand, argues that its proposal for a "faster move to a simpler state pension" is affordable "within the Pensions Commission cost envelope."[354] There are a number of possible explanations for the difference in view as to affordability. One is that the cost will depend on exactly what is being modelled. In the PPI proposal, for example, individuals in couples would get 80% of the single rate. The other is that the costing for the

348 Pensions Commission, Second Report, November 2005, p 246

349 Q 22

350 Q 350 and 354

351 White Paper p 118

352 Q 494

353 White Paper, p 118

354 Ev 395, para 35-6

PPI proposal takes into account the money raised from abolishing contracted out rebates for both DB and DC schemes (£11 billion in 2010 in 2006/7 prices).[355]

Distributional outcomes

259. The White Paper stated that: [356]

> "whatever the precise design, there are concerns about the fairness of any kind of Citizens' Pension: some people would get the same pension despite having paid in very different amounts over the last 50 years, based on an understanding that their contributions would affect their retirement incomes. For example, the self-employed – who have not contributed to the State Second Pension – would get the same outcomes as employees who have."

260. As the Pensions Commission acknowledged, this requires a "judgment on what is the 'fair' way of dealing with the fact that different people not only have different accrued rights, but also have made different contributions".[357] Alison O'Connell argued that an increase in state pension for the self-employed would be one advantage of the PPI's proposals, given that they are one of the under-pensioned groups.[358]

261. In oral evidence, the Secretary of State took the following view: [359]

> "Coming back to the wider S2P point, if we were to take the advice of some and merge the two, actually the biggest losers would be middle income. It will be middle Britain that would take a real pounding if we were to do that".

262. Again, it will depend on exactly what is being modelled. PPI argued that its own proposals had better distributional outcomes than those of the Pensions Commission and those in the White Paper. Of the White Paper proposals, PPI stated that "overall, the income distribution of people over State Pension Age will change very little as a result of the White Paper proposals. The better-off will benefit slightly more than the less well-off. The problem of unequal outcomes will remain." In comparison, its own short transition was "progressive. The least well-off 10% stand to gain around £15 a week, while stopping S2P accruals mean that the most well-off would have around £10 a week less than they would under the current system."[360]

263. As regards the question of distributional outcomes, therefore, the offset method has the advantage of protecting accrued rights. However, some people, such as those who had been self-employed would get an immediate increase in state pension entitlement despite having paid less NI in working life. Whether this is desirable is a question of judgement on what is 'fair' and what should be the priority for the state pension system.

355 Ev 396, para 14

356 White Paper, Box 3a, p 118

357 Pensions Commission, Second Report, November 2005, p 248

358 Q 16

359 Q 354

360 Ev 397, para 49

The impact on earnings-related pension provision

264. A further reason given by the Pensions Commission for retaining S2P was that abolishing it immediately would: [361]

> "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."

265. However, it is possible that the success of the scheme might be better assured if people were clearer about what they could expect from the state and more confident that they would be lifted free of means-testing in the future. [362]

266. **Moving to a simpler, single-tier system more quickly than the Government and Pensions Commission proposed would appear to be possible, using the 'offset' method. It would, however, require difficult decisions to be made – for example, whether to abolish contracted-out rebates for Defined Benefit schemes. It also requires a judgement on priorities and the extent to which moving more quickly to a simple, single-tier flat-rate state pension should take precedence over other objectives. We recommend that the Government conducts further work on the costings and on the feasibility of the offset method.**

Alternative proposals – the Pension Reform Group

267. A further alternative policy model considered by the Pensions Commission was the Universal Protected Pension proposed by the Pension Reform Group, chaired by the Rt Hon Frank Field MP. This involved: [363]

- Maintaining the existing Basic State Pension linked to prices during a person's working life.
- Building up a funded provision alongside the existing basic pension which combined will guarantee a minimum income of 25% of average earnings during retirement.
- The funded provision will cover the cost of uprating the BSP component of this guarantee in line with earnings only at retirement while meeting the overall cost of a pension of not less than 25% of average earnings and maintaining this overall pension in line with earnings throughout retirement."

268. The Pensions Reform Group argued that its proposals had the following advantages:

- They would provide a "guaranteed pension" for all who contribute to society, including carers

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361 Pensions Commission, Second Report, November 2005, p 9

362 Ev 396, para 40

363 Ev 143, para 14

- The scheme would be compulsory for all in work, but there would be no new form of compulsion, contributions would be collected through the NIC system by the Contributions Agency.
- The scheme would be redistributive as is the Basic State Pension scheme – over the relevant National Insurance bands, everyone puts in the same percentage of income for the same monetary pension at the end.
- The scheme would be funded – to distance it from Government – 'it is our/my money: they cannot fiddle with or expropriate it'.
- It would be independent. "It is critical that there should be a governance structure that puts significant distance between the scheme and politicians. We propose a governance model based on the Monetary Policy Committee of the Bank of England."

269. The Pension Reform Group had its proposals costed by the Government Actuary's Department. The GAD report noted that "leaving additional contributions to be settled at a later date when the Chancellor believes it prudent to increase national insurance contributions, the [contracted out] rebate alone, invested in the UPP, for the whole of the person's working life, together with the Basic State Pension, would deliver a pension of a little over the Pension Reform Group minimum target of 25% of national average earnings."[364]

270. The Pensions Commission analysed the Pension Reform Group's proposals and noted advantages, including:

- People might be more willing to pay into an explicit fund than to pay taxes (even if the contributions/benefits relationship was to a degree redistributive). A more generous flat-rate state pension could therefore be sustainably afforded if the funded route was chosen.
- The arm's-length governance structure might ensure continuity, reducing the likelihood of the continual changes which have increased the complexity of the British state system and undermined trust in it.

271. The Commission concluded, however:[365]

> "that these advantages are not sufficiently compelling to justify such a major change in policy which would carry with it some offsetting disadvantages. In particular we are unconvinced that it is politically feasible or acceptable to hand over to an arm's length independent body the huge and inherently political decisions which would need to be made about the appropriate level of the flat-rate BSP in the event that asset values oscillated significantly".

272. Asked about this in oral evidence, the Rt Hon Frank Field MP, Chairman of the Group, argued that there was:[366]

364 Pensions Reform Group, The Chance of a Lifetime, 24 April 2006, p 12

365 Pensions Commission, Second Report, November 2005, pp 68-70

"a huge trust factor here and that increasingly over the next decade we as politicians, if we want to take voters with us to part with their money, are going to have to surrender some of our sovereignty over how we as politicians spend that money."

273. He added that the objection to an "arm's length independent body" making "huge and inherently political decisions" "could have been a valid point if we had not had the experience of the Monetary Policy Committee", the decisions of which can have:

"an immediate and quite devastating effect on many people's household budgets, and therefore we have already got a body that can have a much more immediate impact on people's living standards." [367]

274. Howard Reed of IPPR, however, argued that there was a significant difference between the two bodies:[368]

"I think the analogy Frank has drawn with the Monetary Policy Committee is defective in the key sense that the MPC set one variable interest rate and the Government can change its target if it wants and get it to set, say, an employment target as well as an inflation target if it wanted. This body, the kind of arms-length pension management body that Frank is proposing, will be running a redistributive scheme, using national insurance contributions which effectively are an income tax [...] we feel that it is the Government's direct role to do that."

275. He also questioned the extent to which the pensions provided would actually be "protected."[369]

"One point is that from reading the Pensions Reform Group material it seems to me that they are not totally up front about the fact that any system which invests in equity markets involves risk […] It says it is a protected pension, but I am not clear exactly if there is a huge crash in the stock markets and the fund finds it cannot provide 25 to 30% of earnings without big borrowing or whatever, the Government will have to underwrite the system somehow, either by borrowing or by raising taxes."

276. **The Committee notes that there are some advantages in the model proposed by the Pension Reform Group, in that it might restore trust in pensions by establishing a guaranteed pension overseen by an independent body at arms length from Government. However, we consider that other means might be adopted to reduce the risk of parameters of the pension system being successively changed over time – for example enshrining those that are most important in primary legislation.**

366 Q 145

367 Q 145

368 Q147

369 Q147

Conclusion: a pragmatic consensus?

277. The Government has given a number of reasons for not adopting proposals to move faster to a simpler, single-tier state pension. The most significant reason is, perhaps, that of cost and the proposal that these be met entirely by abolishing rebates for DB schemes, something the Government has rejected. This issue is considered further in chapter 3.

278. Some organisations giving evidence to the inquiry, such as Help the Aged and the National Association of Pension Funds said they would prefer a faster transition to a simpler state pension. However, Help the Aged said that it:[370]

> "would have much preferred the Citizen's Pension model - the Enhanced State Pension in the Commission's report - to have found favour, but if there is no consensus around that, then the Commission's suggestions become the next best way forward, provided they are implemented in full (ie including the residential eligibility test for a full Basic State Pension for everyone at 75) and with due speed."

279. Christine Farnish of the National Association of Pension Funds took a similar view.[371]

280. The Pensions Policy Institute, in a memorandum submitted after publication of the White Paper, suggested that the streamlining of some of the qualifying criteria of BSP and S2P (see para 238) means that "it would be easier in future to merge the two into a single-tier. The logic of doing this will become clearer once contracting-out has been abolished and S2P has flattened further. Legislation could set a date, say 2015, for a review to examine the feasibility of merging BSP and S2P."[372]

281. **The Committee recommends that the Government sets a date at which the feasibility of merging BSP and S2P should be examined, possibly as part of the further independent review we recommend should be commissioned by the end of the next Parliament.**

370 Ev 163, summary

371 Q 493

372 Ev 407, para 23

7 Means-testing

Means-testing

282. Evidence to the inquiry suggested there was widespread support for the Government's overall objectives for pensions reform. As regards the details, however, there was considerable concern about the degree of means-testing and complexity that would remain. These concerns were expressed by a wide range of individuals and organisations, including pensions experts,[373] employer representatives, the insurance industry and organisations working with or representing pensioners.[374]

283. As stated in the White Paper the introduction of the Minimum Income Guarantee and its replacement by Pension Credit has helped reduce the number of pensioners in relative income poverty by 1 million since 1997. A report in 2005 into the Pension Credit by the then Work and Pensions Select Committee said "we welcome the fact that the Pension Credit has increased the incomes of many pensioners."[375] The White Paper commits the Government to continuing to uprate the Guarantee Credit in line with earnings beyond 2008.[376] **The Committee acknowledges the increase in pensioner incomes arising from the Pension Credit, and the contribution that this has made to reducing relative income poverty. It welcomes the commitment to continue to increase the Guarantee Credit in line with earnings beyond 2008.**

Eligibility for means-tested benefits

284. A key motivation for the reforms set out in the White Paper is to reduce the spread of means-testing. "If current indexation arrangements continued, the proportion of pensioner households entitled to Pension Credit would increase from around 45% today to around 70% by 2050 […] The potential future spread of Pension Credit could reduce incentives to save for some people. However, it has never been the Government's intention to move over the long term towards a system where a significant majority of pensioners are entitled to Pension Credit".[377] This was re-iterated in the oral evidence given by the Secretary of State.[378]

285. The DWP has projected that under current indexation arrangements the percentage of pensioners eligible for Pension Credit would increase from around 46% in 2004/5 to around 70% in 2050. Under the White Paper arrangements, this is expected to fall to around 29% in 2050. [379]

373 Q1 [Alison O'Connell] Q132 [Howard Reed]. See also Q 91, Q 59

374 Ev 253, para 1.7

375 Work and Pensions Committee, Third Report of Session 2004-05, Pension Credit, HC 43-I, p 3

376 White Paper, para 3.60

377 White Paper, paras 1.34-5

378 Q 305

379 Ev 380

286. The Pensions Policy Institute disputed these figures – its analysis suggested that eligibility would fall from 50% in 2005 to 45% in 2050. It commented that the White Paper "acknowledges that the number of older people eligible for Pension Credit will be uncertain, but only shows a point estimate calculated as the average of the midpoints of the ranges of outcomes from two different models used." [380]

287. The Committee asked for clarification on how the Department arrived at its projections for Pension Credit entitlement. In response, DWP explained that the starting point for its estimate was that eligibility in 2004/05 is in the range of 43-48%. The White Paper used the mid-point of this range i.e. around 46%. DWP adds that it is confident that "this is a robust estimate and that the reforms will substantially reduce the proportion of pensioners eligible for PC over time. But we need to keep in mind that we are projecting outcomes over 40 years into the future and there is necessarily a degree of uncertainty in the estimates." [381]

288. In a speech on 12 July 2006, James Purnell MP, Minister for Pensions Reform, referred to the fact that there were differing estimates of the impact on means-testing of the White Paper proposals:[382]

> "Far from wanting to ignore this debate, we want to engage with it. This is exactly the kind of issue where we need to address concerns if this policy is to succeed. We will therefore publish our analysis in the autumn, so that everyone can examine the assumptions underlying it."

289. Both projections suggest that the percentage of pensioners would rise under current indexation arrangements and would fall under the White Paper arrangements. **The Committee welcomes the fact that under the White Paper proposals the percentage of pensioners likely to be eligible for means-tested support in retirement would be expected to decline rather than increase, while the support available via the non-means tested pension will increase. The Committee notes that there is necessarily a degree of uncertainty in longer-term projections and welcomes the fact that the Government intends to produce analysis of the extent to which its proposals should reduce means-testing in the future. We recommend that this include the range of numbers of pensioner households likely to be eligible for Pension Credit in the future and the assumptions on which the figures are based.**

290. An earlier report into the Pension Credit from the then Work and Pensions Select Committee stated that "Looking at the Government's pensions strategy overall, we question how the Credit will interact with other policies already announced and whether it is, in fact, too complicated a measure to have a significant impact upon future savings behaviour. We are especially concerned that the Pension Credit appears to leave little, if any, role for the State Second Pension. As it is currently proposed, a person could work all their life, contributing to their second pension, and when they retire still be in receipt of

380 Ev 406, para 13

381 Ev 381

382 Speech to IPPR, 12 July 2006, www.dwp.gov.uk

means-tested benefit, undermining earlier Government aspirations. We urge the DWP to clarify the role of the State Second Pension as soon as possible."[383]

291. As stated in the White Paper a key outcome of the reforms would be to ensure that "Anyone who has been in employment or caring throughout their working life could receive £135 a week in retirement in state pensions – which is £20 a week above the guaranteed income level".[384] Later in the White Paper it states that "These reforms would mean that most people will be able to plan for their retirement in the confidence that the foundation income they receive from the State will provide them with an income above the level of the Guarantee Credit, and will thus ensure that they achieve a higher effective rate of return on any additional private saving that they make".[385]

292. In additional information provided to the Committee, the Department explained that "a low earner or someone credited-in (i.e. always on the flat rate of S2P accrual) retiring in 2053 would need "25 years to clear the Guarantee Credit", and "40 years to clear Pension Credit altogether at the point of retirement".[386] It would appear, then, that people will need a fairly full record of caring or credits - 40 years - to be free of Pension Credit at the point of retirement. Furthermore, because S2P is linked to prices once in payment and the Guarantee Credit is linked to earnings, people may become entitled to Pension Credit in the course of their retirement.

293. **The Committee welcomes the fact that individuals with a full contributions record will be able to expect a retirement income above that provided by the Pension Credit Guarantee. In order to aid individual decision-making it would be useful if further details were provided on the types of individuals who might expect to receive a non-means-tested income below that of the Guarantee Credit.**

Impact of other benefits

294. As stated above it is clear from the analysis in the White Paper that the proposals are expected to lead to a reduction in the number of pensioners eligible for the Pension Credit. Evidence to the Committee from Sally West of Age Concern stressed the importance of considering the impact of other means-tested benefits – such as Housing Benefit and Council Tax Benefit – as well as the impact of the Pension Credit.[387]

295. **The proposals in the White Paper should reduce reliance on other means-tested benefits such as Housing Benefit and Council Tax Benefit. The Committee welcomes this, and would like the DWP to publish figures on the extent to which the proportion of pensioners eligible for any means-tested benefit would be reduced by the White Paper proposals.**

383 Work and Pensions Committee, Second Report of Session 2001-02, Pension Credit, HC 638-I, para 86

384 White Paper, p 20

385 White Paper, Annex E, para E.10

386 Ev 379

387 Q 95

Means-testing and incentives to save

296. In terms of the impact of means-testing on incentives to work and save Professor David Miles, Managing Director and Chief UK Economist at Morgan Stanley and visiting Professor of Financial Economics, Imperial College, University of London, stated:[388]

> "My main point of criticism of the Pensions Commission Report is that it does sign up too readily, I think, to this view that the more means-testing there is, the more distortions there are to economic decisions, the less saving will go on, the less incentive people will have to work and save, because that is absolutely not self-evident, and the most convincing piece of research on this says actually something quite different.".

297. The research that Professor Miles was citing is analysis by James Sefton, Justin van de Ven and Martin Weale of the National Institute of Social and Economic Research that was carried out for the DWP. This simulates the impact on individuals' decisions to work and save from moving from a system with a Basic State Pension and a higher Minimum Income Guarantee to a system with a Pension Credit, and to one where the Basic State Pension is increased to the level of the Minimum Income Guarantee. The analysis shows that while moving from a MIG style system to a non-means-tested system would increase both labour supply and saving by individuals in lower income households it would also reduce labour supply and saving by individuals in higher income households, and could have a negative impact on aggregate pension saving.[389]

298. Alison O'Connell of the Pensions Policy Institute characterised the effect of means-testing differently:[390]

> "It is not a mathematical argument, it is not that if you sit down and do your economically rational calculations you can work out exactly what your rate of return will be on Pension Credit and work out whether it is a good thing to save or not, because, of course, nobody does that. The problem is around the uncertainty of what you are going to get from the state in future and just the uncertainty of what the value of your saving will be. The more that Pension Credit extends up the income distribution the more people are in that zone of uncertainty."

299. The Government estimates that some 6% of pensioners will still be entitled to Guarantee Credit only, in 2010.[391] These pensioners will still face a 100% marginal deduction rate.

300. **In order to get a fuller view of the impact of the White Paper proposals on incentives the Committee recommends that projections of the proportion of pensioners facing different withdrawal rates are published, and that the DWP**

388 Q 10

389 Sefton J, van de Ven, J, and Weale M, (2005), The effects of means-testing pensions on savings and retirement, National Institute of Economic and Social Research (NIESR) (http://www.niesr.ac.uk/pubs/dps/dp265.pdf).

390 Q 40

391 Q 307 [Secretary of State]

commissions or carries out further research on the likely impact of the reforms on individual decisions to work and/or save.

Reform of the Savings Credit

301. The White Paper states that "from 2008 we will uprate the lower threshold of the Savings Credit by earnings. From 2015 the maximum Savings Credit will be frozen in real terms".[392] The objective of this reform is "To ensure that, before implementing the earnings link of the Basic State Pension, means-tested provision continues to be focused on those with small savings".[393]

302. Over the longer-term this change will gradually reduce the importance of the Savings Credit. Mervyn Kohler, Head of Public Affairs, Help the Aged, said "If we get to a position where the Basic State Pension or pensions are providing an income which is pretty close to the guaranteed credit, then clearly there is no logic for a Savings Credit at all; in fact that would be a good move."[394]

303. The Secretary of State agreed that the changes to focus Savings Credit more tightly on those on lower incomes could create a source of pressure on Government in the future:[395]

> "I think that is a question for all of us to address. I have just been pressed over here by someone suggesting that we should continue to restrict the spread of means-testing, and I agree, we should. This is what it means. This is how we do it. You cannot query the means but then desire the outcomes. There is no comfort blanket here, I am afraid."

304. The Pensions Policy Institute said the effect of the policy would be that "low-middle earners currently eligible for Savings Credit will receive less as a result. This will particularly affect older pensioners, who are less likely to have a full BSP and more likely to have low SERPS / S2P pensions; so will find less saving qualifying for Savings Credit. Some pensioners currently receiving Savings Credit will no longer be eligible when entitlement is re-calculated at the end of their assessed income period."[396] Age Concern argued that "care needs to be taken about the timing of the change. Early freezing of the Savings Credit could disadvantage those who have had limited opportunities for savings if they have not had time to start building up better non-means-tested state and private pensions."[397]

305. **The Committee welcomes the Government's commitment to restricting the spread of means-testing over time through changes to the Savings Credit but recommends that care should be taken to avoid penalising those with modest savings who have not yet had a chance to build up a good base level of non-means-tested state pension. The**

392 White Paper, para 3.64

393 White Paper, para 3.62

394 Q 100

395 Q 348

396 Ev 406, para 8

397 Ev 318, para 5.2

mechanisms for achieving this should be placed in primary legislation to build confidence that they will be seen through.

8 Current pensioners

306. Organisations representing or working with today's pensioners emphasised the importance of keeping their needs high on the policy agenda.[398] The National Pensioners' Convention argued that for any meaningful consensus to be achieved, the needs of current pensioners must not be ignored."[399] Help the Aged said that "Pensioners today see little in the [Pensions Commission's] report to cheer them, yet their situation demands to be addressed" [400] and added, once the White Paper was published, that "for older and retired people today, the White Paper holds precious little", a point also made by the Croydon retired people's campaign, which described the proposals as "failing today's 11 million retired people." [401]

307. The Secretary of State commented in the House that the fact that the Guarantee element of the Pension Credit would be uprated in line with earnings beyond 2008 would mean "up to 500,000 pensioners will not end up falling into poverty."[402] The Pension Reform Group commented that the success of Pension Credit meant:[403]

> "that for the first time politicians and policy makers have the opportunity to deliver a long-term and sustainable reform of pensions without simultaneously being concerned with a reform which also helps today's poorest pensioners."

308. While the focus of the Pensions Commission was on future pensions, it did comment that it would be: [404]

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

309. This view received support from witnesses to the inquiry.[405] Christina Barnes of the Equal Opportunities Commission argued that: [406]

> "the most important group that will receive it are those women who currently do not get a full Basic State Pension and are not claiming their Pension Credit. It also sends out the important message that all women should get a full Basic State Pension in their own right rather than being dependent upon their husbands for their income in retirement."

398 Ev 316, para 2.2; Ev 163

399 Ev 142

400 Ev 165, para 5.5 and 5.6

401 Ev 190

402 HC Deb, 27 June 2006, col 140

403 Ev 142, para 4

404 Pensions Commission, Second Report, November 2005, p 10

405 Ev 123; Ev 253; Ev 295

406 Q 119

310. However, the Government has decided not to implement these proposals, as we have already noted.[407]

311. Our predecessor Committee, in its report on the *Future of UK Pensions*, concluded that "there is nothing inherently wrong with a means-tested approach which focuses available resources on the poorest pensioners if the issue of 'take-up' is adequately addressed."[408] Evidence to the inquiry suggests that take-up continues to be a problem. Age Concern said that "despite major take-up initiatives, some 30% of older people entitled to Pension Credit are not receiving the benefit." Teresa Perchard of Citizens Advice said:[409]

> "we are still coming across today pensioners who are missing out on claiming Pension Credit. Their state pension income is a long way from the Pension Credit level and it can be quite a challenge to get people to claim means-tested benefits, they feel a huge loss of dignity and that they are begging for charity by doing so, plus there are quite a lot of administrative obstacles, even with the efforts that have been made to simplify the claiming process for Pension Credit."

312. The Department did not meet its SR2002 target to be paying Pension Credit to at least 3 million pensioner households by 2006. The Secretary of State said when giving evidence to us on the 2006 Department for Work and Pensions Annual Report that:[410]

> "I think the Pensions Minister would want to look very carefully at how we should take forward future work on Pensions Credit. It is very important, it is one of our PSA targets, we are doing all we can to try and reach it, but it is pretty clear now that we will probably fall short of the PSA target."

313. Evidence to the current inquiry suggested that achieving high levels of take-up looks set to become more challenging in the future. The White Paper includes an assumption that take-up of Pension Credit will remain "at the level in 2007/08, which is projected to be around 80%."[411] However, take-up is much higher among those entitled to Guarantee Credit only (between 70% and 81%) than among those entitled to Savings Credit only (between 43% and 50%) (see Table 3). The proportion of the pensioner population entitled to Guarantee Credit only is expected to fall (from 16% in 2010 to 6% in 2050), while the proportion entitled to Savings Credit only, stays at around 14% (see Table 4).

407 White Paper, p 127, Box 3c

408 Work and Pensions Committee, Third Report of Session 2002-03, The Future of UK Pensions, HC 92, para 63

409 Q 504

410 Uncorrected transcript of oral evidence taken before the Work and Pensions Committee on 3 July 2006, HC (2005-06) 1389, Q 34

411 White Paper, Volume 2, para A.17

Table 3: Take-up of Pension Credit for 2004/05

	Lower Bound	Upper Bound
Total Pension Credit	61%	69%
Guarantee Credit only	70%	81%
Guarantee Credit +Savings Credit	70%	81%
Savings Credit only	43%	50%

Source: National Statistics Estimates of Take-Up in 2004/05 (table supplied by Department for Work and Pensions)

Table 4: Projected proportion of pensioner households eligible for Pension Credit for selected years under the White Paper proposals.

	Guarantee only	Guarantee & Savings Credit	Savings Credit only	Total Pension Credit
2010	16%	15%	14%	44%
2020	12%	13%	16%	41%
2030	9%	10%	12%	31%
2040	6%	9%	12%	27%
2050	6%	10%	14%	29%

Source: Department for Work and Pensions

Projections of the proportion of pensioner households eligible for Pension Credit are sensitive to modelling assumptions and to projected changes in the distribution of pensioner incomes.

The estimates of proportions shown here are the mid-points of projections taken from two separate micro-simulation models. Modelling of the reform proposals does not include any increase in private saving from the introduction of personal accounts, which would further reduce the numbers eligible for Pension Credit.

Estimates are calibrated to the mid-points of the 2004/5 National Statistics range estimates of non-eligibility to Pension Credit, which adjust 2004/5 Family Resources Survey data to take account of possible biases in reporting. Although the estimates here are not presented as ranges, they are subject to a margin of uncertainty.

314. DWP acknowledges that it is "more challenging to reach those entitled to smaller amounts or to the Savings Credit only, who may be less familiar with the entitlement available to them." It points out that analysis derived from the Family Resources Survey indicates that "31% of those customers who fail to take up Savings Credit only would be entitled to less than £5 a week if they did so."

315. **The Committee notes that recent attempts to increase Pension Credit take-up have had limited success in terms of making progress against the PSA target. The Committee concludes that achieving and maintaining Pension Credit take-up levels of 80% in the future looks challenging, and asks the Government to set out its analysis of**

how take-up programmes and procedures for claiming all means-tested benefits to which pensioners may be entitled could be made more effective. In this context the Committee believes that the Government should not completely ignore the Pension Commission's recommendation of considering a residency test for older pensioners, and recommends that it remain an option when considering simplification of the system in the longer term.

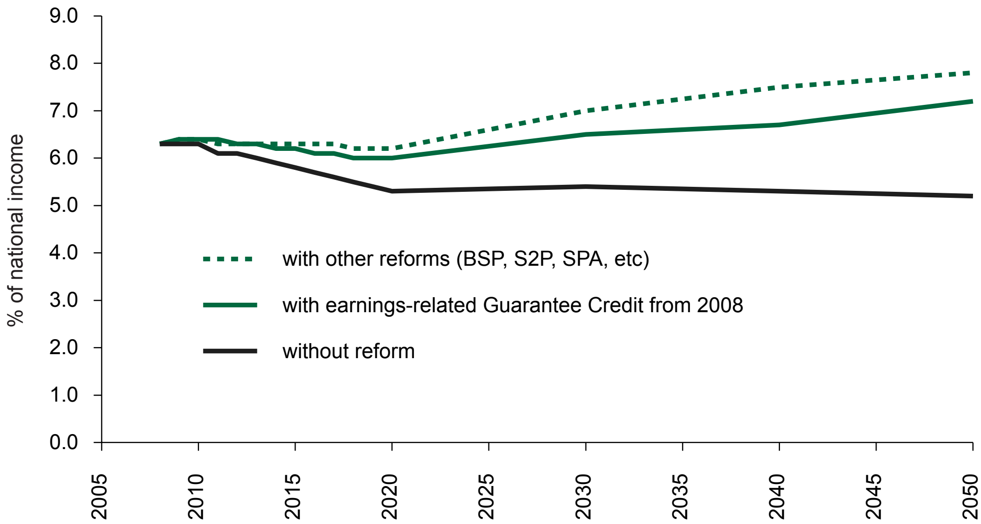
9 How much will this cost and where will the money come from?

Projected total state spending on pensioner benefits

316. The White Paper set out projected spending on pensions and on all pensioner benefits (which includes items such as housing benefit and council tax benefit) from 2008–09 through to 2050–51 under current policy, current policy with earnings indexation of the Pension Credit Guarantee, and under the White Paper proposals. The figures for spending on pensioner benefits as a share of national income are reproduced in Figure 2 (the White Paper also provides the costings in nominal terms, and in constant 2006–07 prices).

317. Figure 2 shows that, under current policy, spending on all pensioner benefits would decline from 6.3% of national income in 2008–09 to 5.2% of national income in 2050–51. Were the Pension Credit Guarantee to be indexed in line with average earnings – which would ensure that changes in the income of those lower-income pensioners receiving this benefit kept pace with those in paid-work – then state spending on all pensioner benefits would be projected to rise to 7.2% of national income by the middle of this century.

Figure 2: Projected costs of UK State Pension reform



Source: data drawn from White Paper, Volume 2, p 128

318. Under the White Paper proposals, and assuming that the Basic State Pension is indexed in line with average earnings from April 2012, total spending on all pensioner benefits is forecast by the DWP to be higher than it would otherwise have been throughout the forecast period, reaching 7.8% of national income in 2050–51. This shows the extent to which, on average, the package represents an increase in generosity of state spending on pensioners relative to that implied by current policy. The reductions in state spending resulting from the proposed increase in the State Pension Age, and the changes to the indexation of the State Second Pension and the Pension Credit Savings Credit, are not sufficient to offset fully the increases in spending implied by the earnings indexation of the Basic State Pension and the reforms to the contributory system. The Committee welcomes

the fact that the proposals set out in the White Paper would increase state support for pensioners relative to that implied by current policy.

319. To date the DWP has not published a breakdown of projected spending into each of its constituent parts. This would show the extent to which the proposals imply an increase (relative to current policy) in forecast spending on the Basic State Pension and the State Second Pension and a reduction in spending on means-tested elements such as the Pension Credit. **The Committee recommends that the DWP publishes a breakdown of its spending projections into forecast spending on the Basic State Pension, the State Second Pension and means-tested elements such as the Pension Credit and Housing Benefit. These figures should be inclusive of additional spending on the State Second Pension arising from the abolition of contracted out rebates for Defined Contribution schemes and the savings from the planned increases in the State Pension Age. The Committee also recommends that the DWP publishes separate estimates of the impact of its proposed reforms on (a) spending on working age benefits such as incapacity benefits arising from the increase in the State Pension Age; (b) Income Tax and National Insurance receipts from the increase in both taxable benefits and the State Pension Age and (c) National Insurance receipts from the abolition of contracting out for Defined Contribution schemes.**

The affordability question

320. One of the Government's five tests for pensions reform is affordability: "Any system needs to be affordable to taxpayers and the economy as a whole. As the nation ages there will be pressures to spend more on pensions, but also on related issues such as healthcare. The Government has an obligation to continue to manage public expenditure prudently and responsibly, and will not put the long term stability of public finances at risk."[412]

321. In his oral evidence the Secretary of State said:[413]

> "We have got to find a way of providing for affordability between now and 2020, but I think largely the increase in the matching of State Pension Age between men and women does that, it broadly funds the reform package, but we have got to find a way of funding it beyond, and in a way that does not involve the suggestion that taxes would have to rise to do it."

322. The DWP projections suggest that state spending on pensioners would, under the White Paper proposals, remain roughly constant as a share of national income between 2008–09 and 2020–21. As a result – at least over this period – the DWP forecasts imply that additional resources from higher borrowing, higher taxes, or lower spending in other areas, will not need to be identified to finance the proposed reformed system.

323. Over the period beyond 2020–21 the DWP projections imply that state spending on pensioner benefits would increase and therefore additional resources from higher borrowing, higher taxation or lower spending elsewhere would need to be identified. In

412 Ev 370

413 Q 358

evidence to the committee, prior to the publication of the White Paper, Professor David Miles, Managing Director and Chief UK Economist at Morgan Stanley and visiting Professor of Financial Economics, Imperial College, University of London, said "My understanding of the current Treasury, or Government, projections of spending is that overall public spending around about 40% of GDP now is projected to go up to 42% or 43%. Therefore, the overall tax take of the public sector will continue to rise from where it is now."[414]

324. The Final Report of the Pensions Commission stated that, with respect to the costing of their proposals for 2050–51, "this is not significantly higher than the expenditure suggested by the Long-Term Public Expenditure projections presented by HM Treasury in the Pre-Budget Report of December 2005, which suggest that expenditure [on pensioner benefits] will rise to 7.6% of GDP by 2050, but this would still carry significant implications either for tax or National Insurance contribution rates, or for other categories of public expenditure".[415]

325. The Final Report added that "It is now for the Government to bring forward proposals which balance the needs of pensions policy against other claims on public expenditure and against concerns about overall taxation levels at different points in the coming decades".[416]

326. **We note that DWP forecasts suggest that the White Paper proposals would pass the Government's affordability test over the period to 2020–21 and recommend that, in order to clarify the tax consequences of the proposals for the period beyond 2020–21, the Government publishes updated projections for total public spending as a share of national income that take into account the proposals set out in the White Paper.**

Projected per pensioner spending on pensioner benefits

327. Over the period from mid-2004 to 2050 the number of individuals aged 65 or over is projected by the Government Actuary's Department to increase from 9.7 million (or 16% of the overall population) to 17.5 million (or 25.3% of the overall population).[417] Were the level of state spending per pensioner relative to income in society not to decline over this period then, as set out in the White Paper, state spending on pensioner benefits "would need to rise from its current level of 6.3% of GDP to around 9.7% of GDP by 2050".[418]

328. In evidence to the Committee Alison O'Connell, Director of the Pensions Policy Institute, defined an appropriate range for public spending on pensions as follows:[419]

414 Q 5

415 Pensions Commission, Final Report, April 2006, p 15

416 Pensions Commission, Final Report, April 2006, p 16

417 Ev 369, para 30

418 White Paper, Annex D, para D.31

419 Q 5

"There are two extremes, really. One is that you keep the level of spending per pensioner constant and as the number of pensioners increases therefore that means a higher share of GDP; or you say, 'No, we're going to keep the share flat and we're going to raise the State Pension Age', in order to make sure that for a smaller number of pensioners they get the same spent on them, on average. The Pensions Commission proposal is essentially a middle way, so it raises State Pension Age a bit, to 67 or 68, and then it does not have to increase the share of GDP to what you would have to do in the absence of new changes to State Pension Age. From the numbers we have done on different scenarios and all the different definitions, and so on, I think we would say that the Pensions Commission got it about right. We would be looking at the higher end of their range rather than the lower end of the range, but I think general agreement would have it that somehow the percentage of GDP on pensions or pensioners has to go up in future".

329. The DWP projections suggest that total public spending on pensioner benefits would increase to 7.8% of GDP. While this is less than the 9.7% of GDP that would be required to keep the per pensioner generosity of state spending constant with an unchanged State Pension Age, the White Paper also proposes that by 2050–51 the State Pension Age be increased to 68 for both men and women. This would reduce the growth in the number of pensioners. As a result the White Paper argues that this will "sustain the generosity per pensioner of the State Pension", although actual figures verifying this have not yet been published.[420]

Contracted-out rebates

330. One possible source of additional revenue for the Government is from the abolition of contracted out rebates. Removing the contracted-out rebates would increase receipts of National Insurance contributions. It would also increase future state spending on the State Second Pension, since those brought back into the state scheme would accrue greater rights. The White Paper sets out both the increase in revenue, and the increase in state spending, as a result of abolishing contracting out for Defined Contribution pensions. This is shown in Table 5.

Table 5: State Second Pension and rebate savings due to the abolition of contracting out for Defined Contribution schemes, £ billion 2006–07 prices

	2012	2015	2020	2030	2040	2050
State Second Pension (£ billion)	+0.0	+0.0	+0.1	+1.3	+3.8	+5.4
Rebates (£ billion)	–4.0	–4.2	–4.3	–4.3	–4.3	–5.1

Source: Figure 3.viii of White Paper, Volume 2.

420 White Paper, para 3.35

331. There were differing views over the appropriate use of the increase in Government revenues that would arise from the change. Howard Reed, director of research at the IPPR, and Alison O'Connell, Director of the Pensions Policy Institute, both argued in favour of an increase in state support for current pensioners.[421] In contrast other witnesses, such as Adrian Waddingham (Association of Consulting Actuaries), Deborah Cooper (Actuarial Profession) and Professor David Miles (Managing Director and Chief UK Economist at Morgan Stanley and visiting Professor of Financial Economics, Imperial College, University of London) argued that it did not really free up new resources because of the increased liability arising in the future and stated that the most appropriate use of the additional revenue would be to run down Government debt. [422]

332. In its report on *The Future of UK Pensions* the then House of Commons Work and Pensions Committee stated that "Abolition of the contracting-out NI rebates [for both Defined Contribution and Defined Benefit schemes] would provide an immediate increase in NI revenue of around £10 billion (1.0% of GDP). But this would be at a cost of a near equivalent increase in the state pension bill for future generations of pensioners who would otherwise have contracted out and so cannot really be regarded as a method of financing an increase in state pension rights. The case for and against contracting-out needs to be considered separately from options for financing an increase in state pension rights".[423]

333. It is clear that it is not possible to spend the same resources twice: increased tax revenues from the abolition of NI rebates cannot be used to both increase state pensions of today's pensioners and finance the implied increase in future rights to the state second pension. However, as pointed out by Alison O'Connell, Director of the Pensions Policy Institute, "in all the projections of future state pension cost it has been taken into account that S2P will be run down, or whatever is happening to S2P, but nowhere is the fact that there is this short-term change in the contracted-out rebates taken into account."[424]

334. As a result some of the increase in state spending on pensioner benefits that was presented in Figure 2 will be due to the abolition of contracting out for Defined Contribution pension arrangements. This part of the increase in state spending could be financed from using the increased receipts of NI contributions (as suggested by Professor David Miles).

335. Figure 2 suggests that state spending on pensioner benefits would increase by 1.5% of national income between 2008–09 and 2050–51. Of this increase £5.4 billion (in 2006–07 prices from Table 5) is directly due to the abolition of contracting out for Defined Contribution schemes. This is equivalent to just under 0.2% of national income in 2050–51, which suggests that the remainder – 1.3% of national income - would need to be financed from increased borrowing, increased taxation or cuts in spending elsewhere.

421 Q 139 [Howard Reed] and Q 30 [Alison O'Connell]

422 Q 184 [Adrian Waddingham and Deborah Cooper] and Q 31 [Professor Miles]

423 Work and Pensions Committee, Third Report of Session 2002-03, The Future of UK Pensions, HC 92, para 156

424 Q 32

336. **The Committee believes that the Government should be explicit about how it intends to use the increased revenue arising from the abolition of contracting out for Defined Contribution schemes. In particular, if the revenue is not being used to reduce Government debt in order to part-finance the resources needed to implement the White Paper proposals over the longer-term then the Government should explain why it has deemed this course of action to be appropriate.**

Tax relief

337. The Pensions Commission's Second Report stated that "Pension tax relief is costly, poorly focussed and not well understood".[425] Much of the evidence received by the Committee supported this view, and argued that reform of tax relief would be desirable.[426]

338. The net cost of tax relief is estimated by the HM Revenue and Customs as being £12.3 billion per year, with a further £6.8 billion from employer relief on National Insurance Contributions.[427] The Pensions Commission also argued that "the calculation is complex and it is possible to argue that the figure is an overstatement since it fails to reflect fully the timing differences between tax relief given (on contributions) and tax imposed (on benefits). But it is clear that the cost is significant, as it must be since many people benefit."[428]

339. The evidence to the Committee suggested that there were two components of tax relief on pensions that could be better targeted: the tax-free lump sum and the relief given to individuals who are higher-rate taxpayers when they are making pension contributions and not higher-rate taxpayers when they receive their pension income.[429]

340. The Rt Hon Frank Field MP, Chairman of the Pensions Reform Group, argued: "I would also hope it would be something the Committee might consider in that if one looks at the tax concessions to pension savings, which overwhelmingly benefit the richest - we have something like 5% of the population gaining over half of all the tax revenue lost through tax concessions on pension savings - to allow all of that at the standard rate again would give us very substantial sums of money to play with."[430]

341. Philip Davis, Professor of Finance and Economics, Brunel Business School, said that in his view "I think the tax-free lump sum is an anomaly and I do not really think it is appropriate. In a sense, it is the Exchequer giving away money; it will otherwise get the tax back on the pension, instead it just gives it away. Furthermore, further to my earlier point, we are [not] annuitising the asset, so it is not being used for retirement income. I do not

425 Pensions Commission, Second Report, November 2005, p 312

426 See, for example: Ev 164, para 3.3; Ev 284; Ev 323, para 14; Ev 398, para 61

427 Figures for 2004–05. Source: Table 7.9 of HM Revenue and Customs Statistics (http://www.hmrc.gov.uk/stats/pensions/7_9_sep05.pdf).

428 Pensions Commission, Second Report, November 2005, p 312

429 Q 56 [Alison O'Connell]

430 Q 138

think, if we were inventing a pension system, we would invent a tax-free lump sum, at least not against the background of the argument that annuitisation is appropriate."[431]

342. The overwhelming consensus, and the view of the Pensions Commission, appeared to be that the resources currently allocated to tax-relief could be focussed better. Indeed, were additional resources required to finance the White Paper proposals (for example over the period beyond 2020–21) one possible source could be through reductions in the generosity of tax-relief for private pension saving.

343. **We recommend that the Government responds to the Pensions Commission view that "pensions tax relief is costly, poorly focussed and not well understood", highlights whether it believes the relief could be targeted better, and whether some of the resources devoted to tax relief might be used to finance the increases in state spending on pensioner benefits.**

431 Q 90

10 Increasing the State Pension Age

344. The State Pension age for women is already due to rise from 60 to 65 between 2010 and 2020. In the White Paper the Government proposes a rise from 65 to 66 for men and women over a two-year period from 2024, a rise from 66 to 67 over a two-year period from 2034 and a rise from 67 to 68 over a two-year period from 2044.[432]

345. The Pensions Commission had concluded that "State Pension Ages will in the long-term need to rise broadly with increases in life expectancy so that each generation spends a roughly similar proportion of adult life contributing to and receiving a state pension."[433] In its modelling it "assumed that the SPA rises after 2020, reaching 66 in 2030, 67 in 2040 and 68 in 2050."

346. The impact of the White Paper reform on people of different ages is set out below:

Table 6: Impact of White Paper on State Pension Age

Future eligibility for State Pension		
Age on 5 April 2006		Eligible for State Pension from
Women	Men	
56		60th birthday
51-55		Between 60th and 65th birthday
47-50	47 and older	65th birthday
46		Between 65th and 66th birthday
38-45		66th birthday
37		Between 66th and 67th birthday
29-36		67th birthday
28		Between 67th and 68th birthday
27 or younger		68th birthday

Source: White Paper, p 147

347. The Secretary of State explained that similar measures were being taken in "most other developed countries"[434], adding:[435]

> "I am absolutely convinced that it is inevitable and absolutely essential that the State Pension Age increases in the way that we have suggested in the White Paper, not

432 White Paper, para 3.34

433 Pensions Commission, Second Report, November 2005, p 130 and p 240

434 Q 358

435 Q 358

> only because that is fair between the generations because it is simply just matching the increase in longevity."

Finding consensus?

348. There is a good news story to be told: people are living longer. Richard Willets, from the Actuarial Profession, told us:[436]

> "at the moment mortality rates for people aged 65-plus are improving at a far faster rate than they have ever done in the past. In fact, if you take men aged in their 60s and 70s, the pace of change is about ten times as rapid as it was during the first seven decades of the 20th century, so we have seen a real step up in the pace of improvement. That has been driven primarily by huge reductions in heart disease mortality."

349. However, the raising of the State Pension Age to reflect this hoped for change is one of the most controversial aspects of pension reform and an area in which it is particularly difficult to reach consensus. The Government's proposals were greeted with headlines such as "Work 3 more years, get £3 pension rise"[437] and "Work till 68 for £3 a week; State Pension Shock for Millions."[438] It is a shame that this line was taken on these important proposals, and that a more balanced view was not presented.

350. At the beginning of the Government's National Pensions Day only 39% of those present agreed with the idea of a gradual increase in the State Pension Age (though this increased to 55% at the end of the day, once the reasons for the change had been put forward).[439] The National Pensioners' Convention told us that:[440]

> "there is no public support for this, the majority of people being hostile to the idea of being forced to work longer to fund their retirement […] today's poorer workers would end up working longer, drawing their pension for a shorter time and dying sooner."

351. The Government itself considered, but rejected, proposals to increase the State Pension Age in its 2002 Green Paper, *Simplicity, security and choice: working and saving in retirement*.[441] It argued at the time that:

> "An increase in State Pension Age would also reduce long-term public expenditure. However, it would disproportionately affect lower-income people who rely more on state benefits in retirement. The same people tend also to have lower life expectancies, and so, with fewer years in retirement, they would see a

436 Q 207

437 The Sun, May 26, 2006

438 Evening Standard, May 25 2006

439 Ev 365

440 Ev 139, para 4.3

441 Department for Work and Pensions, Simplicity, security and choice: Working and Saving for retirement, December 2002, Cm 5677, Chapter 6, para 49

disproportionate reduction in their income. The effect might be particularly severe on those who have done manual work for long periods in heavy industries, in which there is a record of low life expectancy."

352. Responding to that report, our predecessor Committee commended the Government's decision, but added the caveat that "we consider it prudent to keep this particular issue and active ageing generally under review."[442]

353. We received evidence from a number of witnesses in favour of a rise in the State Pension Age, such as the CBI.[443] The Pensions Policy Institute commented that the original proposal to raise the State Pension Age to 68 to 2050 looked "modest."[444] The Actuarial Profession noted:[445]

> "A potential conclusion is that the Commission was less aggressive than it might have been in framing its proposals for SPA. For example, if it had instead targeted holding fixed the post-retirement life expectancy across the UK as a whole, it would have suggested SPAs of 70 for males and 69 for females by 2050".

Concerns about raising the State Pension Age

Socio-economic inequalities

354. The TUC was opposed to any rise in the State Pension Age on the grounds that "differences in life expectancy mean that an across the board increase in the pension age would affect the poor the most."[446] This was echoed by some other unions who gave evidence to the Committee, for example the Royal College of Nursing,[447] the Public and Commercial Services Union[448] and the NASUWT.[449] Others opposed to the Pensions Commission proposal included the National Assembly of Women.[450]

355. The Independent Pensions Research Group Northern Pensions Resource Group commented that:[451]

> "The state pension is extremely important to the lower paid and women in particular whose labour market position is not strong. For those with assets and good private pensions, the state pension is almost irrelevant. Yet their labour market position is much stronger. Many older affluent professionals continue to work part time or as

442 Work and Pensions Committee, Third Report of Session 2002-03, The Future of UK Pensions, HC 92, para 155

443 Ev 356, paras 9-11

444 Ev 391, para 11

445 Ev 265

446 Ev 200, para 1.42

447 Ev 287, para 5

448 Ev 331, para 27

449 Ev 417, para 15

450 Ev 288, para 5

451 Ev 213 para 4.2

> consultants trading on their knowledge and experience. It would be immoral to force the poorer sections of the population to wait longer for their state pension just to save some tax for the richer".

356. Age Concern argued that:[452]

> "steps to increase State Pension Age beyond 65 should not be taken unless: it is part of a clear package of improved state provision; health inequalities are reducing; the least well off are protected and there is a programme of action to facilitate later working".

357. The Equal Opportunities Commission and Help the Aged were more positive, although with some caveats. The EOC stated that it had:[453]

> "no objection to the principle of raising SPA which is a rational response to increasing longevity in women and men. However, any increases in SPA need to be linked to the life expectancy of the lowest socio-economic groups"

358. Help the Aged was generally supportive of the Pensions Commission approach, describing it as "credible" and "proportionate",[454] and asking for health inequalities to be dealt with in their own right by a "dynamic and vigorous campaign". However, it was critical in a supplementary memorandum about the "accelerated" line taken by the Government in the White Paper.[455]

359. The Government is clearly aware that raising the State Pension Age will have a greater impact on those from lower socio-economic groups, and stated in the White Paper that "analysis of disparities in life expectancy between different social classes and the relative effects on different social groups of increases to the State Pension Age"[456] could form part of the "regular reviews" described in the first section of this report.

360. When giving evidence to us the Secretary of State said "I know […] increasing the State Pension Age is a concern for many people, particularly members of this House who represent communities that do not have the same life expectancy as others. I do not think there is a magic wand, however, for this problem."[457]

Demography and statistics

361. Annex D of the White Paper sets out the extent and impact of demographic and societal change in detail, including tables showing how life expectancy has changed over

452 Ev 317 para 2.22

453 Ev 129, para 56

454 Ev 166, para 6.1

455 Ev 168

456 White Paper, para 3.40

457 Q 358

time for all social classes. The DWP's memorandum to the inquiry set out the improvements that have already taken place across all social groups:[458]

> "Mortality rates between the ages of 60 and 69 for the generation born 1936-45 (current retirees) improved significantly from those experienced by the generation born 1896-1905. For Social Class I, mortality rates are down to just one-fifth of those faced by the turn-of-the-century generation; for Social Class V they are down to just two-fifths. During the period 1971-2001 men in Social Class I saw an improvement in life expectancy at 65 from 14.2 to 18.3 years, while those in Social Class V experienced an increase from 11.6 to 13.3 years".

362. However it was put to us that the differentials between groups were increasing. Richard Willets, Actuarial Profession, was clear on this point:[459]

> "The life expectancy of all socio-economic groups has improved quite substantially but it has improved, in relative terms, more for people in higher socio-economic class groups".

- And he added later:[460]

> "If you consider life expectancy for people who have reached age 65, what is their further life expectancy, which is the most important measure in terms of pension provision, there still are very significant differences of at least five years between professionals and unskilled workers, and it is that gap that is widening at age 65".

363. Carol Jagger, Professor of Epidemiology at the University of Leicester, explained that these differentials also extended to 'Healthy Life Expectancy', a measure based on self-rated health. She told the Committee:[461]

> "There is certainly very good evidence that the differentials in healthy life expectancy are greater than the differentials in life expectancy for the different socio-economic groups. Whether that is changing over time we do not have good data to show that".

364. Richard Willets warned the Committee, however, that there were also very wide variations within socio-economic groups which would, for example, make deriving a measure based on individual class very difficult:[462]

> "I think also it is tempting to think of people in different classes being quite similar in terms of their life expectancy but even within the different social class streams there

458 The memorandum includes the caveat that Data on social class are derived from the ONS Longitudinal Study.Since data on life expectancy from this study are computed using the period approach, they might underestimate life expectancies as they ignore projected future improvements in mortality. The causes of the differences in life expectancy across social groups are complex and are linked to people's social, economic and demographic circumstances such as education, occupational health and safety, type of occupation, housing, regional differences, lifestyle choices, material deprivation, and access to health services. Ev 366, para 5

459 Q 213

460 Q 218

461 Q 211

462 Q 231

> is a wide degree of heterogeneity, so for example if you took somebody in the professional classes who smoked and drank heavily and was overweight, they would probably have a shorter life expectancy than somebody in an unskilled occupation who did none of those things".

365. Kay Carberry, of the TUC, suggested that there should be a link between increasing the SPA and measures to make the labour market experience more conducive for older workers,[463] something we discuss in more detail in the next section of this report.

366. **The Government has taken a bold step in proposing an increase in the SPA, given the lack of public consensus on this point. We conclude that the increase is justifiable. However, like many of those who gave evidence to the inquiry, we have concerns about the uncertainty of the projections on which execution of the policy is based, and we also fear that the policy will have a disproportionate effect on those in lower socio-economic groups, manual workers and those with health difficulties. We are also concerned at the potential lack of re-training packages and flexible job opportunities for those over 55.**

Tackling health inequalities

367. The Secretary of State told us that:[464]

> "The Government has set out already some targets for tackling heath inequalities, which is the way that we have phrased it and the way that we would like to approach this problem, reducing variations in mortality between socio-economic groups, if there are already public service agreement targets to do that, and I think the Department of Health is making progress in that direction".

368. The Department of Health has a PSA target to "reduce health inequalities by 10% by 2010 as measured by infant mortality and life expectancy at birth." The PSA target is underpinned by two more detailed objectives:

- Starting with children under one year, by 2010 to reduce by at least 10% the gap in mortality between routine and manual groups and the population as a whole; and
- Starting with local authorities, by 2010 to reduce by at least 10% the gap between the fifth of areas with the lowest life expectancy at birth and the population as a whole.

369. The latest Department of Health Annual Report recorded a worrying lack of progress on the life expectancy target: "Data for 2002-2004 (three-year average) indicate that since the target baseline, the relative gap in life expectancy between England and the spearhead group has increased for both males and females, with a larger increase for females. For males, the relative gap increased by 1%, for females by 8%."[465]

463 Q 399

464 Q 358

465 Department of Health, Departmental Report 2006, May 2006, Cm 6814, p 17

370. The report added that there were "early signs of progress on some key disease areas and in some geographical areas" and also outlined priorities for future action:

- "The targets included in the Department's PSA will strengthen the levers for progress, especially the new inequalities elements of the cancer and heart disease mortality targets"; and

- "The Department's Health Inequalities Unit is currently working with PMDU and HMT on a review of the life expectancy element of the health inequalities PSA. This will include a detailed mapping of the delivery chain with the aim of improving our ability to achieve this element of the target. The review will result in a more defined and forward-looking delivery plan for health inequalities, and will influence our own review of the delivery of the infant mortality element of the target. A new Health Inequalities PSA Board is being established to drive delivery, using the review's recommendations as a platform for action."

371. **The raising of the State Pension Age must be associated with a vigorous pursuit of the health inequalities PSA target. It must not be the case that by the time the State Pension Age rises, health inequalities have further increased. In our view, the achievement of the health inequalities PSA target needs to be a condition of a rise in the SPA, at least for those rises timetabled for the 2030s and 2040s.**

Keeping the Guarantee Credit at the age of 65: a necessary safeguard?

372. The Pensions Commission acknowledged that a "one year increase in SPA has a bigger impact on people in the lower socio-economic groups than in the highest"[466] and considered in depth "whether any mechanisms [could] be created to mitigate the impact of a rising SPA on lower socio-economic groups."

373. One potential method which it identified "if there [was] no sign of the differences in life expectancy by socio-economic class reducing", was to keep "the earliest age of Guarantee Credit, at least initially, at 65 even as the SPA rises, and for thereafter keeping the earliest age of Guarantee Credit eligibility, say, two years below the SPA."[467]

374. This was originally a proposal from the Pensions Policy Institute.[468] Its memorandum stated that:

> "the PPI suggested keeping Guarantee Credit (GC) available a few years below State Pension Age. GC is available now at age 60, but the age of availability is expected to increase to 65 between 2010 and 2020 coincident with the increase in female State Pension Age."

375. Giving evidence to the Committee, Alison O'Connell (the PPI's Director) said that in her view this was the "most practical way of helping" those people in "lower socio-

466 Pensions Commission, Second Report, November 2005, p 338

467 Pensions Commission, Second Report, November 2005, p 340

468 Ev 391, para 11

economic groups having lower life expectancy or worse health outcomes [who were not] able to work right up to the State Pension Age."[469]

376. The Pensions Commission acknowledged that the measure could reduce incentives to work but noted that that would only be for, say, two years and would only be applicable at fairly low levels of income.[470]

377. The White Paper noted the proposal but left a final decision for a later stage:[471]

> "We think this is an issue that must be considered nearer the relevant time in the light of the available evidence about inequalities in life expectancy and trends in working among older people."

378. Replying to a question about the position of those in lower socio-economic groups after his statement to the House, the Secretary of State said:[472]

> "We are aware of the issue to which my hon. Friend draws attention. The State Pension Age will reach 68 in 40 years' time and I am confident that his constituency and others will have a matching rise in longevity to meet that. The Turner commission suggested that we consider the issue of when Pension Credit becomes available, and the White Paper makes it clear that we are doing so, because that proposal might go some way towards addressing the concerns of my hon. Friend and others".

379. **Keeping at 65 the age at which Guarantee Credit could be claimed could mitigate some of the impact of increasing the State Pension Age. However, we note the Pensions Commission's view that it could create disincentives to work. We agree with the Government that the decision on whether or not to increase the earliest age at which individuals can qualify for the Pension Credit in line with the State Pension Age should be made nearer the time when SPA may be raised, in light of evidence on both socio-economic differences in life expectancy and differences in labour market opportunities at older ages.**

Uncertainty and the need for more research

380. The evidence we received pointed clearly to the fact that predictions of life expectancy themselves come with a health warning. The DWP's memorandum referred to projections of future trends in life expectancy as being "notoriously difficult to make."[473]

381. Richard Willets of the Actuarial Profession told the Committee:[474]

469 Q 4

470 Pensions Commission, Second Report, November 2005, p 340

471 White Paper, para 3.42

472 HC Deb, 25 May 2006, col 1666

473 Ev 366, para 8

474 Q 229

> "One of the key learning points for the actuarial profession and for demographers and statisticians looking at trends over recent years is that life expectancy improvements are not certain; they are subject to a great deal of uncertainty […] I think the Pensions Commission report probably downplays a little bit of the uncertainty around the life expectancy of people retiring now at age 65. There is more uncertainty about their potential lifespan than is suggested in the report and going out to 2050 there are a huge number of factors […] that could influence life expectancy".

382. The National Heart Forum expressed concern that life expectancy could go down as well as up:[475]

> "We are witnessing an unprecedented change in the wellbeing and life chances of young people consequent upon systematic changes in lifestyle. These cannot have effects on mortality rates in the short term but are very likely to do so in the longer term, given what we already know about the epidemiology of many diseases . These changes are therefore not predictable from current trends in mortality and current health status of the workforce".

383. While, therefore, some witnesses such as PPI praised the decision to announce planned rises in the SPA up to 2044 because it gave people a decent notice period, others, such as Help the Aged, were critical.[476] The Pensions Commissioners stated that:[477]

> "The detailed implementation of this principle [that the SPA should rise over time to keep roughly stable the proportion of adult life spent receiving a state pension] should reflect future trends in life expectancy […] beyond the initial increase in SPA to 66 we believe that flexibility should be preserved to adjust the timing of subsequent increases in the light of latest life expectancy forecasts which may change over time."

384. **We conclude that the uncertainty around future life expectancy is a powerful argument for the regularly commissioned reviews described in the first section of this report.**

385. While some uncertainty around these figures is inevitable, the lack of clarity means that a clear case can be made for additional research. The National Heart Forum[478] made the case for "better understanding and better epidemiological modelling" to predict changes arising from new lifestyles. Professor Carol Jagger argued that there was a need for more research on differences in healthy life expectancy among different ethnic groups[479] and Richard Willets commented that there was a need for more "research into linking

475 Ev 253, para 4.1

476 See para 358

477 "The Pensions Commissioners welcome White Paper", Pensions Commission press release, 25 May 2006

478 Ev 253, para 4.1

479 Q 217

work on the aging process with projections of life expectancy and healthy life expectancy."[480] The Pensions Policy Institute told the Committee:[481]

> "A more detailed epidemiological model, working 'bottom up' from each cause of death would be required to increase our understanding of future likely trends. Further research on the 'bottom up' approach should be supported. Such a model would help to predict whether it is likely that future life expectancy improvements would be slower than those seen to date, or whether life expectancy would actually start to decline on average or for some groups (although a decline in life expectancy has hardly been seen in the developed world)."

386. The House of Lords Science and Technology Committee conducted a detailed and thorough inquiry on the Scientific Aspects of Ageing in 2005.[482] The Committee was highly critical of the lack of strategic co-ordination of ageing research, and made a number of specific recommendations to improve matters, following these up in a further report when it was unhappy with the Government's response.[483]

387. In a recent debate in the House of Lords on this follow-up report, the DWP Parliamentary Under-Secretary of State, Lord Hunt of King's Heath, made a number of commitments relating to future research into ageing. He told the House that:

- The Government was "considering the role of an observatory on ageing to make best use of existing research and support the policy-making."
- The Government would re-examine research council priorities in relation to budgets, expenditure and policy programmes in the spending review, and "use the Coordination of Research and Analysis Group and the longitudinal studies advisory group to improve research co-ordination and prevent duplication and overlap"
- The Government intended to monitor closely the performance of the Funder's Forum for Research on Ageing and Older People [a body which was set up to extend the existing collaboration between the four research councils, six major charities and the Department of Health] and take action if it was "deemed not to be delivering".[484]

388. Specifically on the issue of life expectancy and healthy life expectancy he told the House that there was "no expert consensus about how the trend in healthy life expectancy will develop" and noted:

> "There is clearly a continuing debate about how best to measure health-life expectancy. There are two key measures; health-life expectancy and disability-free life expectancy, and I guess there are pros and cons of each approach. This is clearly

480 Q 227

481 Ev 391, para 12

482 House of Lords Science and Technology Committee, First Report of Session 2005-06, Ageing: Scientific Aspects, HL (2005-06) 20, para 8.98

483 House of Lords Science and Technology Committee, Sixth Report of Session 2005- 06, Ageing: Scientific Aspects, Follow up, HL (2005-06) 146

484 HL Deb, 5 June 2006, col GC 322

quite complex territory. I accept that the challenge to the Government is to enable this to be pursued with care and speed. We will explore whether it is possible to develop harmonised measures of health-life expectancy with the World Health Organisation and other international organisations. We will also look to progress the committee's recommendation that ONS undertakes further work on the relative merits of different measures. We will continue to support research to understand trends and causes".

389. The White Paper referred to the evidence on healthy life expectancy as "incomplete".[485]

390. **We ask the Government to set out the principal research programmes currently underway on ageing, life expectancy and healthy life expectancy, including work on differentials by social class and ethnic group, and their budgets for the next ten years. Improved co-ordination of research into ageing will also be vital to inform policy makers about future life expectancy and healthy life expectancy. We welcome the Government's commitments made recently in the House of Lords on these issues.**

Unforeseen consequences?

391. The Committee was warned that there could be unforeseen social consequences of the rise in State Pension Age on caring and voluntary work. The National Pensioners Convention noted:[486]

> "The unpaid caring and voluntary work undertaken by retired people that currently saves the Exchequer an estimated £24.2bn a year."

392. And they added:[487]

> "Raising the State Pension Age would also bear hardest on disadvantaged sections of the workforce and would reinforce the difficulties of women in their 60s with caring responsibilities for parents or grandchildren".

393. This was also a point made by Professor Carol Jagger:[488]

> "The fastest-growing section of the population is those aged 85 and over and the main carers of that section of the population are women. Given the mean age at first birth you are going to have women of 60 caring for their elderly parents (and it is potentially parents now as well). So if you are raising the pension age then those women are potentially still in work and doing a fairly major caring role too."

485 White Paper, para 3.41

486 Ev 139, para 4.2

487 Ev 139, para 4.3

488 Q 233

State pension deferral

394. The Pensions Commission suggested that State Pension deferral could be beneficial to people on lower incomes who wanted to continue to work, by allowing them to draw part of their pension while deferring the rest. The Commission's Report stated that part of "ensuring good financial incentives for later retirement" could come from greater flexibility around the taking of the BSP and S2P and concluded:[489]

> "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."

395. Responding to this point, the White Paper noted the additional flexibility for state pension and occupational pension deferral which had already been introduced:[490]

> "In April last year, more generous options for delaying taking the State Pension began, including for the first time the option of taking a lump sum. An individual who delays claiming their State Pension of £84.25 a week for two years could now get about £17.50 extra per week when they do claim, or they could receive a one-off taxable lump sum of around £9,300 plus their £84.25 a week pension. In April this year, we introduced changes to the rules of occupational pensions for those wishing to work more flexibly in the transition to retirement, so that (where schemes allow it) people can draw part of their pension while continuing to work for the same employer".

396. The DWP memorandum expanded on this explanation:[491]

> "People have always had the option of deferring claiming their State Pension at State Pension Age in return for a higher pension when they do claim. The 2004 Pensions Act provided for more attractive deferral options from April 2005. The rate of increment has risen to around 10.4% (from 7.5%) for every year a person defers. In addition, for the first time there is the option of a lump sum instead of a weekly increase where people defer claiming for 12 months or longer. The previous five-year limit on deferral has also been removed".

397. The White Paper concluded that the Government was "keen to see how the changes introduced last year to make State Pension deferral more generous will increase the

489 Pensions Commission, Second Report, November 2005, p 23

490 White Paper, para 4.15

491 Ev 367, para 13

numbers of people working and deferring, and will be undertaking research on this in due course."[492] It continued:

> "We will consider how State Pension deferral might in the future offer greater flexibility, both in terms of the amount drawn and deferred, and in terms of allowing people more flexibility to move in and out of work after State Pension Age. This second flexibility would mean offering people the chance to draw their pension when they need the income and defer it again when they can support themselves through work. However, this would increase complexity and will need careful consideration once research findings are available."

398. When asked about state pension deferral, Mervyn Kohler from Help the Aged told the Committee that "I think there is room for much more promotion than we have seen so far."[493] Research conducted by Norwich Union, and quoted in its memorandum, appeared to bear this out:

- 78% of respondents were unaware of the financial benefits to delay retirement available through the DWP State Pension deferral scheme; and
- Once it was explained, 60% of people were influenced by the financial incentives on offer, and would choose to delay their retirement by a year if they were to receive the extra 10% per week throughout their retirement.

399. Citizens Advice expressed some concerns that this option would be "likely only to be attractive to people on middle incomes, who can afford to forego their state pension in anticipation that they will be able to continue to work for at least a further five years" and added "We might also suggest that any publicity for the state pension deferral come with a free crystal ball."[494]

400. The National Association of Pension Funds made a slightly different suggestion:[495]

> "As we argued in our response to the Commission's First Report, we believe that the current system for state pension deferral is the wrong way around. Behavioural economics suggests that, even if the sums of money involved were identical, people would be more likely to retire later if a bigger pension from a later age was the norm, with an option to take a smaller pension sooner."

401. **We welcome the measures already taken by Government to provide more flexibility to people about the form in which they take their state pension. We also welcome the Government's decision to review the rules for state pension deferral with a view to, possibly, making the system more flexible. In our view this would be a sensible measure which would increase the options available to those nearing retirement. We recommend that the Government sets out its timetable for this review.**

492 White Paper, para 4.32

493 Q 127

494 Ev 259, para 4.13

495 Ev 305, para 66

11 Working longer

402. It is important to draw the distinction between retirement age and pension age. As well as proposing in the White Paper to increase the State Pension Age, the Government noted that it planned "to take measures to support longer working, as set out in the publication *A new deal for welfare: Empowering people to work*, and consider greater flexibility around, and communication of, State Pension deferral."

403. Recent work by the OECD suggested that there were three key barriers to working at an older age:[496]

- Financial disincentives (public pension rules, formal and formal early retirement schemes and few options for phased retirement)
- Employer barriers (negative attitudes, high labour costs and strict job protection rules); and
- Weak employability (obsolete skills, inadequate help for older jobseekers and unsuitable work conditions and poor health).

404. Chapter 4 of the White Paper sets out measures to "extend working life in an ageing society." It refers to the Government's aim to increase the number of older workers by 1 million,[497] the New Deal 50 plus and the recent Age Positive campaign.[498] New legislation comes into force on 1 October 2006 which will make discrimination on the basis of age unlawful in employment and training, and compulsory retirement below the age of 65 will be illegal unless it can be objectively justified. Furthermore, employers will have a duty to formally consider requests from individuals to work beyond 65.[499] The Government has also undertaken to consider in 2011 whether to abolish the default retirement age.[500]

405. The Government set out in its Green Paper on Welfare Reform that there were "a number of specific steps we will take to ensure that messages are communicated consistently to the over-50s, to help them understand the options available to them."[501]

406. In a supplementary memorandum submitted after the White Paper was published, Help the Aged, however, warned that there was:[502]

496 Presentation by Mark Keese, Employment, Labour and Social Affairs, OECD to a High-level OECD Parliamentary seminar on the "Policy Implications of ageing populations", 23 February 2006, based on an OECD publication, Live Longer, Work Longer, available at http://www.oecd.org/document/42/0,2340,en_2649_34747_36104426_1_1_1_1,00.html

497 White Paper, para 4.5

498 White Paper, para 4.11

499 Ev 367, para 14

500 White Paper, para 4.13

501 Department for Work and Pensions, A new deal for welfare: empowering people to work, Cm 6730, January 2006

502 Ev 167

> "a sense of suspended reality in the way in which economists and academics factor in an extension of working lives in order to make the pensions arithmetic look more palatable, but […] precious little action on the ground to support this paper exercise. The Leitch Review is already showing how badly older workers fare as far as training"

407. Citizens Advice quoted research that "one in four people aged 50 to 69 has experienced age discrimination when working or looking for work."[503]

408. The lack of training available for older workers was particularly criticised, with Mervyn Kohler from Help the Aged expressing the problem in strong terms: "There are damn few training opportunities for people over the age of about 40."[504] The CBI took a different view:[505]

> "most important of all is the role played by employees themselves. The Government and unions have to do more to motivate older workers to retrain and take advantage of the training opportunities that come their way".

409. The Equal Opportunities Commission told us:[506]

> "Our research report, 'Older workers and options for flexible work', last year revealed that up to one million older workers want to return to work. However, too many are being prevented from remaining in or returning to the workforce because of a lack of flexible working arrangements, such as flexitime or job sharing. Less than one in six older (50+) men and only one in four older women are currently employed on a flexible working arrangement. This increases the burden of social security payments for taxpayers and exacerbates the UK's skills shortage".

410. Getting more older people into work will be necessary both for pensions reform to be successful and for the achievement of the Government's aspiration to reach an 80% employment rate. However, as alluded to in the evidence we received, achieving this aim will be a considerable challenge.

411. **Partly because of this complexity, and the importance of older workers, the Committee has decided to conduct an inquiry in the autumn into the Government's employment strategy and will include as part of that a detailed study of this aspect of labour market policy. We will therefore return to the matter later this year.**

Public sector pensions

412. The vexed issue of public sector pensions was brought up by a number of witnesses during our inquiry. For example Adrian Waddingham, from the Association of Consulting Actuaries, told us "I think there will be political resentment in future if we do

503 Ev 298, para 4.9

504 Q 123

505 Ev 363, para 73

506 Ev 129, para 58

have the “them” in the public sector and the “us” in the private sector with this huge disparity.”[507]

413. On the other hand, Kay Carberry from the TUC took the view that this was about keeping promises[508] and that the main agreement reached was “exactly the same as what is happening in a lot of private sector occupational schemes.” Lord Turner, giving evidence to us in December, took the view that it was “perfectly reasonable” to have salary related pensions in the public sector, as long as there was a “process of continual adjustment so that as life expectancy goes up the generosity and cost of public sector pensions is kept reasonably stable.”[509]

414. The Rt Hon Frank Field MP told the Committee:[510]

> “I do think one of the areas the Government will have to attend to after it has done its White Paper is to seriously begin a review about public sector pensions and their financing, the different ways that they are financed and the impact on taxation and council taxation as well. I also think that in that review our own pensions, as part of the public sector, have to be put into the equation, and one of the questions voters will want answered is that certainly in the past the public sector rightly got what was thought to be more generous pensions because they had a worse pay deal. Is that currently true, has relative pay in the public sector caught up or in some instances advanced over the private sector? If that is so then it seems reasonable one looks at the other side of the equation as well. Given this is an area where people’s prejudices can be paraded about quite easily, it would be very, very useful for the Government to start collecting the data so that we can have an informed discussion rather than merely shuffling our prejudices”.

415. The DWP memorandum set out the situation from April 2006:[511]

> “The earliest age from which a pension can be taken will be raised from 50 to 55 by 2010. This applies to all non-state pensions. The normal pension age for members of public sector pension schemes will increase from 60 to 65, initially for new members only.”

416. Responding to questions after his statement to the House in May, the Secretary of State said “let me remind the hon. Gentleman and the House that several negotiations are taking place now, scheme by scheme, to change the terms of those [public sector] schemes. It is right to change those terms, and the negotiations will continue.”[512]

417. He expanded on these points when he gave evidence to the Committee:[513]

507 Q 183

508 Q 404

509 Oral evidence taken before the Work and Pensions Committee on 14 December 2005, HC (2005-06) 618, Q 20

510 Q134

511 Ev 367, para 14

512 HC Deb, 25 May 2006, col 1657

513 Q 359

> "We are not going to change our position on that. […] We have negotiated change to the public sector pension schemes and they are going to save the taxpayer significant amounts of money over the next few decades, but, fundamentally, people tend to confuse two quite different things here. In relation to the public sector, we are talking about the normal pensionable age in those schemes going up from 60 to 65, and for existing workers they will stay at 60 where that is the existing age - they will stay at whatever their existing age for the NPA is for those schemes […] They overlook the fact that, if, for example, you take the Civil Service, there is a huge amount of change and churn in employment in the Civil Service. I think last year it changed by about 10%. So, by the time we get to 2026, when the first increase in the State Pension Age takes place, there will be, I think, only a minority of people in the Civil Service who can still retire at 60, and by the time we get to the end of the process of increasing the State Pension Age, I think it will only be 3% of civil servants who will still have an entitlement to retire at the age of 60".

418. **We agree with the point made by the Rt Hon Frank Field MP that informed discussion, rather than "merely shuffling our prejudices" is necessary for a debate on the future level and terms of public sector pensions. We recommend that the Government commission an independent review, which includes involvement from both the private and public sectors, about the future terms, benefits and financing of these schemes.**

12 Public engagement with pensions: information, education, advice

419. Professor Nicholas Barr, London School of Economics, argued that an area in which the Commission might have done more was "public education" to help people understand what the issues are in pension reform.[514] At an individual level, people need to be equipped to take appropriate decisions. The DWP noted that "more than half the UK population have a self-reported knowledge of pensions that is patchy or amounts to little or nothing."[515]

420. David Miles, Managing Director and Chief UK Economist at Morgan Stanley and visiting Professor of Financial Economics, Imperial College, University of London, expressed some optimism about what could be achieved, pointing to experience of an initiative on the Financial Services Authority's website called "Mortgages Laid Bare":[516]

> "which tries to cut through most of the jargon and give people the kind of information that they need to make decisions about mortgages. The number of people who have hit this website is astonishing […] I am more optimistic about the ability of a concerted effort by the public sector - and I think of the FSA as part of the public sector- to improve financial literacy in the UK."

421. Others, while arguing that there was potential to do more in this area, also cautioned against over-optimistic expectations. Alison O'Connell, Director of the Pensions Policy Institute, said:[517]

> "There is room to do a lot better, in terms of giving individuals more information and helping them to make financial decisions in a more informed way, but it is very difficult to find evidence that spending a lot more on financial education will lead to better decisions. In other words, people will always make what appears to be the economically irrational decision because financial decisions are made for a whole host of psychological and seemingly irrational reasons. While improving financial education would clearly be a good thing, it is very difficult to say how far actually that would improve outcomes."

422. This sense of the limitations of information and financial education was one of the reasons some witnesses gave for pressing for simple pension solutions. Professor Nicholas Barr said he thought that "having something which is fairly easily explained to people is helpful to public policy [...] the simpler the saving schemes the easier it is for them to act in ways that are rational and in their own self-interest."[518]

514 Q 59

515 Pensions Commission, Second Report, November 2005, Appendix D, p 115

516 Q 3

517 Q 3

518 Q 87

423. He, along with others, supported the introduction of mechanisms, such as auto-enrolment which created "a very strong steer" and nudged "people who are not well informed to do what experts think they ought to do and what, deep down, most of them know they ought to do."[519] He suggested that there were risks on relying too heavily on people acting on information and making "rational" decisions. The choice given in the Swedish system to retire early on a lower pension, for example, could be "pushing rationality a step too far".[520]

424. The White Paper's approach to state pension reform was described by a number of witnesses as relatively complex. In addition, it was argued that high expectations are placed on the success of the new system of personal accounts, with people needing to participate in order to achieve adequate retirement incomes in the future. While auto-enrolment would 'nudge' people towards participation, it would still leave them with "complex and important decisions" to take[521] (see para 60).

425. The package of proposals as a whole, therefore, will create new challenges in equipping individuals to make appropriate decisions. They will need:

- accurate information about what they can expect from the state in the future (see para 236);
- to be able to make confident and informed decisions with respect to the new system of personal accounts – whether to opt in and how much to contribute (see paras 54 and 84).
- to understand the level of investment risk involved in Defined Contribution schemes (including the new personal accounts). (see para 128).

426. Teresa Perchard of Citizens Advice argued that:[522]

> "By moving to perhaps a simpler system but taking 20 or 20-plus years over it actually generates a greater need for consumer information and advice throughout that process, and would need to be targeted to people in different circumstances, age, income and other things they might want to spend their money on. That is a really complex area of this which is probably understated in the White Paper and certainly will not be resolved through leaflets and whether they are in orange envelopes or not, and will require really a quite sophisticated strategy to ensure everybody gets the information they need to make the choices that would affect them, depending on their age and their income".

427. The package of reforms proposed by the White Paper will create various substantial new information, education and advice needs, which we deal with in turn below.

519 Q 74

520 Q 68

521 Ev 273, para 15

522 Q 505

Information: forecasts and DWP publications

428. The first building block of information people need when planning for retirement is what they will get when they retire if they carry on as they are doing. Giving people clear, simple pensions forecasts is therefore crucial.

429. When the Committee visited Sweden we were shown the annual statement for public and premium pensions that is sent out there.[523] The statement is known by the striking orange envelope in which it is sent out. As well as giving the current monetary values of the funded and non-funded elements of the Swedish state pension, there is a forecast of pension entitlement at the ages of 61, 65 and 70. No information is included about occupational or private provision, although there is a website[524] which enables combined forecasts to be requested.

430. The Department for Work and Pensions has a PSA target, by 2007-08, to issue 15.4 million individuals with a pension forecast "regularly".[525] There are currently four types of targets: Combined Pensions Forecasts (CPFs), Automatic Pension Forecasts (APFs), Individual Pension Forecasts (IPFs) and Real Time Pension Forecasts (RTPFs).

431. Combined Pension Forecasting is a service provided by DWP which means that pension scheme members or employees can see forecasts of both their State Pension and private pension together. It was launched in October 2001 following successful exercises working with private- and public-sector employers and pension providers. These showed that 98% of scheme members and employees who gave feedback about the combined pension forecast exercise said they found the forecast useful.[526]

432. Under the scheme the Pension Service provides the pension provider with details of the current State Pension that the scheme member or employee has built up at the time of the forecast; and a projected State Pension that has been worked out up to State Pension Age. The provider then includes this information in the stakeholder, occupational or personal statements sent out to scheme members or employees.

433. In a written answer in February 2003 the then Minister noted that "State Pension forecasts have been issued to individuals by DWP on request for a number of years. The Department expects to issue around 0.75 million such forecasts in this financial year. The Green Paper also announced that from May 2003, the Department will commence the automatic issue of State Pension forecasts and supporting information to the self-employed with a view to extending this service across the rest of the working-age population over the next five years. We will evaluate the self-employed exercise and alongside other research this will inform the sequencing and volumes of other automatic forecasts."[527] The then Secretary of State reported in June 2004 that "Next year we will send automatic State Pension forecasts to 8 million people, with the aim of reaching out to all parts of society,

523 Ev 432

524 www.minpension.se

525 Department for Work and Pensions, Departmental Report 2006, May 2006, Cm 6829, p 63

526 http://www.thepensionservice.gov.uk/pdf/cpf/cpf2jun05.pdf (Pensions Service guide to Combined Pensions Forecasts)

527 HC Deb 26 February 2003, col 605W

especially those who do not have a workplace pension."[528] The Real-Time Pensions forecast service is available on the Internet and was introduced in autumn 2004.

434. The Department has stated that it is on course to meet its target, as between April 2005 and the end of March 2006, a total of 12,279,266 individuals were issued with "at least one" of the four forecast types.[529]

435. Teresa Perchard, from Citizens Advice, described the introduction of Combined Pensions Forecasts by DWP as "an amazing initiative" but stressed that the provision of information needed to be more consistent:[530]

> "Obviously, some people are not getting combined pension forecasts yet. I have had only my state one; perhaps I am not yet in the danger zone for anything else, or cannot be found anywhere else. That is important, to stabilise it, so that people who are advising individuals know what to expect as well, that there is not a wide variety of different presentations being distributed to individuals. That will be important for the front line in the Pension Service, DWP, too, because its staff need to know, the fewer variants on their communications the better for quality of information and advice, usually."

436. DWP officials have recently visited Sweden and the Secretary of State assured us that the Government was seeking to raise its game and implement what it had learned there:[531]

> "We have looked at that and there is a lot of attraction to that. There is more work that we need to do, and the pensions service themselves are gearing up to do that, to be pro-active in terms of pension forecasting, to make them more regular. The system has got better in recent years but this is an area where we will be looking to improve the service we provide to the public."

437. As noted in our predecessor Committee's report on Pension Credit, the Pension Service currently faces a significant challenge in making substantial reductions in staffing levels as part of the 'efficiency' agenda.[532] In evidence to the current inquiry, the Public and Commercial Services Union pointed to problems of staff morale and rising caseloads.[533] The Pension Service's capacity to meet the new challenges posed by the White Paper reforms is an issue to which the Committee may wish to return.

438. **We think that there is scope to improve the format and the regularity with which the Pensions Service provides pensions forecasts and strongly believe that accurate Combined Pension Forecasting will be a key motivator for increasing retirement saving. While the Swedish orange envelope is not the complete solution to the**

528 Speech by the then Secretary of State for Work and Pensions, the Rt Hon Andrew Smith MP, 29 June 2004, at the Pension Information Pack launch, available at http://www.dwp.gov.uk/aboutus/2004/29_06_04_pensinfo.asp

529 Department for Work and Pensions, Departmental Report 2006, May 2006, Cm 6829, p 63

530 Q 512

531 Q252

532 Work and Pensions Committee, Third Report of Session 2004-05, Pension Credit, HC 43-I

533 Ev 336, para 79

problem, as it does not include information about private or occupational provision, it has two key advantages of being distinctive and simple and should be the starting point for reform.

Availability of DWP leaflets

439. The DWP produces leaflets and publications, as well as its website, to assist people with making pensions decisions. The National Audit Office recently produced a report that was critical of the number and readability of DWP leaflets. One of its conclusions was that leaflets aimed at pensioners and disabled people were the most difficult to obtain. Availability was tested at 100 Departmental outlets, as well as 100 other sites where customers might seek information, such as libraries.[534] The Report concluded that: “the need to convey often complex information in accessible formats is a constant challenge for the Department, on the one hand ensuring that information is complete and accurate, but on the other, that often complex information is concise and accessible.”[535]

440. Giving evidence to the Public Accounts Committee in June, Leigh Lewis, the Permanent Secretary of the Department, said that “every single one of our leaflets should have [Plain English Campaign] crystal mark accreditation”[536] While not disagreeing with the NAO’s comments about the difficulties of getting hold of leaflets aimed at pensioners and disabled people,[537] he said that he was “hugely proud” of the pensions guide, which includes details of all government services relevant to pensioners.[538] He added that the DWP:[539]

> “had now taken a very clear decision that every single one of our Jobcentre Plus offices - that is some 800 nation wide - will now stock a basic leaflet on pension credit.”

441. Matthew Nicholas, Acting Director for External Relations and Communications, Jobcentre Plus, explained later during the same session that more was being done to ensure that Jobcentre Plus was stocking leaflets on pensions:[540]

> “When the National Audit Office did the work we were at an early stage of having clear standards for displaying leaflets. Since then, we have gone back to check every one of our offices, not just the ones that the NAO visited, to make sure that a full set of leaflets is there and on display. We have extended that list to some of the key

534 National Audit Office, *Department for Work and Pensions: Using leaflets to communicate with the public about services and entitlements,* HC (2005-06) 797, para 18

535 National Audit Office, Department for Work and Pensions: Using leaflets to communicate with the public about services and entitlements, HC (2005-06) 797, para 5

536 Uncorrected transcript of oral evidence taken before the Public Accounts Committee on 7 June 2006, HC (2005-06) 1202-I, Q6

537 As above, Q36

538 As above, Q32

539 As above, Q36

540 As above, Q41

> leaflets for people interested in pensions, for example, and we are going to review that at least every six months to make sure that clarity is there."

442. **We were concerned to learn from a recent NAO study that some leaflets relating to pensions were not available at DWP sites and were difficult to obtain elsewhere. We welcome the assurance given to the Public Accounts Committee that from now on "key leaflets" relating to pensions will be displayed in every Jobcentre Plus outlet.**

Building financial capability - access to advice

443. The Resolution Foundation argued that:[541]

> "Pensions decisions are among the most complex and vital of those choices and reform, although much needed, has the potential to add a further layer of complexity. The evidence from the Financial Service Authority's 'baseline' survey into financial capability suggests that the vast majority of people in the UK are capable of exercising the basic financial skills needed to make ends meet and keep track of their money. However, the survey also shows that significant numbers of people are unable to plan their finances effectively or, critically, choose the right products."

444. Citizens Advice expressed disappointment that there was "not more emphasis on information, advice and financial capability in the Pension Commission's report."[542] Citizens Advice supported the Financial Services Authority's initiative to establish a Financial Capability Strategy for the UK and said that "so far it is not clear to us how much consumers who are financially excluded are properly encompassed in that strategy. Activities to address financial capability of adults are likely to involve significant resources."[543]

445. Financial education would form part of any financial capability strategy. The Secretary of State argued that this was important:[544]

> "On the day we published the White Paper, the Prime Minister and I went to the City to visit Merrill Lynch who, as part of their corporate responsibility agenda, which is very impressive, sent some of their people out into the local schools in the East End of the capital to talk to young children, 13 plus, about money and saving. It was very, very interesting to hear the messages that these young people had picked up. They wanted to save for Gucci handbags, which is fine and I have no particular problem with that, but they were beginning to understand the language of saving and putting money aside. That is so important because it underpins a lot of what we are trying to in the White Paper. "

541 Ev 272, para 6-7

542 Ev 263, para 8.1

543 Ev 264, para 8.16

544 Q 253

446. The Pensions Policy Institute suggested there were useful lessons to be learned from the experience in New Zealand, where the Retirement Commission and 'Sorted' website - "well-established sources of information and guidance on making financial decisions" - were to be enhanced with:[545]

> "financial education 'champions' in the workplace widening the reach of such guidance where it is needed because of the workplace-based context of KiwiSaver. The UK has no such unique source of unbiased help. Introducing a similar body offering information, education and tools to help make decisions on financial matters – not just connected with the NPSS, but also covering issues such as debt management and all forms of saving - seems not only essential if an NPSS-style product is introduced, but if done well is also likely to be popular."

447. Both Citizens Advice and the Resolution Foundation, however, agued that financial education and information would not be enough on their own. "People also need advice, accompanied by appropriate external prompts to help them make decisions."[546]

448. The Resolution Foundation argued that the lack of financial advice for some 12 million people on medium to low incomes results in "poor financial decision-making, often at a significant cost to the individual and the State."[547] It argued that it was essential that "generic, non-regulated advice is made available to assist" the target group for the new system of personal accounts to make decisions "at key points during their pensions lifecycle":[548]

- When they first come into contact with the pensions system, need to understand it and are first required to make decisions about their options.
- At key points during their pensions lifecycle, for example if their personal circumstances change, they reconsider their retirement aspirations or the system itself changes.
- When they reach retirement age and need to make decisions about realising their pension assets, alongside other issues such as considering their long term care

449. Teresa Perchard, from Citizens Advice, referred to work done by the Resolution Foundation to establish whether there was a business case for this.[549]

> "we are talking about quite substantial funds, over £100 million, to set up a service which involves any degree of face-to-face advice. It is very important that this is a comprehensive information advice service which can look at debt commitments as well as savings, so borrowing and saving, short and long term."

545 Ev 401, para 76

546 Ev 272 para 10; Ev 253, para 8.15

547 Ev 273, para 13. See also Resolution Foundation, 2006, Closing the Advice Gap: providing financial advice to people on low incomes, www.resolutionfoundation.org. For a definition of generic financial advice see para 62.

548 Ev 272, para 15

549 Q 509

450. Doug Taylor of Which? said:[550]

> "I think it is important that, if such a system were to be set up, it was provided by trusted intermediaries clearly. Citizens Advice Bureau is one such set of trusted intermediaries within the UK."

451. The details of how such advice should be delivered, and by whom, along with issues such as the balance in any strategy between web-based information, generic advice and specialist advice, and the inter-relationship with long term care, are not matters that the Committee has had time to address in the course of this inquiry. We note that the Treasury Committee is currently undertaking an inquiry on financial inclusion[551] and will note the findings with interest.

452. Asked about how generic advice on the personal accounts scheme might be provided, the Minister for Pensions Reform, James Purnell MP, told us that the Government was open-minded. "There are some big decisions that we need to take as a first step before we can decide the type of advice."[552]

453. **We conclude that a strong case has been made for the provision of free generic financial advice to those on below median incomes and recommend that DWP, DTI and the Treasury continue to work with organisations such as Citizens Advice and the Resolution Foundation to develop a model to meet the needs of this group and make the necessary resources available.**

454. **Identifying information and advice needs and developing an appropriate strategy for meeting them will be essential to ensuring the reforms are a success. This strategy must encompass a number of different elements, including pensions forecasts, DWP leaflets on the pensions system, the marketing of the new personal accounts scheme, building financial capability and giving people access to face-to-face generic advice. The crucial point is to ensure that the key messages in all these media are consistent and targeted towards key groups of undersavers.**

550 Q 509

551 Treasury Committee, Fifth Report of Session 2005-06, The Design of the National Pension Savings Scheme and the Role of Financial Services Regulation, HC 1074-I, para 51

552 Oral evidence taken before the Work and Pensions Committee on 28 June 2006, HC (2005-06)1362-I, Q 118

13 Conclusion

455. The central package of reforms outlined in the White Paper is to:

- Reform the state pension system to increase coverage for those with caring responsibilities and to provide a better platform for saving;
- Introduce a new system of personal accounts;
- Introduce limited reforms to the regulatory environment for existing occupational pension provision.
- Increase the State Pension Age to 68 by 2044.

456. Evidence to the inquiry suggested that there is a broad degree of consensus in support of this overall package. A key question for the Committee was whether this consensus was likely to be enduring. In Sweden, the Committee identified two factors as being particularly important to lasting consensus around pension reform – affordability and sufficiency of benefits. We conclude this report by attempting to identify some strains that might emerge in future and threaten to destabilise consensus.

Personal accounts

457. As part of the package of reforms in the White Paper, the success of the personal accounts scheme will be critical. In evidence to the Committee on 7 June, the Secretary of State said:

> "The question for us is how much more and how many more people we can get to save. This is going to be the acid test for these reforms, and I accept that. The whole balance between what we were doing on personal accounts and then the complementary reforms for the State Pension are designed fundamentally to generate more savings, to provide people with the peace of mind to know that it is worth their while to save. That is what we have to do."

458. The Committee identified a number of possible risks to the success of the scheme and recommends that the Department prioritise:

- Maximising participation of the target groups, in particular the self-employed and employees in small businesses. This will be a challenge given that there is to be no automatic enrolment process for the self-employed and concerns expressed by small business representatives about the new obligations the scheme will impose on them.
- Ensuring that the delivery model is universal and that the process for auto-enrolment is as simple as possible for both employers and individuals.
- Taking steps to ensuring people have the information and advice to make the right decisions as to their participation in the scheme.
- Developing independent, arms-length governance arrangements.

Existing occupational provision

459. The Committee heard conflicting views on whether there was likely to be a 'levelling down of existing provision in response to the introduction of personal accounts. This will need careful monitoring. The Committee welcomed the deregulatory review and the inclusion of representatives from Which? and the TUC on the group established to make recommendations to Government.

State Pension Reform

460. The Secretary of State explained that the state pension reforms "are fundamentally designed to support the introduction of the low cost personal accounts."[553] In particular, therefore, it is vital that the scope of means-testing is reduced so that people can safely be auto-enrolled with confidence that they will not end up on Guarantee Credit in the future. To encourage this confidence we recommend that the Government:

- make a firm commitment to re-link the Basic State Pension to earnings no later than 2012 in primary legislation; and
- publish details of what groups are likely to find themselves entitled to Guarantee Credit in future and what it estimates to be the range of possible outcomes for future entitlement.

461. Other key parameters of state pension reform – such as the indexation arrangements for Pension Credit – should also be placed in primary legislation to give confidence that they will be carried through.

462. The Committee notes that there is an element of complexity in the state pension reforms, particularly as regards future entitlement to the State Second Pension. Alternative proposals for state pension reform have included the suggestion that the Government should move more quickly to a single-tier flat rate state pension. We recommend that further down the line – probably as part of the independent review that we recommend - the case for merging the Basic State Pension and the State Second Pension should be reviewed. In addition, we strongly recommend that the Government look again at the case for reviewing tax relief on pension saving, recognised by the Pensions Commission as "costly, poorly focused, and not well understood."

State pension Age

463. A further source of difficulty might be around raising the State Pension Age. The Committee registered strong concerns around the potential impact of this on lower socio-economic groups. We recommend that this should be looked at by an advisory commission, tasked with one of the periodic reviews of the pensions landscape. We also recommend that future rises are subject to achievement of the health inequalities target.

553 Q 248-9

Locking in consensus?

464. The reforms will inevitably come under strain over coming years. As we have suggested, some key parameters need to be in primary legislation to give confidence that the reforms will be carried through. At the same time periodic reviews will be needed to provide independent advice as to whether changes are needed in response to changing circumstances.

Conclusions and recommendations

1. We applaud the Pensions Commission for its assessment of pension provision and recommend that it be regarded as a model of how to utilise expertise in the policy process. (Paragraph 15)

2. No reform of the pensions system will succeed unless it is able to transform individual savings and retirement behaviour, and employer and state contributions. For this to be achieved a political and then a public consensus must be reached. A consistent political commitment will then be required to make it stick. (Paragraph 22)

3. We understand the Secretary of State's argument that there may not be time for the flagship Pensions Bill to be subject to pre-legislative scrutiny. We regret that the timing would appear to preclude this. We ask for a firm commitment that any follow-up bill on personal accounts, where much of the detail has yet to be finalised, will be made available for pre-legislative scrutiny. (Paragraph 27)

4. We ask the Government to set out what form its periodically commissioned pension reviews will take and what their remit will be. We recommend that they be held regularly, the timings set in advance, and that they result in reports which are laid before Parliament. We also recommend that by the end of the next Parliament the Government commissions an independent review to analyse how implementation is progressing, broadly along the lines of the Pensions Commission. (Paragraph 35)

5. We recommend that the Government consider alternative ways of building additional stability into its proposed pensions reforms, to allow the new system to absorb external shocks and changes in political opinion more effectively over time. These could include predefined calculations akin to the Swedish 'balancing mechanism', to allow for changes in key variables such as longevity, rather than politically-based reviews, establishing an additional duty for the proposed personal accounts scheme trustees to analyse and comment on future proposed changes to the pensions system (from the point of view of maintaining the Government's published criteria for success over time) and enshrining any variables which may prove vulnerable to future political fiddling in primary legislation. (Paragraph 37)

6. We recommend that the Government consults on what proactive measures it could take to rebuild confidence in the pensions system and savings generally. (Paragraph 47)

7. The success of the new system of personal accounts will be critical to encouraging saving and delivering 'adequate' retirement incomes in the future for those on median earnings. This will need careful monitoring. (Paragraph 53)

8. The target group for the new system of personal accounts includes those on low to median incomes, many of whom do not currently have access to financial advice. For some people deciding to save for a pension will involve complex decisions regarding, for example, how to deal with existing financial commitments. Generic financial advice would assist people in doing this effectively (see para 453). (Paragraph 64)

9. In response to this report, the Department should outline its strategy for maximising participation in the new system of personal accounts, explain what targets it intends to set for participation in personal accounts, identify a level of participation below which it will review the policy of auto-enrolment and consider whether people should be compelled to participate, and outline contingency plans for coping with the work-load if participation is higher than expected. (Paragraph 72)

10. Small employers are more likely than large ones to offer no pension provision and there is concern among this group at the prospect of being obliged to administer and contribute to employees' pensions. The Government should outline its strategy for maximising participation among employees in small businesses. (Paragraph 79)

11. The White Paper does not provide the self-employed either with access to the State Second Pension or with an automatic enrolment process to the personal accounts system. This will make a strategy to maximise participation in personal accounts by this group critical. (Paragraph 82)

12. The Department should set targets for additional contributions above the minimum 8% and publish a strategy to deliver, and closely monitor, progress. (Paragraph 86)

13. We agree that the Government will need to monitor closely the impact of the new personal accounts scheme on existing occupational provision and guard against levelling down. This will need to be a key aspect of consideration in the regular reviews of the system and the further independent study that we have recommended (see para 35) should be instigated before the end of the next Parliament. (Paragraph 100)

14. The Committee welcomes the measures announced in the White Paper to support employers with the new requirements imposed on them by the personal accounts scheme. The Committee is concerned that employers should not encourage employees to opt out and recommends that the Government outline its proposed arrangements for monitoring and enforcing compliance with these requirements, the mechanisms for reporting breaches with compliance and the proposed penalty regime. (Paragraph 109)

15. Participating in the new personal accounts scheme should be as simple as possible. We believe that employees should be opted-in within three months of beginning employment. Care will need to be taken to ensure that arrangements for auto-enrolment are workable for firms with employees on 'non-standard' work patterns, for example, temporary contracts or more than one job. (Paragraph 117)

16. The Committee agrees with the Pensions Commission that the focus should be on keeping Annual Management Charges as low as possible in order to increase retirement incomes. The Committee notes that if charges cannot be driven towards or below 0.3% it would substantially erode the value of people's pensions. We believe that the option of fixed administrative fees should be considered but note that the impact of such a charging structure on those saving small amounts would have to be considered as part of that review. (Paragraph 122)

17. The Government has set out a list of eleven criteria against which it intends to assess the two proposed alternative delivery models. We believe that two of these are particularly important: achieving a lower level of charges and simplicity for employers and individuals. For this reason, the Committee accepts the Government's initial view that this can be achieved through the delivery model proposed by the Pensions Commission. However, we await with interest the outcome of further work to establish whether similar objectives could be achieved through a limited multi-provider model. (Paragraph 127)

18. The Government has a responsibility for the running of the macro-economy and the regulatory framework for pensions. It does not have a responsibility for investment risk in the new system of personal accounts, but Government and regulators will have an obligation to communicate the risks and benefits clearly while still encouraging participation in the scheme. In response to this report, the Government should set out how it proposes to do this. We agree with the Pensions Commission that the default fund should be a 'lifestyle-smoothing' fund with a relatively high equity weight at early ages, and a gradual shift to bonds as people approach retirement. (Paragraph 134)

19. The Committee agrees with Which? and the IMA that governance arrangements – ensuring the scheme is overseen by trustees which are independent of government and have an overriding duty of care to protect the interests of savers – will be critical to the scheme's success. Independence will also be vital to ensure that corporate governance standards are not compromised. Political interference in investment strategy and on how the voting rights of the personal accounts scheme investments are exercised would be unacceptable. (Paragraph 137)

20. The Government and Pensions Commission have rightly recognised that establishing the infrastructure for the new system of personal accounts will be a challenge. We strongly recommend that Government involvement in the development of any necessary IT system is based on a clear understanding of lessons learned from previous government IT systems failures. (Paragraph 143)

21. We recommend that the Government should set a date when the future of contracting out for DB schemes is to be reviewed. This could form part of the further independent review we recommend should be commissioned by the end of the next Parliament. (Paragraph 165)

22. While we welcome the Government's decision to set up a rolling deregulatory review of pensions regulation, we note that it will have to maintain fairness to those who have already accrued pension rights and effectiveness in terms of ensuring that DB schemes do not close because of unnecessary costs and provision. We welcome the fact that a group has been established to make recommendations to the Government, including employer and employee representatives. We ask the Government to outline the timetable for this review including interim progress updates. (Paragraph 173)

23. We recommend that the Government considers whether more needs to be done to create an overall level playing field in which risk-sharing schemes, as well DC and

DB schemes, can all develop to their full potential, and encourage higher levels of contribution to whichever form of scheme is chosen. (Paragraph 181)

24. The Committee welcomes the decision to re-link the Basic State Pension to earnings but is concerned by the inconsistency between the unequivocal statement that the link will be re-established by the end of the next Parliament "in any event" and the Secretary of State's statement that affordability will come first. We ask the Government to clarify this. In our view, the link should be restored as soon as possible, and certainly no later than April 2012. (Paragraph 200)

25. The Committee agrees that the focus should be on the outcome of increasing the numbers of people entitled to a full Basic State Pension. The Government has said that it is more practical to do this, with greater effect on outcomes, through changes to the current system of contributions and credits than through the introduction of a residence test. The reduction to 30 in the number of years required for a full BSP should go some way to providing people with more confidence about what they can expect from the state in the future. We therefore welcome the Government's proposals. (Paragraph 214)

26. We welcome the Secretary of State's undertaking that the DWP will do further analysis to establish which groups reaching State Pension Age after 2025 will not be entitled to a full BSP. We recommend that the analysis covers entitlement for those reaching SPA in 2010, and includes an assessment of the amount by which people will fall short of full entitlement. (Paragraph 217)

27. The Committee accepts that it might be difficult to apply the carer's credit retrospectively, but is concerned about those with interrupted work records reaching State Pension Age between now and April 2010 who will not benefit from the proposals to increase coverage. We recommend that consideration be given to mitigating the gap in entitlement of those born before April 1950 compared with those reaching SPA under the new rules. (Paragraph 221)

28. The Committee believes that those on the Employment and Support Allowance should be credited into the State Second Pension after the 13 week assessment phase. (Paragraph 243)

29. The Committee welcomes measures in the White Paper to improve coverage of S2P for carers and the simplification that would arise in the long term from moving to flat rate accrual. However, we note that inequalities in S2P provision are set to continue and the fact that, as the Secretary of State acknowledged, S2P will continue to be a source of complexity . DWP should provide estimates of how many people it expects to receive less than £135 a week in BSP and S2P in 2030 and in 2050. (Paragraph 245)

30. Moving to a simpler, single-tier system more quickly than the Government and Pensions Commission proposed would appear to be possible, using the 'offset' method. It would, however, require difficult decisions to be made – for example, whether to abolish contracted-out rebates for Defined Benefit schemes. It also requires a judgement on priorities and the extent to which moving more quickly to a simple, single-tier flat-rate state pension should take precedence over other objectives. We recommend that the Government conducts further work on the costings and on the feasibility of the offset method. (Paragraph 267)

31. The Committee notes that there are some advantages in the model proposed by the Pension Reform Group, in that it might restore trust in pensions by establishing a guaranteed pension overseen by an independent body at arms length from Government. However, we consider that other means might be adopted to reduce the risk of parameters of the pension system being successively changed over time – for example enshrining those that are most important in primary legislation. (Paragraph 278)

32. The Committee recommends that the Government sets a date at which the feasibility of merging BSP and S2P should be examined, possibly as part of the further independent review we recommend should be commissioned by the end of the next Parliament. (Paragraph 281)

33. The Committee acknowledges the increase in pensioner incomes arising from the Pension Credit, and the contribution that this has made to reducing relative income poverty. It welcomes the commitment to continue to increase the Guarantee Credit in line with earnings beyond 2008. (Paragraph 283)

34. The Committee welcomes the fact that under the White Paper proposals the percentage of pensioners likely to be eligible for means-tested support in retirement would be expected to decline rather than increase, while the support available via the non-means tested pension will increase. The Committee notes that there is necessarily a degree of uncertainty in longer-term projections and welcomes the fact that the Government intends to produce analysis of the extent to which its proposals should reduce means-testing in the future. We recommend that this include the range of numbers of pensioner households likely to be eligible for Pension Credit in the future and the assumptions on which the figures are based.(Paragraph 289)

35. The Committee welcomes the fact that individuals with a full contributions record will be able to expect a retirement income above that provided by the Pension Credit Guarantee. In order to aid individual decision-making it would be useful if further details were provided on the types of individuals who might expect to receive a non-means-tested income below that of the Guarantee Credit. (Paragraph 293)

36. The proposals in the White Paper should reduce reliance on other means-tested benefits such as Housing Benefit and Council Tax Benefit. The Committee welcomes this, and would like the DWP to publish figures on the extent to which the proportion of pensioners eligible for any means-tested benefit would be reduced by the White Paper proposals. (Paragraph 295)

37. In order to get a fuller view of the impact of the White Paper proposals on incentives the Committee recommends that projections of the proportion of pensioners facing different withdrawal rates are published, and that the DWP commissions or carries out further research on the likely impact of the reforms on individual decisions to work and/or save. (Paragraph 300)

38. The Committee welcomes the Government's commitment to restricting the spread of means-testing over time through changes to the Savings Credit but recommends that care should be taken to avoid penalising those with modest savings who have not yet had a chance to build up a good base level of non-means-tested state pension. The mechanisms for achieving this should be placed in primary legislation to build confidence that they will be seen through. (Paragraph 305)

39. The Committee notes that recent attempts to increase Pension Credit take-up have had limited success in terms of making progress against the PSA target. The Committee concludes that achieving and maintaining Pension Credit take-up levels of 80% in the future looks challenging, and asks the Government to set out its analysis of how take-up programmes and procedures for claiming all means-tested benefits to which pensioners may be entitled could be made more effective. In this context the Committee believes that the Government should not completely ignore the Pension Commission's recommendation of considering a residency test for older pensioners, and recommend that it remain an option when considering simplification of the system in the longer term. (Paragraph 315)

40. The Committee recommends that the DWP publishes a breakdown of its spending projections into forecast spending on the Basic State Pension, the State Second Pension and means-tested elements such as the Pension Credit and Housing Benefit. These figures should be inclusive of additional spending on the State Second Pension arising from the abolition of contracted-out rebates for Defined Contribution schemes and the savings from the planned increases in the State Pension Age. The Committee also recommends that the DWP publishes separate estimates of the impact of its proposed reforms on (a) spending on working age benefits such as incapacity benefits arising from the increase in the State Pension Age; (b) Income Tax and National Insurance receipts from the increase in both taxable benefits and the State Pension Age and (c) National Insurance receipts from the abolition of contracting out for Defined Contribution schemes. (Paragraph 319)

41. We note that DWP forecasts suggest that the White Paper proposals would pass the Government's affordability test over the period to 2020–21 and recommend that, in order to clarify the tax consequences of the proposals for the period beyond 2020–21, the Government publishes updated projections for total public spending as a share of national income that take into account the proposals set out in the White Paper. (Paragraph 326)

42. The Committee believes that the Government should be explicit about how it intends to use the increased revenue arising from the abolition of contracting out for Defined Contribution schemes. In particular, if the revenue is not being used to reduce Government debt in order to part-finance the resources needed to implement the White Paper proposals over the longer-term then the Government should explain why it has deemed this course of action to be appropriate. (Paragraph 336)

43. We recommend that the Government responds to the Pensions Commission view that "pensions tax relief is costly, poorly focussed and not well understood", highlights whether it believes the relief could be targeted better, and whether some of

the resources devoted to tax relief might be used to finance the increases in state spending on pensioner benefits. (Paragraph 343)

44. The Government has taken a bold step in proposing an increase in the State Pension Age (SPA), given the lack of public consensus on this point. We conclude, that the increase is justifiable. However, like many of those who gave evidence to the inquiry, we have concerns about the uncertainty of the projections on which execution of the policy is based, and we also fear that the policy will have a disproportionate effect on those in lower socio-economic groups, manual workers and those with health difficulties. We are also concerned at the potential lack of re-training packages and flexible job opportunities for those over 55. (Paragraph 366)

45. The raising of the State Pension Age must be associated with a vigorous pursuit of the health inequalities PSA target. It must not be the case that by the time the State Pension Age rises, health inequalities have further increased. In our view, the achievement of the health inequalities PSA target needs to be a condition of a rise in the SPA, at least for those rises timetabled for the 2030s and 2040s. (Paragraph 371)

46. Keeping at 65 the age at which Guarantee Credit could be claimed could mitigate some of the impact of increasing the State Pension Age. However, we note the Pensions Commission's view that it could create disincentives to work. We agree with the Government that the decision on whether or not to increase the earliest age at which individuals can qualify for the Pension Credit in line with the State Pension Age should be made nearer the time when SPA may be raised, in light of evidence on both socio-economic differences in life expectancy and differences in labour market opportunities at older ages. (Paragraph 379)

47. We conclude that the uncertainty around future life expectancy is a powerful argument for the regularly commissioned reviews described in the first section of this report. (Paragraph 384)

48. We ask the Government to set out the principal research programmes currently underway on ageing, life expectancy and healthy life expectancy, including work on differentials by social class and ethnic group, and their budgets for the next ten years. Improved co-ordination of research into ageing will also be vital to inform policy makers about future life expectancy and healthy life expectancy. We welcome the Government's commitments made recently in the House of Lords on these issues. (Paragraph 390)

49. We welcome the measures already taken by Government to provide more flexibility to people about the form in which they take their state pension. We also welcome the Government's decision to review the rules for state pension deferral with a view to, possibly, making the system more flexible. In our view this would be a sensible measure which would increase the options available to those nearing retirement. We recommend that the Government sets out its timetable for this review. (Paragraph 401)

50. Partly because of this complexity, and the importance of older workers, the Committee has decided to conduct an inquiry in the autumn into the Government's employment strategy and will include as part of that a detailed study of this aspect of labour market policy. We will therefore return to the matter later this year. (Paragraph 411)

51. We agree with the point made by the Rt Hon Frank Field MP that informed discussion, rather than "merely shuffling our prejudices" is necessary for a debate on the future level and terms of public sector pensions. We recommend that the Government commission an independent review, which includes involvement from both the private and public sectors, about the future terms, benefits and financing of these schemes. (Paragraph 418)

52. We think that there is scope to improve the format and the regularity with which the Pensions Service provides pensions forecasts and strongly believe that accurate Combined Pension Forecasting will be a key motivator for increasing retirement saving. While the Swedish orange envelope is not the complete solution to the problem, as it does not include information about private or occupational provision, it has two key advantages of being distinctive and simple and should be the starting point for reform. (Paragraph 438)

53. We were concerned to learn from a recent NAO study that some leaflets relating to pensions were not available at DWP sites and were difficult to obtain elsewhere. We welcome the assurance given to the Public Accounts Committee that from now on "key leaflets" relating to pensions will be displayed in every Jobcentre Plus outlet. (Paragraph 442)

54. We conclude that a strong case has been made for the provision of free generic financial advice to those on below median incomes and recommend that DWP, DTI and the Treasury continue to work with organisations such as Citizens Advice and the Resolution Foundation to develop a model to meet the needs of this group and make the necessary resources available. (Paragraph 453)

55. Identifying information and advice needs and developing an appropriate strategy for meeting them will be essential to ensuring the reforms are a success. This strategy must encompass a number of different elements, including pensions forecasts, DWP leaflets on the pensions system, the marketing of the new personal accounts scheme, building financial capability and giving people access to face-to-face generic advice. The crucial point is to ensure that the key messages in all these media are consistent and targeted towards key groups of undersavers. (Paragraph 454)

Appendix A

Terms of reference for the inquiry

- Whether the proposal for a National Pension Savings Scheme is the right way forward and, if so, how it should work;

- The impact on saving behaviour of the reforms and of existing incentives (such as tax relief);

- The future role of employers in pension provision and the impact on this of proposals for reform;

- Proposals for reform of the state pension system;

- Whether, when and by how much the State Pension Age should be increased;

- Measures to facilitate later working and flexible retirement;

- The impact of reform proposals on the pension incomes of different groups, including the self-employed and those currently at particular risk of being 'under-pensioned', such as women, disabled people, ethnic minorities and people with varied work patterns; and

Whether proposals for reform adequately address inequalities in pension provision.

Formal minutes

Thursday 13 July 2006

Members present:

Mr Terry Rooney, in the Chair

Miss Anne Begg
Harry Cohen
Mr Philip Dunne
Michael Jabez Foster
Mrs Joan Humble
Greg Mulholland
John Penrose

1. Pension Reform: Report text

The Committee considered this matter.

2. Pension Reform: Formal consideration

Draft Report (*Pension Reform*), proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 417 read and agreed to.

Paragraph 418 read, as follows:

"418. We agree with the point made by the Rt Hon Frank Field MP that informed discussion, rather than "merely shuffling our prejudices" is necessary for a debate on the future level and terms of public sector pensions. We recommend that the Government commission an independent review, which includes involvement from both the private and public sectors, about the future terms, benefits and financing of these schemes"

Amendment proposed, in line 3, after "public sector pensions" insert "However, in our view, long-standing members of such schemes, especially those with low incomes and overall pension entitlements, should not be adversely affected by any changes."—(*Harry Cohen*).

Question put, that the Amendment be made.

The Committee divided.

Ayes, 3	Noes, 4
Miss Anne Begg	Mr Philip Dunne
Harry Cohen	Michael Jabez Foster
Greg Mulholland	Mrs Joan Humble
	John Penrose

Paragraph 418 agreed to.

Paragraphs 419- 464 read and agreed to.

Summary (paragraphs 1-7) agreed to.

Summary (paragraph 8) read as follows:

"The Government's decision to re-link the Basic State Pension to earnings is also commendable. The White Paper does not guarantee the date when this will take place – it states that it will be 2012, or at the end of the next Parliament, subject to affordability. We questioned the Secretary of State hard on this point, as we think such equivocation is unhelpful and a firm commitment would be welcome."

Amendment proposed, at the end, to add the words "The additional delay beyond 2010-11 will defer the benefits of the reforms for current and future pensioners." - (*Mr Philip Dunne*)

Question put, that the Amendment be made.

The Committee divided.

Ayes, 4	Noes, 3
Harry Cohen	Miss Anne Begg
Mr Philip Dunne	Michael Jabez Foster
Greg Mulholland	Mrs Joan Humble
John Penrose	

Paragraph, as amended, agreed to.

Summary (paragraphs 9-12) agreed to.

Resolved, That the Report, as amended, be the Fourth Report of the Committee to the House.

Ordered, That the Chairman do make the Report to the House.

Ordered That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Several papers were ordered to be appended to the Minutes of Evidence.

Ordered That the Appendices to the Minutes of Evidence taken before the Committee be reported to the House.

[Adjourned till Wednesday 19 July at 9.15am

EXTRACT FROM THE MINUTES OF PROCEEDINGS RELATING TO DECLARATIONS OF INTEREST

Monday 12 June 2006

Mrs Joan Humble declared an interest as a member of the Transport and General Workers Union.

Monday 19 June 2006

Mr Philip Dunne declared an interest as a designated member and non-executive representative, Management Board of Ruffer LLP, investment managers.

Witnesses

List of written evidence

Reports from the Work and Pensions Committee 2005-06

Session 2005–06

First Joint Report	Home Affairs and Work and Pensions Committee: Draft Corporate Manslaughter Bill	HC 540
First Special Report	Pension Credit and Delivery of Services to Ethnic Minority Clients: Government Response to the Committee's 3rd and 4th Reports of Session 2004-05	HC 297
Second Report	The Efficiency Savings Programme in Jobcentre Plus	HC 834
Third Report	Incapacity Benefits and Pathways to Work	HC 616
Second Special Report	The Efficiency Savings Programme in Jobcentre Plus: Government Response to the Committee's Second Report of Session 2005-06	HC 1187