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The manufacturers' organisation

Rethinking Pensions

Preparing for an Ageing Society



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Introduction

The future provision of pensions is now one of the biggest issues facing government, business and individuals. Without decisive action being taken over the next few years, this will become a major problem that will affect all of us for many years to come. To make progress, we must all face up to certain realities, consider where we are today and identify what we are prepared to do. The proposals in this report are EEF's constructive contribution to the important debate that is now taking place on how to achieve a lasting solution on pensions.

Employers need to play a key role in developing the way forward on pensions. Business is already involved as a major contributor to the funding of both occupational and personal pensions. It also pays both the wages from which individuals make pension contributions and the taxes that partly finance state pensions. However, the involvement of business in occupational pensions exposes it to many complex issues that make major demands on management time. In the future, these demands could cause firms to lose focus on the core issues of developing new and improved products, processes and services, entering new markets and raising productivity.

Pensions also expose companies to rising levels of risk that have the potential to bring good companies down and, in many other cases, to incur increased costs that prevent them from making much-needed investment in their future. Indeed, some EEF members are stating that these risks have now become so significant that managing their pension scheme is becoming as important to them as managing their business. In addition, some employers are concerned

that large pension funds on which employees now rely for a significant part of their retirement income are not being managed by professionals with financial expertise.

Business is already in so deep that it cannot now walk away from pensions issues and it is unrealistic to expect that it would be allowed to do so. It would also not be in the interest of those firms that want to use pensions as a key part of their human resources strategy to recruit, motivate and retain the talented and committed people who are the basis of their future success. At the same time, we need to find a way through the risks, regulation, sheer complexity and drain on management time that, combined, inevitably mean that some employers are deterred from providing pensions for their employees and which are causing many others to re-examine their current involvement. We must also address the factors that cause some companies to opt out completely from pension provision, placing the burden disproportionately on those that remain involved, and on the taxes paid by employers and employees.

However, we need to do this in a way that offers employers flexibility and choice in how they engage with pensions. At one extreme there will be companies that will want to persevere with long-established defined benefit schemes. At the other extreme there will be, generally but not exclusively, smaller firms that wish to limit their involvement simply to paying monies towards their employees' pensions, which are then managed by someone else. In between, there will be a variety of firms that still want to run their own pension scheme but will differ in how far they want to get involved in its management.

In this report we have put together a package of measures that we believe will meet these needs but will also address the other pressing issues facing the UK's ageing society. These include the need to provide pensioners with dignity in retirement and to recognise that our labour market and society has changed substantially since the current pensions system was set up. This package also recognises the need to overcome the traditional reluctance of individuals to make important financial decisions such as saving for their retirement. Our package should also be affordable for individuals, employers and the government and be capable of being sold as a comprehensive package to different interest groups. Finally, it should facilitate the better regulation of occupational and private pension arrangements.

These measures must be supported by efforts to raise significantly the understanding of financial issues among the general public, increase their awareness of the need to save for retirement and boost employment rates among older workers. Government must also play its role by maintaining strong and stable economic growth. Strong growth in profitability and in disposable incomes will improve the ability of both companies and individuals to make pension contributions as well as enhance the investment performance of their savings for retirement. Continued economic stability is also needed to encourage individuals to take a long-term perspective and help them make rational decisions about saving for their retirement. It is therefore vital that the government seeks to achieve higher levels of productivity performance by encouraging innovation and investment in skills. It must also avoid damaging increases in taxation and regulation as well as restrain the growth of public sector spending. Part of this must involve reforming public sector pensions given the increasing financial burden that they are now imposing on taxpayers and therefore on the ability of people to save for their retirement.

If we succeed in achieving these objectives and in developing a consensus on the way forward, there are some major prizes to be won. It will allow employers to concentrate on running their companies and avoid putting their business at risk, but still enable them to be involved financially in providing pensions for their employees. In addition, the state would play a far more effective role in preventing poverty in retirement, the burden of pension

provision would be shared more fairly among employers, and individuals would be better equipped to take financial responsibility for themselves. We believe that this can be achieved by creating a pensions system that is simple, transparent and inclusive, and gives individuals a real sense of ownership, backed up by steps to improve financial literacy.

In this report we have set out our proposals as EEF's constructive contribution to the debate on how to move forward. We do not claim to have all the answers and we have identified some important questions that will need to be addressed. We have also not attempted to tackle the complex issue of the transition from where we are today to our proposed model for the future. However, determining how to manage this transition will be a key issue for the Pensions Commission to examine in the future, and EEF will want to contribute to the debate.

The Pensions Commission has already undertaken a huge task in sifting through the mass of evidence and opinions on pensions, and in making proposals on developing an approach that can deliver a long-term solution to the UK's pensions issues. However, just as vital is its contribution to starting a debate on the costs and benefits of the various alternatives and on the importance of creating a system that can endure rather than simply putting another 'sticking plaster' on the current system to get us through the next few years. Its work must therefore not stop once its *Second Report* is published (expected to be in late 2005), particularly as ways need to be found to engage the general public in this important debate. Key tasks will include developing more flexible attitudes among both employers and employees about working beyond the current basic state pension age and addressing the current widespread resentment among the general public towards the idea of raising the age at which the basic state pension can be drawn. In particular, a much better understanding needs to be developed of the variety of ways in which work and retirement and the incomes from employment and pensions can be combined to suit the circumstances and preferences of different people.

The long-term nature of pension provision means that this is one area of public policy where it is vital to try to create a stable environment in which individuals, employers and pension providers can have real confidence that the rules

of the game will not continually be changed. Inevitably, given its significant public finance implications, it will be difficult to achieve complete consensus across the political spectrum and between different interest groups on future pensions policy. However, it is important to try to achieve consensus on the broad objectives of future pensions policy even if there are differing views of the means by which these objectives are to be achieved.

We believe that basing future pensions policy on the key overarching principles of simplicity, transparency, inclusion, and individual ownership and responsibility will be vitally important in helping to achieve these objectives. However, it has to be recognised that rigorous adherence to the key principle of simplicity will inevitably result in some elements of 'rough justice' with a number of 'winners' and 'losers'.

Any issues that are created by our proposed approach to future pension arrangements will therefore need to be handled sensitively. However, this must be done in a way that avoids re-creating the complex arrangements that bedevil today's pension arrangements.

Finally, we would like to thank the large number of EEF member companies that have helped to shape our proposals and, in particular, the members of EEF's Pensions Strategy Group, which was chaired by Paul Lester, the Chief Executive of VT Group plc and a former EEF President. The membership of EEF's Pensions Strategy Group and its terms of reference are detailed in Appendix 2. We are also grateful to the Pensions Policy Institute for their assistance in costing our proposals.

Executive summary of key recommendations

The challenges we face

Any proposals for reforming the UK's pensions system must address a number of difficult problems and unfavourable trends. These include:

- pensioner poverty;
- declining and patchy provision;
- rising levels of complexity and associated poor levels of understanding;
- falling levels of trust in the pensions system and pension providers;
- rising levels of regulation that deter employers from making provision; and
- the need to reflect the substantial changes in the labour market and society since our pensions system was devised.

The scale of these problems means that small changes, such as tinkering with tax incentives, are by themselves unlikely to provide the whole solution. Indeed, without action, these unfavourable trends are likely to worsen. We must also avoid responses that expose business to further administrative burdens and increased risks, which then divert employers from the core activity of running their companies. This would only exacerbate the current problems, making it increasingly difficult to find a lasting solution to the pensions issues facing the UK.

The choices before us

- **State or private?** A shift away from state provision is likely to produce unfavourable pension outcomes for the UK unless steps are taken to address other associated

problems. Nonetheless, it will be important to explore options that give people a sense of ownership and overcome the current problems of distrust of government, but which do not expose individuals to unacceptably high levels of risk and the consequences of making bad decisions.

- **Voluntary or compulsory?** Minor changes to the current voluntary system will not be sufficient to deliver decent levels of retirement income across UK society. Efforts to raise understanding and overcome reluctance to make financial decisions would certainly produce results. At the very least, a major public campaign is required. However, we doubt that on its own this will generate the required change in attitude and behaviour by both individuals and employers. We therefore must begin to look at alternatives to voluntary private pension arrangements. This should include trials to gauge the effectiveness in the UK of mechanisms such as automatic enrolment schemes and the US's 'Save More Tomorrow' plans. Introducing any form of compulsory private pension would need to be done gradually to allow enough time to make the case for it and to seek to build a consensus. In addition, it would be important to give employers and individuals the opportunity to adjust to the financial consequences of compulsion. Nonetheless, we believe that work must begin soon on making the case for this change.
- **Funded or pay as you go?** We should seek to find a combination of approaches to state and compulsory pension provision that gives people a sense of ownership but does not expose them to unacceptable levels of risk. We should look closely at which aspects

of the Swedish and New Zealand approaches to pensions it would be appropriate to introduce in the UK. Sweden's system offers a low-cost way of involving the private sector in managing the funds in which people invest, while New Zealand's system for public sector workers shows how to provide savers with a choice between a limited number of investments that are clearly branded according to the level of risk involved.

- **Contributory or residence-based?** On balance, we believe that the contributory principle should be preserved, although the system needs to be modernised to address the unfair treatment of those, particularly women, who struggle to qualify for the full basic state pension under the current rules.
- **Means-testing.** Our proposal to provide an enhanced basic state pension equal to the current level of the Pension Credit and increase it in line with movements in average earnings would significantly reduce the need for means-testing. We believe that this is essential if we are to move forward and remove the current barriers to saving for retirement created by disincentives to save and lack of understanding.

EEF's proposed pensions model

This report sets out EEF's proposal for a three-pillar model for the structure of state and occupational/private pension arrangements for the UK in 2015. It seeks to meet the following important priorities that have been identified by EEF's Pensions Strategy Group:

- providing pensioners with dignity in retirement;
- addressing the changing nature of the UK labour market and society;
- overcoming individuals' inertia about saving for their retirement;
- providing some flexibility in pension arrangements for employees and employers;
- ensuring affordability for individuals, employers and the government;
- facilitating the better regulation of occupational and private pension arrangements; and
- being saleable as a package to different interest groups.

Our proposed three-pillar model for addressing the pension issues facing the UK is summarised in the following subsections.

First pillar: Enhanced basic state pension

We are proposing that there should be an enhanced basic state pension paying 21% of national average earnings at age 65 and 25% of national average earnings at age 75.

We have chosen age 75 for the higher level of basic state pension because we believe the state should play a greater role in looking after older citizens. It also fits with the current approach of starting to provide some modest extra benefits for pensioners of age 75, and problems of pensioner poverty also tend to be greater from age 75.

This enhanced basic state pension would be increased annually in line with average earnings to enable pensioners to benefit from the UK's improved economic performance. These ages would be regularly reviewed by an independent body of pension experts, although the final decision on any change would rest with the government. In our view, this will probably mean that these ages would be increased gradually to, respectively, 68 and 78 by 2055.

It is vital that these increases are felt to be acceptable by the majority of the population and that the reasons for them are widely understood. The independent body would therefore play a key role in getting these messages across. It is also important that changes are announced well in advance and that any movement towards a higher age at which the basic state pension is paid is gradual so that employers and individuals have sufficient time to adjust to this new environment.

Entitlement would be determined by National Insurance contribution (NIC) records but would be based on different contribution criteria to reflect the changing nature of the UK labour market and society so that, in particular, women would have the same opportunity as men to receive the full value of the basic state pension. The future role played by means-tested pension benefits would be substantially reduced because our proposed basic state pension for those aged 65 to 74 inclusive would be set at the current level of the Pension Credit.

Second pillar: Modest compulsory contributions

We are proposing that a relatively modest compulsory contribution by all employees, employers and the self-employed would be paid into a second pension. This would be set at, initially, 2% of all earnings and then

gradually increased to 4% of all earnings between 2015 and 2025, payable by both employees and employers. We are undecided at this stage on whether the self-employed should have to make the 'employer' contribution as well as the 'employee' contribution and would leave this decision until further debate had taken place. Employees, the self-employed and employers would also be positively encouraged to make voluntary contributions in addition to this compulsory contribution. However, any employees, self-employed or employers who made contributions into separate pension arrangements that were greater than this minimum level would be exempt from contributing on a compulsory level into this second pillar pension.

All employees who earned more than 25% of national average earnings would be required to make this minimum pension contribution, with the government contributing the minimum 'employee' contribution on behalf of those earning less than this figure. Requiring employees earning more than 25% of average earnings to make contributions on their total earnings allows the compulsory contribution rate to be set at a lower level than it would otherwise have been. However, we will need to look carefully at how this approach would interact with the taxation of earned income and whether the level of government contribution could be set in a way that smooths the transition for individuals moving from earning just below to just above 25% of average earnings.

Employee and employer contributions would be collected by the government through the National Insurance system and initially placed in a central clearing house before they were invested. Individuals would then be able to choose between investing in a limited number of funds and there would also be a default fund, with a balanced portfolio, for those who did not want to invest on an active basis. There would therefore be a limited need for individuals to receive financial advice, helping to minimise costs. Private pensions providers would bid competitively on, for example, a five-yearly basis for the opportunity to run these limited number of investment funds with one of the key criteria for selection being high net returns – i.e. a strong investment performance record backed by the ability to deliver low administrative costs. Decisions on the appointment of the providers to run these investment funds would be made by an independent body, separate from government.

Over time, these funds would become very large and they would therefore need to be strongly regulated. Because people's compulsory savings would be invested in these funds, there would need to be clear information on the degree of risk associated with each of them. One of the options should be very low risk, such as government bonds, and it should be made easy for people to be able to switch between funds without incurring any costs.

The current system of tax relief for employers would be left unchanged but the tax relief for employees would be remodelled to provide greater incentives for individuals, particularly those on low incomes, to contribute. We are proposing that the government replaces the current complex system of tax relief on individual pension contributions with a co-contribution approach, with the government supplementing the contribution of individuals with one of its own. The government's contribution would be smaller than the individual's, although the level of contribution could be higher for those on lower incomes. We believe that this approach would provide a real incentive for those paying little or no tax and would also be much easier for individuals to understand.

However, we consider that the current system of employer tax relief on employer pension contributions should be left untouched. In addition, the tax treatment of voluntary payments made by both employees and employers into personal and occupational pensions (our third pillar) should be left unchanged. Given the absolute importance of encouraging a higher level of savings, it is vital that the introduction of compulsory pension contributions is not used by the government to justify any scaling back in the overall amount of tax relief available on pension contributions.

A substantial effort needs to be made to improve the understanding of pensions and other financial issues among all individuals. This should start in schools, but the UK also needs a national publicity campaign to raise financial awareness that covers people of working age. The government needs to play a leading role in this, but it will also be vital to engage employers and the providers of financial services in such a campaign. We also believe that the Pensions Commission should continue beyond the publication of its *Second Report* in late 2005 with part of its role being to promote a better public understanding of the

need for individuals to save for their retirement. Together with a more understandable form of financial support for pensions by the government that is also more generous to those on low to middle incomes, we believe that improving financial awareness can play a vital role in developing a better understanding of the need to save for retirement. This will be essential in ensuring that the compulsory savings level is not to be seen as the maximum as well as the minimum.

Third pillar: Less regulated additional voluntary occupational and private pension provision

We are proposing that this would be regulated more loosely than it is today because the first and second pillars of our proposed model would provide a higher level of secure income in retirement than is currently provided by state pension arrangements. Regulation of this third pillar should therefore focus on encouraging individuals and employers to maximise savings for retirement rather than on guaranteeing accrued occupational/private pension rights and benefits and minimising tax leakage.

As stated above, we consider it important that the current tax relief arrangements for both employees and employers for occupational and personal pensions outside the second pillar be retained. This will therefore minimise any adverse effect that our proposed second pillar might have on existing occupational and private pension arrangements.

Improving employability

Put simply, improving employability and employment levels increases the number of people able to afford to make provision for their retirement and the level of national income available to fund pensions. This will require employers and the government to place a greater focus on rehabilitating sick and injured employees back into the workplace as well as on reforming incapacity benefit to reduce the numbers of people dropping out of the labour market in their fifties and early sixties. Enhanced lifelong learning opportunities to improve the skills and employability of older employees will also be needed. In particular, the government should look closely at what can be learned from the success of Finland's 'Maintenance of Work Ability' programme and which aspects of it could be fruitfully employed in the UK. These issues are explored in more detail in Section 6 of this report.

Costs and impact on retirement incomes of our proposals

EEF has commissioned the Pensions Policy Institute (PPI) to look at three aspects of our proposals:

- The cost of raising the value and improving the coverage of the basic state pension (BSP).
- The cost of our proposal that the government makes 'employee' contributions into the second pillar pension for those on less than 25% of average earnings or in receipt of certain labour market-related benefits.
- The percentage of national average earnings and the replacement rates (i.e. retirement income as a percentage of final earnings) that the BSP and second pillar pension would generate under our proposal for seven different categories of people.

Estimates of future government expenditure on pensions are subject to some uncertainty dependent on the take-up of Pension Credit and the level of voluntary savings. The PPI's estimate for comparative purposes has the costs of future government expenditure on pensions rising from 5.5% of GDP in 2015 to 6.8% in 2055. In practice, it seems unlikely that government expenditure on pensions will grow as slowly as this, because retaining the current policy of increasing the BSP in line with prices would mean that it becomes just 9% of average earnings by 2035 and between 5% and 6% by 2055. Over the same period, the costs associated with EEF's proposed enhanced BSP would rise from 6.5% of GDP in 2015 to 8.0% in 2055.

The PPI has also estimated the cost of our proposal that the government would pay 'employee' contributions into the second pillar pension on behalf of those on less than 25% of average earnings (or not in work and in receipt of certain labour market-related benefits). In 2015/16 and at 2005/06 prices, these contributions would cost £670 million at the 2% contribution rate and £1.3 billion at the 4% contribution rate. In practice, these costs may turn out to be lower than this if the government adopts our recommendation to improve the employability of people in their fifties and early sixties as well as those in receipt of incapacity benefit.

The PPI's analysis of the impact of our proposals compared with the current system on different income groups in 2055 shows that, at age 78, the vast majority of people

would be better off under EEF's proposals. At age 68, most people would be marginally better off or roughly the same, although this depends on whether they claim Pension Credit. Because not everybody who qualifies for Pension Credit currently claims it, our proposal would therefore reduce the risk of poverty in retirement for people on low incomes.

Another way of looking at our proposals is to examine the replacement rates (retirement income as a percentage of final earnings) that they would generate compared with the target replacement rates set out in the Pensions Commission's interim report (*Pensions – Challenges and Choices: The First Report of the Pensions Commission*, October 2004). Our proposals would generate high replacement rates for low earners that are very close to the Pensions Commission's target rates (67% vs. 70% for men and 78% vs. 80% for women). As income levels rise, replacement rates would fall, although a median-earning woman (57%) and man (43%) would still see a healthy rate of earnings replacement. However, the PPI's analysis of our proposed model suggests that median and higher earners would need to make additional voluntary savings if they want to achieve the Pensions Commission's target replacement rates.

Managing the transition

This report has not addressed how to get from where we stand today to our vision for the future. This is because we have focused our contribution to the debate on how we respond to the pensions challenges facing the UK. Also, analysing how to manage the transition would require another report almost as long as this one. We plan to

undertake further work on this important issue but we also believe that this should be a key part of what the Pensions Commission should examine next.

We therefore simply comment on some broad principles for managing the transition and set out some key issues that we feel will need to be addressed:

- **The transition period should be as short as possible.** This will help to reduce the complexity and cost of administering more than one system. Faster transition will also aid understanding of the new system and help deliver buy-in to the new approach.
- **We must avoid creating large numbers of winners and losers.** No system of reform will be totally fair to everyone or be seen as such. However, it will be important to limit as far as possible any feelings of unfairness if any approach is to gain widespread acceptance. For example, care will be needed to avoid heavy-handed redistribution that leaves any income groups feeling substantially worse off. We must also avoid creating significant winners and losers among different generations.
- **Limit avoidable damage to existing coverage.** We must ensure that we do not unintentionally undermine existing pension schemes that would otherwise continue to provide substantial numbers of people with a secure income in retirement. Detailed work will therefore be required on the interrelationship between our proposed system of government co-contribution to employee contributions to our second pillar, tax relief arrangements for employers and employees, and pension scheme regulation so that they will allow our second and third pillars to work alongside each other.

1 The challenges we face

The interim report of the Pensions Commission set out the nature of the challenge facing the UK. For example, maintaining an average replacement rate of 60% without any change in the actual retirement age would require an increase in the proportion of GDP transferred to the retirement age group from 9.9% today to 17.5% in 2050, or somewhat less if effective male and female retirement ages are equalised.

Alternatively, keeping pensioners as well off relative to their pre-retirement incomes as they are today without raising taxation or the savings rate would require the average male retirement age to rise from 63.8 to 69.8 by 2050. Among the 30 member countries of the Organisation for Economic Co-operation and Development (OECD), only Mexico and Israel have effective male retirement ages at anything close to this, both averaging about 68. In reality, the solution to this pensions challenge will have to come from a combination of an increased transfer of resources to the retired population, financed partly through increased pension contributions and partly through higher taxation/ National Insurance contributions, and higher average retirement ages.

We also accept the analysis set out in the Pensions Commission's interim report and in subsequent presentations by Commissioners that other possible solutions will only provide a limited contribution. These include increased immigration, accumulating wealth through the housing market and investing overseas to raise returns. However, our analysis of these issues and, in particular, of prospective investment returns reinforces the

importance of ensuring that the UK experiences strong and stable economic growth and reduces the administrative costs associated with providing pensions.

Substantial problems to overcome

Any proposals for reforming the UK's pensions system must address a number of difficult problems and unfavourable trends. The scale of these problems, many of which are interrelated, means that small changes, such as tinkering with tax incentives, are unlikely by themselves to provide the whole solution. In addition, the need to address unfavourable trends may well mean that the best solution is different from what might be proposed if we were starting today with a blank sheet of paper.

Pensioner poverty

A recent report by the OECD ranked Britain's state pension system as 26th out of 30 in terms of the proportion of post-tax income that a worker on average earnings would expect to receive in retirement, and concluded that it was 'arguably the least generous' in the developed world. This OECD report showed that someone working full-time on average annual earnings of £22,000 could expect their retirement income from the state to be 48% of their after-tax earnings whereas state pension systems in other advanced countries replace, on average, around 70% of post-tax earnings.

In addition, a significant number of pensioners still live in relative poverty today despite some recent government initiatives to try to address this. While the richest fifth

of single pensioners have an annual income of around £19,000 (87% of national average earnings), the poorest fifth have to make do with just £4,600 (21% of national average earnings). A report by the Pensions Policy Institute (PPI), *The Pensions Landscape*, showed that private pension income, mainly from occupational pensions, was the main reason for the difference between the incomes of richer and poorer pensioners and that the recent growth of private pension income had widened the gap between the richest and the poorest pensioners. The PPI estimated that about a quarter of all pensioners were living in relative poverty, with these being typically older pensioners, women, people from ethnic minority groups and those who had previously been self-employed. This situation is likely to be politically unsustainable in the longer term, particularly given the growing strength and influence of the increasingly vocal 'grey' lobby.

Declining and patchy provision

The latest figures continue to paint a picture of declining pension provision in the private sector. They show a continuing shift away from defined benefit (DB) towards defined contribution (DC) occupational pension schemes, a growing reliance on individual provision, and substantially lower levels of coverage for the self-employed and those in smaller firms. They also confirm that contributions to DC schemes are significantly lower than those to DB schemes.

Some of the key trends are as follows:

- Within the private sector, data from the Government Actuary's Department (GAD) shows that active membership of DB schemes has declined from covering 29.9% of employees in 1983 to 19.1% in 2000. Over the same period, membership of DC schemes rose from 1.3% in 1983 to 4.8% in 1995 but fell back to 3.7% in 2000. More recent data from a survey by Hewitt, Bacon and Woodrow shows that, for the first time, more than half (51%) of employees who have the right to join a DC scheme have failed to do so. The number of companies with very high penetration of scheme membership (80% to 89%) has also halved from 13% in 2004 to just 6% in 2005.
 - A survey by the Association of Consulting Actuaries (ACA) indicated that almost 70% of DB schemes are now closed to new members and that 10% of them are closed to contributions from existing members.
- This latter proportion is expected to rise as 45% of DB schemes are being reviewed by their sponsoring employer over the next 12 months.
- Contributions to DC schemes are generally significantly lower than those to DB arrangements. According to the above ACA survey, combined employer and employee contributions to DC schemes average 10% of earnings compared with 22% of earnings for DB schemes. However, this gap may close in the future as there are some signs that companies are seeking to reduce their contributions to DB schemes while raising their payments into DC arrangements.
 - Stakeholder pension schemes have failed to fill the gap. Overall, 30% of employers provide access to a stakeholder pension scheme but only 5% of them make any contributions to them. Even among firms with more than 1,000 employees, less than a fifth make any contributions.
 - Declining employer provision has been partially offset by increased personal provision. However, individual personal pensions account for a small proportion of the total with very few sales to employees on less than average earnings.
 - Between 1996/97 and 2002/03 the number of people who were not contributing to private pensions increased from 9.6 million to 11.3 million. Some of the biggest reductions in participation were among the self-employed, with the proportion of men contributing falling from 58% in 1996/97 to 42% in 2002/03 and of women from 35% to 30%.
 - People working for smaller firms are particularly vulnerable: 71% of firms with 1 to 49 employees do not offer any sort of pension for their employees, compared with 40% of companies with 250 or more employees.
 - 53% of self-employed men and 71% of self-employed women had no pension provision according to the 2001/02 *General Household Survey*.
 - There is huge variation in pension provision by industry sector, ranging from just 19% of employees in hotels and restaurants to 87.5% in the public sector. Manufacturing is in the middle of the pack at 60.5%.
 - Just under three-quarters (72%) of those earning an annual salary of between £25,000 and £39,999 are members of private sector employer-sponsored pension schemes but exactly the same proportion of those earning less than £9,500 per annum are not members.
 - Those in less secure employment are much less likely to

be covered. Some 81% of men in full-time employment with five years or more service reported that their employer had a pension scheme and 89% of them participated in it. By contrast, only 57% of men in full-time employment with less than two years in their jobs indicated that their employer had a pension scheme and only 49% participated in it.

Rising complexity, poor understanding

While the UK's state pension arrangements have always been quite complex, this problem has increased in recent years for a number of reasons. These include the replacement of the State Earnings-Related Pension Scheme (SERPS) by the State Second Pension (S2P) and the growth of means-tested benefits. The Pensions Commission has commented that 'the UK has the most complex state/private pension system in the world'. Only 44% of people claim that they have a good or reasonable understanding of pension issues and this percentage is falling.

This complexity has made it increasingly difficult for those below pension age to know accurately what their entitlement to state pension benefits will be when they eventually come to retire. The recent extension of means-tested benefits means that it is also now more difficult for individuals, particularly if they are on relatively low incomes, to know whether or not it will be financially worthwhile for them to make some modest savings for their retirement. This is because these savings could reduce their eligibility for some means-tested benefits to which they might otherwise be entitled.

This problem will be exacerbated in the future if the government continues to raise the basic state pension (BSP) in line with prices but increases the guaranteed part of the Pension Credit in line with average earnings. This will expand the number of pensioners on low and middle incomes who will become eligible for means-tested benefits. According to the PPI's *General Election Pensions Briefing*, 2.7 million households received Pension Credit in 2004, with this expected to rise to 3.35 million households by 2009/10. However, this understates the number of people entitled to Pension Credit because around 25% of all eligible households are currently not claiming it. The PPI estimates that up to 64% of all those aged over 65 will be entitled to receive Pension Credit by 2025 compared with around 50% today.

These problems are compounded by the interrelationship of these arrangements with occupational and private pensions, particularly the opportunity for individuals and pension providers to contract out of part of the state pension arrangements.

The complexity of the UK system has also exacerbated the problem of selling pensions profitably to low-income savers. Modelling by Deloitte, the tax consultants, shows that providing pensions to low-income savers is only profitable if they are subsidised by 'bundling' them with high-income savers. Complexity compounds the fears of providers that, in the future, they will be accused of having mis-sold pensions, particularly to lower-income groups.

Given the problems of complexity and high levels of financial illiteracy and basic innumeracy, it is not surprising that levels of public understanding of pensions are low and falling. Only 13% of people claim to have a good understanding of pension issues, with 53% reporting patchy or minimal knowledge (up from 46% in 2000).

This complexity has made it possible for previous governments to make quite significant changes to state pension arrangements that have reduced the pension entitlement of many people without any real public outcry. This is because most people, as well as most politicians and pressure groups, were either unaware that the change was being made or, if they were aware, they did not really appreciate its financial impact. An example of this was the significant reduction in future SERPS benefits made by the government in the 1980s. It is difficult to imagine that this change could have been introduced without public outcry in an environment where people really understood their state pension arrangements and, therefore, the reduction in their future state pension benefits that was being made.

Lack of trust

There is increasing evidence of declining trust in all pension providers, although employers tend to come out best from these comparisons. In a YouGov survey for the Association of British Insurers (ABI) 81% of those asked tended to distrust or not trust the government at all, with corresponding figures of 38% for pension providers and 27% for employers. Less than 1% trust the government a great deal, compared with 7% for pension providers and 13% for employers. A CIPD survey showed broad levels

of trust in employer schemes, particularly in the public sector (92% level of trust) where they are more generous, compared with 83% in services and 73% in manufacturing where more changes have occurred in recent years.

The lack of public confidence in government partly reflects the changes to public pensions policy that have been made over recent years. Public distrust of the private pension industry has been driven by the mass mis-selling of private pensions in the 1980s and early 1990s together with more recent problems associated with Equitable Life.

There is also a growing distrust of the government among employers on pension issues as they have seen governments altering the rules of the game by making legislative changes on many occasions over recent years, particularly for DB schemes. This has meant that the value of the pension 'promise', and its associated cost, initially made by employers to employees when their DB scheme was started has increased due to legislative requirements, often quite significantly.

Regulation deters employers

Rising levels of complexity and regulation are also impacting on employer attitudes towards pensions. Despite government statements that it is trying to reduce this complexity, the Pensions Act 2004 contains 325 clauses and 13 schedules in 366 pages of complex legislation. This is now being supplemented by around 90 sets of detailed regulations, which in some instances are over 100 pages long, together with numerous codes of practice from the Pensions Regulator. This has inevitably increased the complexity of the legal framework.

Part of the reason for this has been the government's desire for occupational and private pensions to play a greater role relative to public provision, which has led it to regulate occupational and private pensions tightly. For example, it has responded to concerns over employers becoming insolvent with DB occupational pension schemes that are insufficiently funded to meet accrued pension benefits in full. It has introduced the Pension Protection Fund (PPF) as a form of insurance scheme for members of DB schemes and brought in the Financial Assistance Scheme (FAS) to provide some compensation for members of schemes that are not covered by the PPF.

The simplification of taxation affecting occupational and private pension arrangements, which will come into effect in April 2006, has generally been welcomed by employers and employees. However, it is still felt by many people that the legislation affecting occupational and private pensions is largely being driven by the desire of the Treasury and Inland Revenue to prevent tax 'leakage' from the system rather than designed to encourage saving for retirement.

It can be argued that one reason for the complexity of the legislation affecting occupational and private pension arrangements is the relatively low level of state pension provision in the UK. Understandably, the government has sought to ensure that occupational and private pensions are relatively tightly regulated in order to protect accrued pension benefits. This is because the level of state pension on which people will have to fall back if these pension benefits do not materialise is relatively low. In reality, the government is using occupational and private pensions to deliver some form of guaranteed level of pension over and above the relatively modest state pension and, therefore, avoiding members of these schemes having to rely on means-tested benefits for part of their retirement income.

This problem has been demonstrated by some recent examples of employers with DB schemes becoming insolvent with schemes that are insufficiently funded to meet, in full, accrued pension benefits. This has often resulted in members losing significant pension benefits and therefore having to rely on state pension benefits in retirement. The government's response to this has been to introduce further legislation in the form of both the PPF, as an 'insurance' scheme for members of DB pension schemes that is being financed by a levy on all DB schemes in the private sector, and its FAS.

A constant stream of legislation affecting occupational pensions and, in particular, DB arrangements has been introduced by governments of all political persuasions over the last 20 or 30 years. As a result, the original benefit structure of these schemes has had to be changed by employers during this period to meet these additional legislative requirements. Examples of these changes include the requirements to provide increased transfer values for members who leave schemes, to enhance the value of deferred pensions and to provide limited price indexation (LPI) of certain accrued pension benefits. Most

recently, legislation has required solvent employers with DB schemes, who want to limit their future liabilities by closing them, to ensure that they have sufficient funds to secure all accrued member liabilities before their scheme can be closed.

All of these legislative changes have, over this period, gradually increased the cost to employers of providing occupational pensions for their employees because the value of the original pension benefits that were initially 'promised' to members when the scheme was set up have had to be increased. Moreover, these employers are effectively locked into these enhanced arrangements as it is difficult and often expensive to get out of them without a consequential adverse impact on company finances. It will be important to ensure that, with the increasing move from DB to DC pension arrangements, future governments do not introduce legislation that will increase the costs for employers of providing DC pensions. They could do this by, for example, specifying that a minimum level of investment return has to be achieved by funds providing DC pensions, as has occurred recently in Switzerland.

Pensions out of line with changing labour market and society

Pensions arrangements no longer reflect today's realities. Originally, state pensions were designed so that most women gained their entitlement to their pension income through their husband rather than in their own right. This is increasingly inappropriate with a rising number of women in paid work, marriages breaking down more frequently and a growing number of people with caring responsibilities. In addition, an increasing number of people, particularly women, have more than one part-time job, with none of them on their own paying above the lower earnings limit for NICs and therefore not generating entitlement to the BSP. In many cases, these jobs are juggled with part-time caring responsibilities that are less than the 35-hour weekly level required to generate credits towards entitlement to the BSP.

This is contributing to some people considering new arrangements, such as a Citizens' Pension, where eligibility for state pensions would be determined by an individual's number of years of residence in the UK rather than their NICs prior to retirement. However, this would bring to an end the contributory principle on which the UK's state pension arrangements have been based since they were first introduced, even if the link between contributions and payments of the BSP is much weaker today than is commonly understood. We examine later in this report whether alternative approaches would bring pension arrangements into line with what today's labour market and society needs.

The dangers of doing nothing

Some people believe that, left to their own devices, individuals will make rational decisions and that we can rely on the market to adjust to the demographic challenges facing the UK. However, the evidence both from current trends in the UK and elsewhere, as well as from economic analysis, is that this approach will turn out to be dangerously complacent. Without action, the current problems of pensioner poverty, lack of understanding and trust, together with the disengagement from pension provision by many employers, will worsen. Indeed, it is not too difficult to construct a scenario in which increasing levels of pensioner poverty lead to more means-testing and greater regulation of occupational and private pensions. This in turn could compound the current problems of disincentives to save, lack of understanding and disengagement from pensions. In this scenario, the eventual increase in taxation that would be required to provide decent incomes in retirement for a growing number of older people is likely to be much higher than it would have been if we had taken the right action in sufficient time.

2 The choices before us

In deciding the course that pensions policy in the UK should take in the coming decades we face a number of choices that are discussed in this section. In reality, we may end up choosing a middle way on some of these issues. However, these choices illustrate the fundamental decisions that will need to be taken in the near future. They will need to be rooted in rigorous analysis and backed up by a substantial base of evidence. They must also provide the foundation for building a consensus on the way forward and be capable of being sold to all the key stakeholders – individuals, employers and pension providers.

State or private?

The Department for Work and Pensions (DWP) currently has a Public Service Agreement target that sets out a long-term goal of shifting the balance of pension provision from 60% public, 40% private to 40% public, 60% private. This has superficial appeal in that employers and many economists tend to favour a smaller role for the state, with the market left to provide the most efficient outcome. In addition, evidence showing high levels of distrust of the government in the field of pensions provides another reason for it to want to step aside.

One way of doing this would be to follow New Zealand's approach. New Zealand has one of the world's simplest pensions systems. It pays out a flat rate Citizens' Pension worth around 35% of average earnings. Its approach is based on leaving decisions on pensions to individual preferences and using other parts of the tax and benefit

system to redistribute income from the better off towards poorer households. New Zealand is one of only four OECD countries – along with Australia, Ireland and Mexico – without some form of public earnings-related second-tier pension.

However, the market does not always provide either the most efficient or the fairest outcomes and there is significant evidence that market failure, particularly in the UK, makes a compelling case for a greater role for the state. The evidence from behavioural economics suggests that people do not make rational financial decisions, particularly about pensions. Given the complexity of the decisions involved, people are driven by emotion and by familiarity, invest in what they understand, chase the market and follow fashions.

They also tend to put off decisions until external events force their hand, with more choice tending to generate greater levels of procrastination. The UK's complex pensions system and the lack of public trust in all pension providers make the situation worse, as do our relatively high levels of financial illiteracy and basic innumeracy. This complexity also tends to make providers unwilling to sell pensions to people on low and middle incomes, both for fear of providing the wrong advice and because of the high costs involved. In-depth interviews conducted by Which?, the consumer lobbying group, also illustrate the problems associated with getting people to focus on pensions – in particular, the tendency to put off decisions until another day, too much choice, lack of trust in providers and in pensions generally (with property seen as a better

investment), poor understanding and a desire to delegate responsibility for taking decisions to others.

Making pensions mainly an issue of personal responsibility therefore creates the risk that a large number of people will make bad decisions or none at all, and will then face poverty in retirement and/or have to be bailed out by the state. This parallels the problems of moral hazard in insurance, except that there is also a political dimension to pension provision. If bad investment decisions mean that large numbers of people go into retirement facing low incomes for the rest of their lives, the government of the day will face heavy pressure to increase basic pension provision at potentially great expense.

A shift in the balance towards private provision would also mean that employers would be likely to come under considerable pressure to take a greater role in providing the advice needed to help people make decisions about pensions and raise the level of savings. Similar comments apply to tackling low levels of financial understanding and awareness of tax incentives. In addition, the government will be inclined to regulate occupational and private pensions even more tightly if it expects them to play a greater role in providing retirement income.

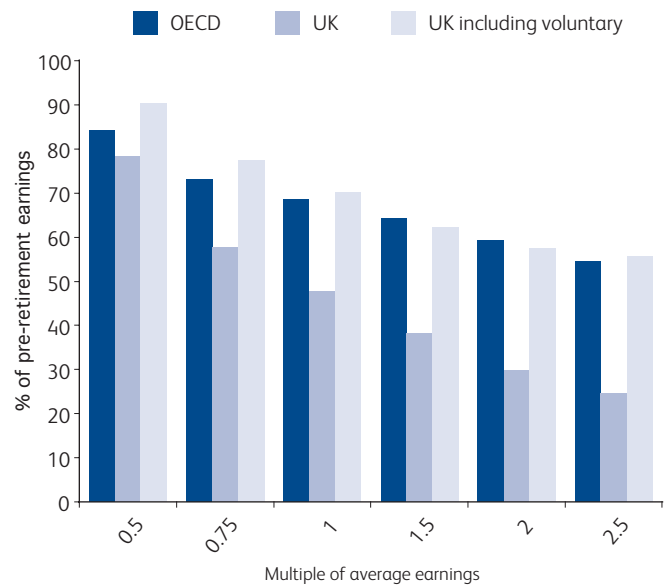
The government's planned shift from public to private provision combined with the movement (outlined in Section 1) away from the greater certainty provided by DB pensions towards a more uncertain world of DC schemes will increase the risks borne by individuals that could lead to many people facing retirement without adequate incomes. This is because members of DC schemes bear the following risks:

- **investment return risk** associated with volatile stock market returns;
- **longevity risk** associated with increases in the life expectancy of their cohort, which depresses the returns on the annuity they purchase on retirement; and
- **earnings progression risk** associated with earnings just before retirement turning out higher than anticipated when they started saving, and their pension therefore failing to deliver their expected replacement rate.

Chart 1 presents information drawn from the OECD's 2005 *Pensions at a Glance* publication. The OECD excludes

Chart 1

UK pensioners reliant on voluntary provision
Net replacement rates by earnings level,
mandatory pension programmes, men



Source: OECD *Pensions at a Glance* 2005

voluntary occupational provision in countries such as the UK, the US, Canada and Denmark because coverage is significantly less than 90%. However, it also presents separate figures including voluntary provision. Based on the OECD's modelling of current pension systems, Chart 1 shows that, if voluntary provision is excluded, the UK system provides a substantially lower level of wage replacement. However, including voluntary provision puts the UK more or less on a par with the OECD average. This illustrates the risks of poverty in retirement in the UK for those not covered by good occupational pensions or who make poor investment choices.

Our analysis suggests that a shift away from state provision is likely to produce unfavourable pension outcomes for the UK unless steps are taken to address other associated problems. Nonetheless, it will be important to explore options that give people a sense of ownership and overcome the current problems of distrust of government but which do not expose individuals to unacceptably high levels of risk and the consequences of making bad decisions.

Voluntary or compulsory?

The trends presented in Section 1 suggest that the voluntary system will not deliver adequate incomes in retirement unless steps can be taken to turn round its performance. The question is whether this is possible and, even if it is, how long will it take to achieve the required increase in savings? Can we find ways of overcoming the current forces of confusion, cynicism and inertia? The experience from abroad suggests that some improvements are possible, but will they go far enough in the time available?

Overcoming ignorance and inertia bears fruit ...

Recent evidence shows that efforts to improve understanding of financial issues can bear substantial fruit. This includes:

- Evidence from 401K retirement plans in the US shows that efforts by management to communicate the benefits of investing in pensions are more effective in raising participation rates than employers offering to match the contributions made by employees. For example, employers matching employee contributions at a rate of 25% are far more effective in raising participation rates when combined with active communication efforts than without them. In addition, 25% matched contributions combined with management communication are almost as effective as 100% matched contributions and no communications.
- Employer-provided financial education seminars in the US increased participation rates of lower-paid workers by 12% and higher-paid workers by 6%. The financial wealth of those on the lowest incomes also increased by 70%.
- A financial responsibility and pension education programme in New Zealand, involving press and TV advertising as well as a website that provides information, advice and assistance with calculations, has helped to double contributions to personal pensions without the government providing any tax relief. Around 1 million people out of a population of 4 million have visited the website, making 2 million calculations, with high participation rates among women and ethnic groups.
- The DWP's analysis shows that statutory money purchase illustrations (SMPIs) have generated awareness of the need for increased savings, with 62%

of all respondents saying that they would increase savings. In a follow-up DWP survey, 63% said that they had noticed their SMPI figures with 37% of them claiming to have already increased savings.

Similarly in Sweden, the percentage of people saving in personal pensions has doubled in the decade since the introduction of pensions forecasting.

... but requires significant effort ...

Studies in the US also show that developing mechanisms to overcome the reluctance of people to take financial decisions can also be effective in raising participation in pension arrangements and pension contributions. These mechanisms include automatic enrolment (enrolling people as members of schemes and giving them the decision of whether to opt out) and Save More Tomorrow (SMT) plans where employees are given the choice to increase contributions immediately or to adopt SMT plans by delaying the increase until after their next pay rise. Those who choose SMT plans have their rate of contributions increased at each pay rise until they decide to stop.

A US study by the Wharton School and the United Health Group found that automatic enrolment raised participation among poorer workers from just over 10% to 80%. Other US studies have shown automatic enrolment in 401K plans has increased participation from 30% to 80–90%. Research into SMT plans in the US shows that people joining them have tripled their pension savings from 3.5% of earnings to 11.6% in just 28 months. However, it is necessary to be careful with this evidence as SMT plans have only been trialled in a very small number of companies, with the results being boosted by the high level of involvement of company chief executives in providing briefings to all employees.

US politicians are currently looking at whether to include automatic enrolment in 401K plans in forthcoming social security legislation. In New Zealand, the government is looking at introducing measures that would require new employees to pay 5% of their earnings into a state-sponsored funded scheme with very low administrative and fund management costs. However, the New Zealand approach would stop short of full compulsion as employees would be allowed to opt out of this scheme.

Overall, the evidence suggests that a combination of

education, advice and measures that overcome inertia can be effective in raising participation in pension arrangements and pension contribution rates, particularly among low-income groups. In many cases, this works well when it appeals to people's gut instincts, fears and aspirations. Good examples of this are US campaigns asking people whether they still want to be working when they are 82. The government would need to lead such a campaign and it would also be in the interest of financial service providers to support this with resources. However, this would still leave a role for employers in terms of communications to their employees and administering anti-inertia mechanisms such as auto-enrolment and SMT plans.

... and does not address workplaces with no provision

Despite the effectiveness of these measures, only 42% of the US working population is covered by occupational pensions, which is below the UK's figure of 45%. It is similar to the 47% coverage in Australia before it introduced compulsory pension contributions but it is well below the 91% that has been achieved in Australia today. This suggests that more radical measures would be required to address the problems of the number of companies in the UK that make no pension provision for their employees. For example, some 71% of employees in firms with less than 49 employees do not participate in an employer-sponsored pension scheme and the same is true for 56% of those with 50 to 249 employees. Even 40% of employees in firms with more than 250 employees are not covered. Most of these people will also have limited personal pensions.

Compulsory pensions have raised participation in Australia ...

Australia's experience with compulsory pensions shows the potential to achieve results although their model has a number of defects. Its scheme was based on compulsory employer contributions, originally starting at 3% of earnings and gradually rising to reach 9% from 2002. Benefits from these contributions can be drawn from age 55 as either a lump sum payment, an annuity or can be drawn down in stages. Based on 9% contributions over 40 years, the OECD estimates that this should replace 52% of earnings in retirement. The lump sum option is currently taken up by 80% of pensioners.

Occupational pensions are mainly trust-based and operate under the superannuation guarantee system which is compulsory for all employees earning more than 15% of average earnings. Over 80% of these pensions are on a DC basis, with DB schemes being mainly confined to the public sector. There is a mix of retail and industry funds with charges varying from 0.42% of assets for public sector schemes to 2.34% for some retail funds.

Compulsory pension savings in Australia have achieved a number of results:

- Coverage of occupational pensions has been extended from 47% to 91% of employees.
- Employees now generally make voluntary contributions of 3% to 5% of earnings on top of their compulsory contributions, although this is partly because pensions savings are tax-efficient compared with high rates of tax (47%) on other forms of savings. Some 60% of employees aged 45 and above make additional contributions of at least 5% of salary.
- Studies have suggested that compulsory pension savings have resulted in the savings ratio being raised by around two percentage points above what it would otherwise have been, although it has still fallen and has recently turned negative. This, however, reflects other trends in Australia such as financial deregulation and rising property values, and also the fact that savings are highly taxed.
- Wage inflation fell following the agreement on compulsory pension contributions, with Australian wage rises averaging 3.4% in the 1990s, well below the OECD's average of 5.2%. This contrasts with the 1980s when wage rises averaged 8.4% in Australia compared with 7.0% across the OECD.

... but their system has defects

Despite these achievements, we believe that the Australian system has a number of weaknesses:

- The ability to draw an occupational pension at age 55 (although this is soon to be raised to 60) provides little incentive to carrying on working beyond this age. In addition, Australians are able to take this as a lump sum payment, which might get used up by the time they reach the basic state pension age of 65, confining them to low incomes for the rest of their lives.

- Pensions are highly taxed with contributions taxed at 15% and an extra 15% if individuals earn over an income threshold, a 15% tax is levied on each fund and benefits are taxed at between zero and 30%.
- The compulsion threshold has been set very low at 15% of average earnings, causing hardship for those on low incomes.
- Pension accounts are not fully portable with each employee having, on average, three accounts, which has pushed up administration costs.

Is there an appetite for compulsion?

The Australian experience illustrates how compulsory pensions can work but the question is whether it would be acceptable in the UK. The evidence suggests that support for compulsion is growing but that we are some distance away from a consensus forming that this is the best way forward. A considerable effort would be needed to make the case for compulsion, and supporters of this approach might therefore need to look at staging posts on the road to compulsory savings such as the measures considered above.

However, it is important to remember that there is already an element of pensions compulsion for both employees and employers, although less so for the self-employed, in the current arrangements. Therefore, the real question to be asked is whether there should be more compulsion and/or whether the current level and form of compulsion needs to be changed so that it is more effective in delivering pension provision.

The *EEF/Aon Consulting 2004 Pensions Survey* pointed to growing support for compulsory employer contributions among companies that were already providing pensions for their employees. The proportion of these companies supporting compulsory employer contributions has increased from 50% in 1998 to 56% in 2002 and 68% in 2004. As Table 1 shows, the largest increases in support have come from the smallest and medium-sized firms.

In contrast, support for compulsory employee contributions has barely changed over the same period, rising from 74% in 1998 to 77% in both 2002 and 2004. Only among the smallest firms has support grown, from 69% in 1998 to 80% in 2004.

Table 1 Growing support for employer compulsion among those who provide pensions
% of firms (by number of employees) supporting compulsory employer contributions

	1998	2002	2004
Less than 50	40	38	62
50–499	52	58	72
500 and above	57	68	61

Source: *EEF/Aon Consulting 2004 Pensions Survey*

Some other organisations also support compulsion to varying degrees. The Institute of Directors’ *Business Election Manifesto* stated that the guiding principles for pensions reform should include ‘an element of compulsory contributions for both employers and employees’. The TUC also supports compulsory contributions by employers and, to a lesser extent, by employees. The Employer Task Force on Pensions in its recent report for the DWP set out a number of recommendations to make voluntarism work better. However, it warned that ‘this is the last chance saloon for voluntarism’.

The Association of British Insurers (ABI) released research in 2004 showing that over 70% of people see compulsion as a ‘good idea’, generally shared between employers and employees. Overall, 17% regard compulsion as a ‘bad idea’, although this rises to 28% among the self-employed, 25% among those who do not have a pension and 24% for those with just a personal pension – the key groups that need to be saving more. When respondents were alerted to the fact that there might well be a trade-off between higher employer contributions and their salary, the proportion supporting no compulsory employer contributions rose from 14% to 21%, while the number of ‘don’t knows’ expanded from 13% to 21%. However, this still leaves 58% of people supporting compulsory employer contributions, even when potential salary trade-offs were spelt out, with 27% supporting employer contributions of 7% or more.

Overall, the ABI survey suggests that 17% of working adults oppose compulsion and a further 15% are undecided, 42% support compulsion at or below their current levels (with two-thirds favouring compulsion of

above 10% of earnings) and 26% support compulsion that would force them to pay more or at least something, when they are currently contributing nothing. A more recent survey this year by Which? found that some 73% supported compulsory employer contributions and 71% favoured employee compulsion.

In contrast, the CBI and the British Chambers of Commerce oppose compulsion, as does the Federation of Small Business, claiming that it would have ‘a devastating impact on many small businesses, which would not be able to afford the extra cost’.

Strong campaign needed

Overall, the evidence suggests that there is the potential to build a case for compulsory pension contributions but that it would need a concerted campaign to improve public understanding of the issue and to overcome levels of distrust in government about pensions. The experience of countries like Australia and Sweden that have recently made significant changes to their pensions systems illustrates the importance of developing a coalition of interests to make the case for change.

The circumstances in Australia were very favourable in that the process was started by a new government with a large majority led by the ex-leader of the Australian TUC, Bob Hawke. Gaining trade union support was therefore relatively easy as Australian unions, faced with declining membership, were looking to extend their role beyond central pay bargaining. There was strong trade union pressure to extend the coverage of company pensions, which previously had been the preserve of only 40% of the population, mainly male, ‘white-collar’, middle-class workers. Big business also saw the benefits of increasing the national savings rate and thereby developing stronger capital markets.

The case for change was also made easier by setting up an independent inquiry and by having a large-scale public education programme. In addition, Australia had a system of national and sectoral collective bargaining that allowed trade-offs to be made between increased employer contributions and lower wage rises at a national level. High levels of inflation in pay and wages also made it easier to introduce the initial employer pension contribution of 3% of earnings than would be the case in periods of

low inflation. This was because it involved a similar-size sacrifice in the rate of the annual wage rise received by employees. Even with these favourable headwinds, the original Australian plan did not survive intact. Of the 15% of earnings that was intended to be the total compulsory pension contribution, only the 9% employer contribution has been introduced, with the 3% contribution by both employees and the government being cut out of the original plan. This illustrates not only the limits of compulsory savings but also the difficulties of achieving change.

Minor changes will be insufficient

Overall we believe that making minor changes to the current voluntary system will not be sufficient to deliver decent levels of retirement income across UK society. Efforts to raise understanding and to overcome inertia would certainly produce results and are needed in the UK. At the very least, a major public campaign is required. However, we doubt that on its own this will generate the required change in attitudes and behaviour by both individuals and employees.

We therefore must begin to look at alternatives to voluntary private pension arrangements. This should include trials to gauge the effectiveness in the UK of mechanisms such as automatic enrolment schemes (which according to the Government Actuary’s Department (GAD) and the National Association of Pension Funds (NAPF) are already used by 41% of UK pension schemes) and SMT plans. Introducing any form of compulsory private pensions would need to be done gradually to allow enough time to make the case for it and to seek to build a consensus. In addition, it would be important to give employers and individuals the opportunity to adjust to the financial consequences of compulsion. Nonetheless, we believe that work must begin soon on making the case for this change.

Funded or pay as you go?

Funded pensions offer higher returns and greater choice ...

A key choice facing any government devising public pension schemes is whether they should operate on a ‘pay as you go’ (PAYG) basis under which today’s taxpayers

fund the pensions paid out to today's pensioners or whether they should be fully funded (FF), providing income for future pensioners on the basis of the returns earned by investing their contributions. In practice, it is possible to devise hybrid arrangements that seek to capture the advantages of both approaches (such as the type that exists in Sweden, examined later in this section).

An FF pension has a number of potential advantages. In one way, it reduces the burden on government spending by moving from the taxpayer to the stock market the mechanism for transferring resources from employees to pensioners. It has the potential to deliver high returns linked to the performance of the stock market although this also carries with it higher risks. Funded schemes also have the potential to increase the growth rate of the UK economy by expanding the pool of savings available to fund investment, although this depends on today's employees reducing the growth in their spending and saving more.

It can also provide future pensioners with a degree of choice about how they invest their savings. People may be more willing to accept forced savings if they can clearly see money in their own account. It is also easier for FF pension schemes to be ring-fenced from government and to be presented as such to those making contributions into them. This could well be an important factor in an era where trust in government has fallen, particularly in the area of pensions. Presented in this way, paying pension contributions into individual pots is more likely to be seen by individuals as saving for their retirement rather than just additional taxation.

... but are riskier and more expensive

Against this, there are some significant disadvantages with FF schemes. One major downside is the degree of risk associated with investing in shares. Shares perform better than other investments. For example, between 1899 and 2003 the average annual return for all of the 20-year periods was 5.5%. This compares with 2% for index-linked bonds. However, returns have varied hugely over the last 100 years, with 15 20-year periods when annual returns were less than 2% and 18 periods when they were over 8%. Poverty or prosperity in retirement is therefore very much a matter of luck under FF arrangements. This raises major questions as to the degree of risk to which low-

income savers should be exposed, particularly if pension savings are compulsory. Of course, risk can be reduced by investing in bonds, but this reduces one of the advantages associated with FF schemes – the higher returns that they can deliver.

In addition, FF schemes tend to be more expensive in terms of the costs of administration, marketing and advice. This is important because returns in the future are likely to be lower than the unusually high ones seen in the past two decades, and demographic trends are likely to have a negative influence on returns. If any government decides to increase the funded element of pension provision, it will need to find some way of minimising costs while keeping some element of choice for individuals. This will not be easy given that across the world even compulsory schemes have suffered from high administrative costs.

The transition from PAYG to FF arrangements can also be highly expensive as either the government or employees will be required both to finance the claims of existing pensioners and also to make contributions towards their own pensions. Some detailed work by David Miles and Alan Timmermann has looked at the crossover point where the contribution rate required for a funded scheme including transition costs falls below the contribution rate required by the existing PAYG scheme. The results are very sensitive to annual rates of return, with the crossover point being reached in 20 years with returns of 9% but only reached in 50 years if returns are as low as 3%. This again emphasises the importance of a strong stock market and low administration and fund management costs.

One of the advantages of PAYG schemes is that they protect people from the implications of risky investments, although not from the political risk of governments defaulting on pension promises. They also tend to be cheaper to run, although this depends on whether the government gives individuals the option of contracting out of public provision as they can currently do with the State Second Pension (S2P). Alternatively, governments could give people the choice of having their savings invested in funds with different combinations of risk and return. Allowing people to do this should, in theory, provide better outcomes by allowing people to make arrangements that most closely match their needs. However, choice implies advice and this means higher costs.

The above analysis demonstrates that it may be better to try to avoid having ‘all of one’s eggs in one basket’ by adopting some combination of PAYG and FF approaches for state and compulsory pension provision.

Swedish approach offers middle way

The reforms introduced in Sweden in 1999 offer a possible way to capture the advantages of both PAYG and FF approaches. They comprise a premium pension into which 2.5% of average earnings are paid (see Section 4) and a defined contribution system with notional accounts into which 16% of earnings are paid. This is a new type of scheme – an unfunded, defined contribution scheme with the overall returns to participants indexed to average wage growth. This system therefore gives each person contributing to it a share of the fruits of Sweden’s economic growth but without exposing them to the uncertainties of the stock market. Each person has an individual account based on their contributions, which allows them to access an annuity from the age of 61, but there are strong incentives to continue working and contributing for longer.

These make the difference between a replacement rate of 61% at age 70 and 37% at age 61. Although the Swedish system is more expensive than many others in Europe, it has been designed to prevent increases in costs, such as those caused by rising life expectancy, by including a mechanism that will lower the rate of indexation of assets in the system if projections show liabilities starting to exceed assets. Effectively, this means that individuals collectively take on the risks associated with rising life expectancy but still have a reasonable degree of certainty about the income that they will enjoy in retirement.

The Swedish system may not prove to be appropriate for the UK, but it illustrates the importance of exploring approaches that give people a sense of ownership and do not expose them to unacceptable levels of risk. One way to do this might be to give them a choice between a limited number of investments that are clearly branded according to the level of risk involved. Some, for example, might have a high weighting of government bonds. This is the approach followed in the voluntary system for public sector workers in New Zealand. Contributors are able to choose between four main types of investment fund that are labelled as growth (expectation of higher risk and

higher returns), balanced (expectation of medium risk and medium returns), conservative (expectation of lower risk and lower returns) and cash or fixed interest (expectation of very low risk and low returns).

We should seek to find a combination of approaches to state and compulsory pension provision that gives people a sense of ownership but does not expose them to unacceptable levels of risk. We should look closely at which aspects of the Swedish and New Zealand approaches it would be appropriate to introduce in the UK. Sweden’s system offers a low-cost way of involving the private sector in managing the funds in which people invest, while New Zealand’s system for public sector workers shows how to provide savers with a choice between a limited number of investments that are clearly branded according to the level of risk involved.

Contributory or residence-based?

Growing interest has been shown in the idea of a universal entitlement to state pensions rather than the current approach based on contributions. One example of this is the Citizens’ Pension that has been proposed by the National Association of Pension Funds (NAPF) and which attracted significant interest from Alan Johnson, the previous Secretary of State for Work and Pensions. Under this model, people would qualify for their pension on the basis of their years of residence in the UK rather than their record of National Insurance contributions (NICs).

This would address the unfairness in the current system which means that, in any one year, some 4.5 million people are not able to accrue credits towards the BSP and around 9 million people fail to qualify for S2P. This is mainly because they earn too little or because the rules regarding credits for people caring for dependent relatives do not cover their particular circumstances. This tends to put those with interrupted careers, particularly women, at a disadvantage. The current system is also complex in that a system of credits covers people who have caring responsibilities or receive one of a range of benefits, as well as men aged between 60 and 64. This means that only just over 60% of those of working age actually contribute to both contributory pensions. In addition, the current plan for S2P means that the link with earnings will weaken further over time until it becomes virtually flat. The current

system is therefore unfair, complex and no longer genuinely contributory.

The case for reform is therefore strong and there are some arguments in favour of making the system residence-based. It should be simpler to administer, although there would need to be some way of recording an individual's period of residence in the UK and also of relating entitlement to period of residence, unless the unfairness of an arbitrary cut-off was seen to be acceptable. It could also be argued that the simplicity of a universal benefit would make it easier for people to decide whether it was in their interest to save for their retirement.

However, contributory systems also have advantages that are worth preserving and strengthening and there are ways to address the unfairness of the current system without dismantling it. The UK system has a strong tradition of individuals getting 'something for something' even if the reality today is some way away from this. We believe that it is important to preserve this principle if we are to persuade people of the importance of saving for their retirement. In addition, it can be argued that basing qualification on NIC records provides an incentive to remain in work or to find a job. These are the major reasons why most OECD countries have some form of contributory principle.

Other countries have also shown that there are alternative approaches to address the unfairness associated with basing qualification on NIC records. In Sweden, benefits for sickness, disability and unemployment are treated as earnings in computing pension contributions. Its benefit system may be rather more generous to those out of work than is the case in the UK but it provides a good example of how to preserve the contributory principle while making pension provision more inclusive. For Swedes over 55 who qualify for disability grants, the calculation of their pension is based on estimates of their future earnings up to retirement. Women out of work because they are raising children also receive almost complete compensation for lost pension contributions with childbirth credits lasting a maximum of four years per child.

Some organisations have put forward proposals for modernising the current contributory framework. These include reducing the lower earnings limit to bring more people into the National Insurance system, abolishing

the rules requiring people to have at least ten years of contribution record to qualify for the BSP and granting credits according to the number of hours that are spent caring each week. We have not examined these ideas in this report but we recommend in our proposals set out in the next section that the objective of any changes that are introduced should be that women have the same opportunity as men of receiving the full value of the BSP. We acknowledge that our proposals may be more complex than a universal pension and may take longer to bring about pensions equality between the sexes. However, the contributory principle has a number of advantages and consultation with EEF members has clearly demonstrated strong support for preserving it.

We believe that, on balance, the contributory principle should be preserved, although the system needs to be modernised to address the unfair treatment of those, particularly women, who struggle to qualify for the full basic state pension under the current rules.

What role for means-tested benefits?

Related to the debate on residence or contribution-based qualification for pensions is the role that means-testing plays. All OECD countries have some form of safety net for older people and this is usually means-tested, although the assets covered by the means test and the rate of withdrawal of benefits differ considerably. OECD comparisons show that the UK is unusually reliant on minimum pensions to provide income in retirement. It estimates that the UK's system of credits for pensioners provides some 35% of the total pension promise. Only five other countries – Belgium, Luxembourg, Portugal, Slovakia and Spain – make use of a minimum pension and in all five countries it plays a much smaller role than in the UK. Only in Belgium does it account for more than 10% of the pension promise (11.1%) and in the remaining four countries it is below 5%.

Research by the ABI suggests that close to 20 million people are deterred from saving for their old age because they fear that the means-testing rules will penalise them. It calculated that ending means-testing would yield an extra £3.7 billion in savings each year by those on low to middle incomes.

We believe that it will be essential to offer some form of safety net for those who do not qualify for our proposed enhanced BSP (see Section 3) and that this should be set below the level of the enhanced BSP. **However, we believe that our proposed first and second pillars should provide a decent income in retirement for most people, given that our proposals would include people with low or interrupted incomes within the system. The safety net would therefore need to cover relatively few people. The need for means-testing would also be significantly reduced as our proposed enhanced BSP is being set at the current level of the Pension Credit and would be increased in line with movements in average earnings. We believe that this is essential if we are to move forward and remove the current barriers to saving for retirement created by disincentives to save and lack of understanding.**

A proposed three-pillar model

In the next three sections we detail our proposals for a three-pillar model for pensions in the UK from 2015. This aims to overcome our current problems through:

- **First pillar** – an enhanced BSP that significantly reduces the need for means-testing and provides more financial assistance to older pensioners to whom the state has a greater duty of care.
- **Second pillar** – a modest level of compulsory contributions by employees, employers and the self-employed into individual accounts that are understandable, give people a sense of ownership, support portability, are low cost and do not impose a large administrative burden on employers.
- **Third pillar** – a more lightly regulated regime for voluntary occupational or private pensions which would address employers' current concerns over the growing legislative burden that is being placed on occupational and personal pensions. The combination of our proposed first and second pillar of future pension arrangements would provide individuals with a higher level of secure income in retirement and therefore reduce the need for regulation.

Taken together, we believe that our proposals would engage employers and individuals and address the factors responsible for the current extremes in provision and participation. They would not be costless for employers. However, they would enable them to reduce their exposure to risk and regulation and allow them to concentrate on what they do best – developing new products, entering new markets and creating wealth.

3 The first pillar: An enhanced basic state pension

What the basic state pension should deliver

Our first pillar is an enhanced basic state pension (BSP). To meet the needs of an ageing society in the future, the BSP needs to deliver:

- sufficient guaranteed income in retirement to significantly reduce the need for means-testing;
- incentives to save by making it possible for employees on average income to save enough to bridge the gap between the BSP and their target level of income in retirement;
- a higher level of assistance for those pensioners in greatest need – those aged 75 and over; and
- incentives to continue working beyond the BSP access age by minimising the implicit tax rate on continued employment.

Increasing incentives to continue working

The simplest way to raise the value of the BSP in an affordable way would be to increase the age at which the BSP can be accessed from 65 to, say, 70 as some organisations have proposed. However, we consider that this would be harsh on people from lower social classes whose life expectancy is lower than those in higher social groups and those doing manual work, many of whom would find it hard to work for another five years. In addition, the evidence shows that very few people who can work beyond normal retirement age in their area of work actually choose to do so. Of these, 80% are women and

nearly half of men who choose to do so are self-employed.

Survey evidence shows that there is a general reluctance to work much beyond age 60. For example, a 2003 survey by the Chartered Institute of Purchasing and Supply showed that 70% of people wanted to retire before age 60, although this fell to 57% for those currently aged over 50 who were still working. Analysis by Pam Meadows for the DTI in 2003 also revealed two distinct groups who were likely to go on working beyond the normal age – highly qualified people who enjoyed work for its own sake and those at the other extreme who faced poverty in retirement. However, the great majority of people preferred not to carry on working far into their sixties.

Nevertheless, evidence from surveys and in-depth interviews also consistently reveals a desire among the UK population to remain independent for as long as possible and for flexibility in retirement. In addition, as people get close to their retirement age, their desire to keep working seems to increase. We therefore need to develop a system that provides people with incentives to keep working and the flexibility that they are seeking.

A 2005 OECD study entitled *The Retirement Effects of Old Age Pension and Early Retirement Schemes in OECD Countries* illustrates the powerful impact that the age and level at which individuals can access pensions has on retirement decisions. Indeed, this OECD study suggests that early retirement schemes have played a major role in depressing employment at older ages, particularly in a number of European countries. In its study the OECD uses

the concept of *implicit taxes* on continued work. This refers to the fact that some pension systems are not actuarially neutral – i.e. the cost of staying in work in terms of pension forgone and contributions paid outweighs the higher future pension benefit gained from remaining at work. Looking across the OECD countries, its analysis shows a strong correlation between implicit tax rates and changes in labour participation between consecutive age groups. It suggests that a 10% decline in the implicit tax rate reduces the fall in participation rates between two consecutive groups of older employees by between 3% and 4%.

Across OECD countries, implicit taxes exceed 30% at age 65, partly reflecting the fact that early retirement was generally encouraged in previous decades as a response to high levels of unemployment. For those aged 60, the implicit tax rate on working for the next five years in the UK is around 15%, half the OECD average. However, the UK figure rises to just over 20% by age 65 and is closer to the OECD's average implicit tax rate of just over 30%. If we allow for other welfare payments such as incapacity benefits, the UK's implicit tax rate rises to nearly 30% for those aged 60 and around 25% for those aged 55. The key message is that, although these figures are lower than elsewhere, the incentives to retire early in the UK are still fairly strong. The OECD's modelling suggests that addressing disincentives to continue working could have a powerful impact in almost every country in raising employment rates for older workers. They suggest that, in the UK, this could raise the participation rate for those aged 55 to 64 from 35% to 48% in 2015. **This would equate to an extra 1.1 million people in this latter age band who would be working in the UK in 2025.**

As well as discouraging early retirement, some other European countries are changing their pension systems to create incentives for individuals to continue working for longer:

- In Sweden people can access their state pension at 61 but their pension accounts are indexed by 1.6% per annum (based on an assumed annual rate of economic growth) less than if they had continued working. Taking into account this indexing mechanism and the extra contributions they would have made, this means that there is a replacement rate of 61% at age 70, 46% at age 65 and 37% at age 61.
- Finland is replacing a fixed state pension age of 65 by allowing people to choose between a retirement age band of 63 to 68. For those staying in work after age 63, the pension that they receive increases by 4.5% per annum. Along with stricter disability criteria, this aims to raise the effective retirement age by two to three years.
- In Spain the standard retirement age is 65 and anyone retiring before this faces a financial penalty that depends on how many years' contributions they have made. For someone with 30 years' contributions, their pension is reduced by 8% per annum so that someone retiring at 61 has their pension reduced by 32%.
- In Denmark the age at which an early retirement pension can be accessed has been raised from 60 to 62, with a tax bonus of €13,500 (£9,200) paid to people working beyond age 62.

A two-step basic state pension

Our proposed approach is along similar lines to that adopted by some other countries and seeks to provide some incentive for people to continue working for longer. We are proposing that the BSP paid at age 65 is enhanced but remains at a relatively modest level. The BSP is now around 16% of average earnings, although this will fall over time as a percentage of average earnings because the BSP is currently indexed in line with inflation rather than earnings. On this basis, it is projected to be only 9% of average earnings in 2030. We are proposing that the BSP should be increased to 21% of national average earnings from 2015 and that it is then indexed in line with average earnings so that the replacement rate remains constant and pensioners benefit from the UK's improved economic performance. At the same time, the BSP paid to those aged 75 and over would be increased to 25% of national average earnings and also be indexed in line with average earnings.

We consider that an independent body of pensions experts should regularly review these ages on the basis of changes in life expectancy and in physical and mental health as well as trends in employment patterns and affordability. However, the government would ultimately have to take any decisions to increase these ages based on recommendations made by the independent body. We anticipate that this will probably mean that these ages would increase by three years to, respectively, 68 and 78 by 2055.

It is vital that any changes in these ages are felt to be acceptable by the majority of the population and the reasons for them are widely understood. The independent body would therefore play a key role in getting these messages across. It is also important that these changes are announced well in advance and that movement towards a higher BSP age is gradual so that employers and individuals have sufficient time to adjust to this new environment.

Our proposals would give people a reasonably adequate income if they retired at 65 but would also give them some incentive to continue working beyond this age on either a part-time or full-time basis to supplement their income. As we show in Section 4, their second pillar pension, based on compulsory contributions, would top up this income. People would also be given a positive incentive to make additional voluntary contributions over and above the compulsory level. If they chose to work for longer, this would also increase the value of the pension they eventually received and reduce the number of years of retirement that it would need to cover. In effect, compulsory contributions could be used as a way to bridge the gap between our proposed different levels of the BSP at age 65 and age 75. An annuity purchased on that basis and required to last for ten years or less could deliver a reasonable retirement income for a relatively modest level of saving.

We have selected age 75 for the higher level of BSP because we believe that the state should play a greater role in looking after its oldest citizens and it also fits with the current approach of starting to provide some modest extra benefits for pensioners at age 75. Problems of pensioner poverty also tend to be greater from age 75. An alternative to the jump in the level of BSP between age 65 and age 75 would be to adjust actuarially the BSP for each year between 65 and 75. However, we believe that this would add an unnecessary element of complexity into the system.

On balance, we believe that entitlement to the BSP should be determined by National Insurance contribution (NIC) records rather than by years of residence in the UK. However, the current NIC arrangements would need to be modified to allow those people, currently mainly women,

who spend periods out of the labour market to care for children and other dependants to have a higher level of BSP than they currently do. The policy objective of this change should be to provide women with the same opportunity as men in having full entitlement to the BSP.

The cost of our proposed enhanced BSP would be partially offset by the significantly reduced need for means-tested benefits and the ending of accruals to S2P in 2015, with any existing entitlements to S2P being paid out when individuals eventually retired. In addition, we are suggesting that other benefits and payments made from age 75, such as free TV licences and the winter fuel allowance, would also end in 2015. Increasing the number of older people who remain active in the labour market would also assist by increasing the government's taxation/ National Insurance revenue as well as reducing public expenditure on benefits. The long time period over which these additional costs will build up should also give the government scope to make savings in other areas of public spending and improve its own efficiency. Nonetheless, it is likely that there will be some need to finance the enhanced BSP through higher taxation with NICs being the most likely candidate.

More flexibility in deferring taking the basic state pension

The government should also look at providing more flexibility in the system for allowing people to defer taking their BSP. Currently people can defer taking their BSP for as long as they like and the BSP that they eventually receive is enhanced by one-fifth of 1% for every week that it is deferred. Alternatively, they can choose to have a lump sum payment, based on paying the deferred pension into an account paying an interest rate of 2% above base rate, in addition to the BSP that they had earned at age 65. However, the government could give people more flexibility and control over their working arrangements beyond 65 by allowing them to decide what proportion of their BSP at 65 they wished to defer and to be able to vary this over time. This would then better suit those people who wanted to work part-time or to vary the amount of the work that they did after age 65.

4 The second pillar: A modest level of compulsory pension contributions

Replacing the State Second Pension

There now seems to be widespread agreement that the current State Second Pension (S2P) needs reforming or replacing. We propose replacing it with a modest level of compulsory contributions into individual pension ‘pots’ managed by a small number of providers who would bid competitively to run them. All employers, employees and the self-employed would pay into these ‘pots’, with individuals being able to choose between investing in a limited number of funds, branded clearly according to the degree of risk attached to them. These pension ‘pots’ would be fully portable, with employees being able to carry their ‘pot’ with them when they changed employer without incurring any costs. Individuals would also be able to transfer their investment between funds easily and without incurring any costs.

The employer’s role would be confined to paying pension contributions for their employees through the National Insurance system. In addition, employees and employers who were making contributions into separate pension arrangements that were greater than this minimum level would be exempt from having to make this compulsory minimum contribution and could choose to remain outside this system. We look in more detail at how this would work in the next section on our proposed third pillar.

Setting up the delivery mechanism

In setting the delivery mechanism for our proposed second pillar we need to balance a number of objectives. We want to provide people with choice but avoid the expensive

advice required when choosing between a large number of different types of investment. We also want to avoid the high levels of marketing costs involved when large numbers of providers are competing with each other.

Given the crucial role played by returns on savings and the prospect that in the future they may be lower than in the past, it will be important to minimise the administrative costs associated with pensions. Minimising costs is vital in an era when future investment returns are likely to be lower than in the past two decades. For example, administrative costs that reduce annual returns from 4% to 3% would cut growth in the value of the initial investment by close to 40% over a period of 30 years. However, we would also want to avoid the situation in which the government is managing large sums of private money, and we need to ring-fence the system so that people do not feel that they are simply paying more taxes to the government.

We believe that a lot can be learned from the Swedish Premium Pension that was introduced in 1999, although it is important to avoid some mistakes that we feel have been made. A new government agency – the premierpensionsmyndigheten (PPM) – was set up to administer the system and act as a clearing house for the contributions of 2.5% of average earnings that are paid through the tax system. These contributions can be invested in a variety of funds, and individuals are expected to put together their own portfolio, which they can spread across a maximum of five funds. They can currently choose between investing in about 650 private funds and two that are provided by the Swedish Government.

The first of these government funds is a default fund for those not wishing to make a choice and it seeks to provide low levels of risk and high returns (in the top quartile over a five-year period). It also has a very low money management fee of 0.16% of assets compared with 0.43% for all funds. (There is also a fixed administrative fee of 0.3% for all funds.) Over time, these costs are expected to fall further as the funds increase in size. Although the risk–return combination seems rather ambitious, the default fund has performed above average so far. The other government fund allows people to make an active choice in how their funds are invested but the Swedish Government is involved in its management.

All individuals making payments receive a large catalogue providing details of all these funds and they can switch between them on a daily basis. However, because the Swedish centre-right parties were keen to limit the role of the government in money management, people who have decided to be active investors cannot also put any money into default funds nor can they switch into a default fund at a later date. This seems to be a major flaw in the scheme as it does not allow people to change their minds on whether they want to be active investors. In addition, it closes one route for reducing exposure to risk as people are prevented from moving to a default fund as they get older.

Of course, investors can reduce exposure to risk themselves by rebalancing their own portfolios by, for example, reducing the proportion of equities in them. However, experience so far in Sweden and research into 401K plans in the US suggests that most people fail to diversify their retirement investment plans in this way.

The Swedish experience also suggests that giving people too much choice has certain results. As well as managing risk poorly, there has been a dramatic shift away from making active investment decisions. After the initial wave of enthusiasm when 68% of new participants made an active choice, this proportion fell to less than 20% in the following year and to 10% by 2004. Those who are more educated and more experienced with equity investment are more likely to make an active choice. This rather passive approach may also be because very little advice is provided to savers. The result is that large amounts of money have become concentrated in one government fund, which could distort investment flows. As this fund builds up, the Swedish

Government will end up managing large sums of money and it is therefore currently looking at reforms that would give the private sector a greater role in managing this fund.

The Swedish approach raises some important issues. For example, to how much risk can people reasonably be exposed if these savings are compulsory? At the same time, extremely low-risk schemes would be expected to yield low returns over time. It is therefore vital that the funds in which individuals can choose to invest are clearly labelled with information on the degrees of risk associated with them. One of these funds should be very low risk, such as government bonds, and it should be made easy for people to switch between different funds at no cost to themselves.

At the same time, assisting people to make informed choices should help to prevent the default fund from becoming too large relative to the other funds. Nonetheless, these investment funds will inevitably become very large over time and it is therefore vital that they are tightly regulated.

In our proposed arrangements, we are recommending that private pension providers bid competitively on, for example, a five-yearly basis for the opportunity to run this limited number of investment funds. Criteria for selection would be based on both investment performance and administrative costs. An independent body of experts, rather than the government, would decide on the awarding of these contracts.

Key issues to resolve

Proposing a compulsory pension system raises a number of issues. These include setting the right level for compulsory contributions, how to treat small firms, the self-employed and those on low or interrupted incomes, as well as the role that tax incentives should play.

Setting the right contribution levels

One of the key issues is the level at which compulsory contributions should be set and how this should be shared between employers and employees. This will in part depend on the level of the BSP because, the more generous the BSP, the more limited role the second pillar pension would have to play. The level of contributions required would also depend on other factors such as the likely effective

retirement age, rates of return on investments and the availability of tax incentives. Our proposal would enable individuals to choose to use their second pillar pension to bridge the gap between our proposed BSP at age 65 and the higher level of BSP at age 75. To achieve this, the level of compulsory savings could be set fairly low.

In addition to this issue, we need to consider the factors involved in setting a ceiling and a floor to compulsory pension contributions. For employers, the ceiling would be influenced by concerns over competitiveness and affordability. However, too low a level of contribution would increase the role that our third pillar of provision – voluntary personal and occupational pensions – would need to play and, therefore, the extent to which the government would seek to regulate it. In addition, the evidence from compulsory saving arrangements elsewhere is that some employers would scale back their contributions to the compulsory level. If the minimum effectively became the maximum for many employers, we would want to avoid setting it at too low a level. However, and as is indicated below, we believe that the current system of tax relief could be modified to try to prevent this from happening.

The *EEF/Aon Consulting 2002 Pensions Survey* asked EEF members about levels of compulsion. Some 77% of firms with pension schemes thought that employee contributions should be compulsory, with employees contributing between 4% and 6% of their earnings. Some 56% of these firms thought that employer contributions should also be compulsory with employers also contributing between 4% and 6% of their employees' earnings. Together, this gives a range of between 8% and 12% of earnings for total compulsory pension contributions by employees and employers. This is fairly similar to the ABI survey of public attitudes, which showed that the band of 4% to 6% of earnings was the most popular for both employee contributions (29%) and employer contributions (24%).

In contrast, the TUC is arguing for compulsory contributions of 10% of employees' earnings by all employers, although this would start from an initial base of 4% and would be increased over time. It is also suggesting that it would be fair for employees to have to pay around half this figure. Although not advocating compulsion, the Employer Task Force on Pensions has also recommended

that there should be a 2:1 ratio of pension contributions, with employers eventually contributing 10% of earnings and employees 5%.

In the light of the above, we are therefore recommending that, initially, all employers and all employees should each make a compulsory pension contribution of 2% of earnings. Over a period of ten years, this level of compulsion would be gradually increased to 4% of earnings. However, employees and employers who were making contributions into separate pension arrangements that were greater than the minimum level would be exempt from having to make this minimum contribution.

Currently, only 40% of self-employed men and around a quarter of self-employed women make any pension contributions other than to the basic state pension, and yet the nature of self-employment today means that many of them will not be able to rely on their self-employment business to provide them with an adequate level of income in retirement.

Because of this, and our belief that in the future it is likely that an increasing number of people will spend some part of their working life as self-employed, we consider that all of the self-employed should be required to make the compulsory 'employee' pension contribution as this would support our important principle of inclusion. However, we are undecided as to whether they should also make the 'employer' compulsory contribution and feel that this is an issue that requires further debate before a decision is taken.

One size fits all?

Given the confusion caused by the complexity of today's pensions, there is a very strong case for keeping any system of compulsory pension savings as simple as possible. Despite this, we should consider whether 'a one size fits all' approach would be the best way to go forward or whether contributions should vary according to, for example, an individual's age or the size of firm.

People currently in their twenties who are not covered by company or personal pensions are in a much less serious position than those in their forties who have not saved for a pension. The Pensions Commission estimates

that to achieve a replacement rate of 20% from private savings requires a contribution rate of 9% of earnings from someone starting saving at age 40 but just 4% from someone who started at age 25. In addition, many people in their twenties are less able to save, given the large levels of debt that many of those going through higher education will have accumulated. Survey evidence also demonstrates lower levels of interest in saving among young people.

Allowing younger people to contribute initially at a lower compulsory rate could therefore gradually introduce them to the savings habit. In addition to increasing the complexity of pension arrangements, this approach could, however, raise age discrimination issues because, if lower employee contributions were to be matched by lower employer contributions, this could create financial incentives for employers to recruit younger employees at the expenses of older ones.

Varying compulsory contributions to the second pension by age would inevitably increase complexity in the pensions system, which we are seeking to minimise. However, our proposed approach could be used to try to relate the level of compulsory contributions that are paid by different age groups according to their need and their ability to save. For example, people under the age of, say, 30 could be exempted from the need to make compulsory contributions or pay a lower compulsory rate. However, this would probably mean that they would be required to contribute at a slightly higher rate than the compulsory rate once they reached age 30.

We also need to consider the case of those on high incomes, who will generally need a lower replacement rate to enjoy a decent income in retirement and, in any case, are also likely to have access to other forms of wealth. Most of these individuals are likely to be making significant contributions into occupational or personal pensions or having them paid for them by their employer. However, a small number of them may be making pension contributions that are below our proposed employee minimum (4% of earnings by 2025), but these contributions may still be large in absolute terms. In these cases, it may not make sense to compel these individuals to pay the full level of the minimum employee contribution into our second pillar pension subject to them making

contributions that are above some predetermined absolute level.

Small firms today are more likely to be making lower levels of pension contributions or paying nothing at all, and these companies would therefore face the greatest financial difficulties in making compulsory pension contributions. In manufacturing, many smaller firms are at the lower end of the supply chain, facing a severe squeeze on prices, margins and cash flow, and are vulnerable to decisions by their large customers to shift production or purchasing abroad. In this group, there are also start-up firms that have the potential to be significant wealth creators in the future but often struggle to survive in their early years. These issues could be addressed by allowing smaller firms to make lower contributions or by phasing in the increased level of compulsory pension contributions over a longer time period as happened in Australia. However, such an approach might be seen as unfair on those working for smaller firms and could also create incentives for firms not to increase employment above a certain threshold. Alternatively, the Employer Task Force on Pensions recommended the introduction of additional tax incentives for smaller firms to encourage them to make pension provision for their employees, and this idea is probably worth examining in more detail.

Consultation with EEF members indicates that there is little support for smaller firms to be treated differently as far as compulsory pension contributions are concerned and we are therefore not recommending it. However, this is an issue that the Pensions Commission will need to consider carefully based on evidence from other sectors.

How would people with low or interrupted earnings fit into the system?

We also need to consider how to deal with employees on low incomes who would find it hard to save at the compulsory level, as well as those who are outside the labour market but in receipt of labour market-related state benefits.

The evidence from Australia, where compulsory pensions saving covers everyone above 15% of average earnings, is that those on very low incomes have suffered real hardship. In addition, the need to contribute a percentage

of earnings to a pension could be seen by those on low incomes as a disincentive to work. The UK's Office for National Statistics' *Food and Expenditure Survey* suggests that, for those in the bottom 40% of incomes, even on a harsh definition less than a fifth of spending is discretionary. We therefore believe that it is important to set the floor for compulsory employee contributions at a higher level than in Australia and we are suggesting that it should be set at 25% of average earnings.

We are proposing that everyone earning more than 25% of average earnings would have to make contributions based on their total earnings, not just on what they earned above this level. This approach allows the minimum compulsory contribution rate to be set at a lower level than would otherwise have been the case. However, it does mean that the compulsory pension contribution rate would jump suddenly from zero to, eventually, 4% of earnings for someone moving from just under 25% of average earnings to just over this level, which could potentially weaken work incentives. We would therefore need to look very carefully at whether the level of government contribution could be set in a way that smoothes this transition as well as how this threshold interacted with the income tax and National Insurance bands operating when compulsory contributions are introduced.

However, we need to decide how to deal with those earning less than 25% of average earnings and, since we feel that most people would need retirement incomes above the level of the BSP, we consider that we should find some way of covering those on low earnings.

We are therefore suggesting that the government should make 'employee' compulsory pension contributions on behalf of those on less than 25% of average earnings in the expectation that, at some point in their working life, they would be earning enough to make these pensions contributions themselves. This would support our important principle of inclusion as well as give low earners more of a sense of ownership in the pensions system than the expectation of simply receiving a low state pension, possibly topped up by means-tested benefits.

We are also proposing that those out of the labour market and in receipt of state benefits because, for example, they are caring for children or other dependent relatives,

have lost their job or are suffering from a disability (either temporary or permanent) that prevents them from working should have a compulsory 'employee' pension contribution paid by the government based on the level of their state benefit. We believe that this latter approach would also support our important principle of inclusion.

How can tax relief be made more effective?

In 2003/04, tax relief on employer and employee pension contributions was £17.2 billion or 1.5% of GDP and, of this, income tax relief cost £11.4 billion and NIC relief on employer contributions cost a further £5.8 billion. Given the patchy nature of pensions coverage, we consider that there is scope for using this money more effectively. Currently, employees receive tax relief at their marginal rate of income tax. While this is simple to administer, it means that those who are most able to afford to make pension contributions enjoy the largest amount of tax relief. Some 2.5 million higher-rate taxpayers currently benefit from some 55% of this tax relief, leaving relatively little tax relief to encourage lower-income households to save towards their pension.

The evidence suggests that most people on higher incomes are either covered by a good occupational scheme, can afford to make their own contributions to personal pensions or have other forms of wealth that they can access in retirement. In addition, they will be generally better educated, more employable and therefore have more opportunities to continue working beyond the BSP age if they want to top up their pension income. In contrast, lower-rate taxpayers will be in the opposite situation – less able to afford to make pension contributions, enjoying a less generous or no employer pension, less likely to have access to other forms of wealth and have more limited prospects of earning a decent income in later life.

In addition, we need to consider whether it makes sense to use tax relief to provide incentives to make contributions that are compulsory. Tax incentives might also play a useful role in preventing people from scaling back their existing contributions to the compulsory level. One way to address this would be to make tax relief available on all contributions provided that they exceeded the minimum level. This would reward people paying more than this. However, it would be unfair to those people who

were unable to afford to pay more than the compulsory contribution as they would get no tax relief, while the better off would receive tax relief on their total pension contribution.

We believe that a fairer, more transparent and, therefore, more saleable approach than the current complex tax relief arrangements would be for the government to make a pension contribution in addition to that made by employees. This co-contribution approach was introduced in Australia in 2003 for those on low incomes to address concerns over the hardship they suffered. Going up the earnings scale, the level of government co-contribution could be gradually reduced to zero at a certain earnings level. However, care would need to be taken to ensure that this co-contribution tapered off in a way that did not effectively create high marginal rates of tax for people in the income band(s) covered by the taper.

We would also need to look carefully at the implications of replacing tax relief by government co-contributions for the increasing number of people who are being drawn into paying the higher rate of income tax. Since the failure to index income tax allowances in line with earnings has already drawn an increasing number of people into the higher tax rate band, we would need to look carefully at whether the higher rate threshold would therefore need to be raised.

On balance, we believe that any such disadvantage in having a simple government co-contribution approach rather than the current complex tax regime arrangements is outweighed by the fact that it would make government support for pensions saving much more transparent and understandable to the general public.

We are recommending that the current system of tax relief on individual pension contributions is replaced by a government co-contribution approach. However, we consider that the current system of employer tax relief on employer pension contributions should be left untouched. In addition, the tax treatment of additional voluntary payments made by employees and employers into personal and occupational pensions (our third pillar) should be left unchanged. Given the absolute importance of encouraging a higher level of savings, it is vital that

the introduction of compulsory contributions is not used by the government to justify any scaling back in the overall amount of tax relief available on pension contributions.

Addressing concerns over levelling down

One of the concerns associated with setting a minimum level of compulsory pension contributions is that employers and employees currently paying more than the minimum into their pensions will scale back their contributions. In effect, the minimum level of pension contribution could become the maximum.

There are reasons why we might expect a number of companies to continue paying contributions at their current level or close to it, irrespective of whether or not a compulsory second pillar pension is introduced. For some companies, offering an attractive pensions package will remain an important part of their recruitment, motivation and retention strategy. Others will continue to pay above the minimum out of a sense of paternalistic obligation towards their employees. In other cases, pressure from unions or from the workforce generally will deter companies from scaling back their pension contributions to the minimum level. At the same time, the shift from DB to DC occupational pension schemes will occur irrespective of the reforms that we are proposing. However, the difference in the level of employer/employee contributions between DB and DC schemes may well narrow.

Nonetheless, the risk that introducing a compulsory minimum level of pension contributions will lead to a levelling down of pension contribution is an important issue that advocates of compulsion have to address. This is one reason why we believe that it is important to leave the tax treatment of voluntary employer and employee contributions in our proposed third pillar pension unchanged. This will avoid the need for complex transition arrangements that might cause more employers to rethink whether they want to continue to provide their existing DB and, to probably a lesser extent, DC schemes. Linked to this, we consider that our proposals for lighter regulation of third pillar pensions will help persuade some employers to retain their current pension arrangements. A simpler, and therefore more understandable, form of government support for pension savings, such as co-contribution, would

also help to encourage individuals to save more than the compulsory minimum level.

In addition to this, there is an overwhelming requirement for a national campaign to raise substantially levels of financial understanding and awareness as well as acceptance among the UK population of the need to save. A recent study by Scottish Widows of over 4,000 people who it was felt 'could and should be saving' (aged over 30 and earning more than £10,000 per year) is instructive. It suggests that simplifying pensions will have a limited impact, as the non-savers in this survey avoided financial decisions even when the level of complexity was low.

In addition, levels of distrust towards financial organisations did not differ significantly between savers and non-savers, suggesting that addressing the trust issue is also far from the whole solution. Indeed, the Scottish Widows' study confirms what previous research has suggested, which is that the key difference between savers and non-savers is often not their level of income or education but their psychology. According to this research, non-savers tend to have more debt, are less likely to own a house, to have a bank account or either short-term or long-term savings. However, they also have greater expectations that they will be able to retire at or before 65. This suggests a role for government and others in appealing to both hearts and minds to persuade people that they need to save for their retirement.

A substantial effort therefore needs to be made to increase the understanding of pensions and other financial issues among all individuals. A recent OECD report, *Recommendations on Principles and Good Practice for Financial Education and Awareness*, made the following recommendations:

- encouraging national campaigns to improve the general public's understanding of financial risks, and ways to protect against them through adequate savings, insurance and financial education;

- starting financial education at school;
- giving consideration to making financial education part of state welfare assistance programmes; and
- promoting websites to provide user-friendly financial information to the public.

We support these recommendations. Evidence from the Office for Standards in Education (Ofsted) suggests that the current provision of financial awareness education is patchy and not coherent. We are therefore encouraged that the Qualifications and Curriculum Authority is currently considering the case for rooting financial literacy more firmly in the core curriculum, possibly as part of functional mathematics.

However, the UK also needs a national publicity campaign to raise financial awareness that covers people of working age. The experience of New Zealand illustrates what can be achieved if good quality information on this is provided in the right context. Its Retirement Commission provides public information campaigns that seek to encourage saving, an interactive website with financial advice that helps people to make financial calculations and decisions, backed up with a telephone help line, and publications on key issues that are targeted at specific audiences. Since it was created ten years ago, personal saving in retail funds has almost doubled.

The government needs to play a leading role in this, but it will also be vital to engage employers and the providers of financial services in such a campaign. We also believe that the Pensions Commission should continue beyond the publication of its *Second Report* due in late 2005, with part of its role being to promote a better public understanding of the need for individuals to save for their retirement.

5 The third pillar: Voluntary provision in a less regulated environment

Less regulation is needed given higher level of secure income from first two pillars

Our third pillar would be additional voluntary occupational and private pension provision by employees and employers. We consider that the combination of our proposed first and second pillars would provide individuals with a higher level of secure income in retirement than is currently the case.

This means that it will no longer be necessary for occupational and private pension arrangements to be as tightly regulated as they are today. Accordingly, we believe that the regulation of these pension arrangements should be focused on encouraging individuals and employers to maximise their savings for retirement rather than guaranteeing accrued occupational/private pension benefits and minimising tax leakage. As set out in the previous section, we are also recommending that the tax treatment of employee and employer contributions into third pillar pensions should not be changed.

Better regulatory environment

The prize of a better regulatory environment is a major one that would help to address one of the key concerns raised by EEF members with occupational and personal pension arrangements. If approached correctly and in tandem with other measures, we believe that it could help to revitalise voluntary pension provision. However, this is an issue that would require significant further analysis since DB schemes would be in a state of transition, as a result of both existing trends and of our proposals, and because there would

be legitimate government concerns over preserving the tax base. In addition, the government would need to be confident that this lighter regulatory approach would be acceptable to those making voluntary contributions and that it was sufficiently robust to prevent the type of pension ‘scandals’ that have further undermined public trust in the pensions system.

How would the second and third pillars fit together in practice?

We are proposing that employers, employees and the self-employed should be able to opt out of our proposed second pillar if they are making contributions into an alternative pension arrangement that are above the minimum compulsory level. This would address one of the concerns that have been raised about compulsory pension contributions, namely that some people who do not need to make such payments, because they already have adequate pension arrangements, would be forced to do so.

Setting out how these exemption arrangements would work in practice is fairly complex and we recognise that this is a subject on which further work needs to be done. This is particularly true for DB pension schemes where employer and employee contributions may vary substantially from year to year without this necessarily affecting the level of the scheme’s pension ‘promise’. In addition, and depending on the funding level of their pension scheme, the level of pension contributions that has to be made can vary quite significantly from employer to employer,

even though they are offering similar levels of DB pension benefits to their employees.

Set out in the following subsections are our initial thoughts on how these exemption arrangements could work for employers, starting with the simpler case of DC schemes and then moving on to the more complex issue of DB pensions.

Defined contribution pensions

In this example, it is assumed that compulsory employer pension contributions of 2% of employees' earnings have been introduced. The following options would therefore be available for a company that is already contributing X% above this minimum level into its DC scheme:

- *Option A.* The company pays 2% of its employees' earnings into the second pillar (the compulsory pension) and X% into the third pillar (its voluntary DC scheme).
- *Option B.* The company pays 2% plus X% of its employees' earnings into the second pillar.
- *Option C.* The company pays 2% plus X% of its employees' earnings into the third pillar.

Under Options A and B there are no additional regulatory issues as, in both cases, the company is paying at least the minimum compulsory pension contribution into the second pillar. However, Option C would require there to be some form of 'protective' regulation of the first 2% of the company's contribution into its own scheme. We are suggesting that the return on this contribution would have

to be guaranteed to be at least equal to the return on the default fund that is available under our proposed second pillar

Defined benefit pensions

The number of people who will be members of a DB pension scheme and able to make new contributions into it when our proposed pension arrangements come into effect in 2015 is likely to be significantly less than it is today. However, there would probably still be a legacy of DB schemes, even in the private sector, and how they would fit into our proposed new pension arrangements is quite complex.

We are suggesting that the best approach would be to consider the notional contribution that has to be made into their scheme by the employer to deliver the DB pension 'promise' for members of the scheme. Any company that was paying a notional contribution into its DB scheme above the minimum compulsory pension contribution would be able to choose to put all of its pension contribution into its voluntary third pillar pension.

As in Option C above, there would still, however, need to be some 'protective' regulation of the first 2% of the company's contribution into its own fund. Again, we are suggesting that the return on this contribution would have to be guaranteed to be at least equal to the return on the default fund that is available under our proposed second pillar.

6 Raising employment levels among older workers

Extending working lives delivers big wins

A key part of addressing the pensions issues facing the UK is to raise the number of people working in their fifties and early sixties as well as those over the BSP age. Lengthening the average working life by even two years can make a considerable difference. It delivers a double win both by increasing the amount of money that those working generate in taxation/National Insurance revenue and/or pension contributions and by reducing the number of years for which pensions will have to be paid. If this also involves moving some people off incapacity and unemployment benefits, this becomes a triple win by making savings in public spending.

At the same time, we have to be realistic about how far average working lives can be extended, because survey evidence suggests that only a minority of people in the UK want to continue in full-time work to the end of their sixties. In addition, life expectancy is lower among the lowest social classes who are more likely to need to continue working later in life to generate a decent retirement income (unless state pensions become more generous or people start saving more for their pensions). Nonetheless, updated life expectancy estimates by the Pensions Policy Institute show that a man aged 65 in the lowest social class can today expect to live to 81, suggesting that most people could still enjoy a lengthy period of retirement even if they carry on working for a few more years.

In addition, raising the average retirement age by even three to four years would not fully reverse the decline seen

over the previous four decades. For example, the average age of male retirement in the OECD fell from 65 in 1950 to 59 in 1995 and from 67.2 to 62.7 over the same period in the UK. Even in 1980, the average male retirement age in the UK was 64.6. Retirement ages have fallen at the same time as rising life expectancy and improving health levels have made longer working lives more feasible. Reversing these trends will involve a combination of:

- getting those people still in employment in their early sixties to remain in work for a little longer;
- cutting the number of people in their fifties dropping out of work altogether either through voluntary/involuntary redundancy or early retirement; and
- reducing the number of people in their fifties on incapacity benefit.

Overcoming barriers to remaining in work

Although changes to the tax and benefits system outlined in the previous three sections (particularly Section 3) can play a powerful role in raising the number of people remaining in work up to and beyond the BSP age, they are far from the whole story. For example, the Labour Force Survey showed that, in the most recent three-month period it covers, almost 2.5 million men aged between 50 and 64 and women between 50 and 59 were economically inactive. Some 42% of these men were inactive because they were long-term sick and disabled, as were 35% of women. A further 23% of men and 13% of women were retired. Some 32% of women and 23% fell into the 'other reasons' category. Many of these people are inactive

because they have given up looking for work due to a perceived lack of opportunities.

Behind these bald statistics are a variety of reasons why many people in their fifties and sixties are not looking for work. We have grouped them together under three headings – problems in getting work, difficulties in continuing work and not wanting to continue in work.

People face problems in getting work

People who have lost their jobs are always disadvantaged in getting another one compared with those already in work. These problems are compounded if they have been out of work for a long time and are even worse if people are older, although the introduction of age discrimination legislation in October 2006 and the consequent culture change that should take place in the workplace ought to improve this.

People who are out of work also lack access to the informal contacts and networks that provide job leads, are often low on confidence, and their skills and working habits are often eroded by a period of unemployment. In addition, employers tend to be reluctant to hire people who are older and who have been unemployed for some time. People in this age group with some form of incapacity will also face a further hurdle in finding work.

People find it difficult to continue working

There are a number of reasons why people will find it hard to continue working. For example, some people doing tough manual work will find it difficult to continue work into their sixties and are also often unlikely to want to do so. However, as manufacturing reshapes itself with a greater focus on innovation and new technology, the number of these heavy manual jobs is likely to contract. In addition, studies of ageing show that it is possible for employers to reorganise work so that older employees face less physical strain.

The attitudes of employers towards older employees are not always positive, based on perceptions that they are less productive and/or less skilled. The 2003 Chartered Institute of Personnel and Development (CIPD) survey showed that 42% of employees felt that their employer did something to encourage the employment of older workers, with 48% saying that they did not. These proportions reversed for

those aged over 50 and still working, to 47% and 42%, although this is more of a select group since it excludes those no longer working in their fifties. A *Personnel Today* survey from 2004 found that 85% of the most skilled (ABs) thought that most companies did not want to employ people over 65, as did 66% of the least skilled (DEs).

Older employees are sometimes seen as less productive, but the evidence shows that this is not the case. It also demonstrates that, while older employees may take longer to learn new skills, they benefit as much as their younger colleagues from training. Rising skill levels of older employees in the future are also likely to help address this problem.

A study of employment across the EU by the European Commission showed that more highly skilled employees in the 55 to 64 age band were far more likely to be in work than those who are lower skilled. Among men in the UK, the employment rates were 66% for the highly skilled, 61.5% for the medium skilled and 54% for the low skilled. For women, the comparative figures were 73% (highly skilled), 65% (medium skilled) and 56% (low skilled). The same report quotes OECD projections showing that skill levels are rising in the UK. For example, the proportion of those aged 45 to 64 with less than upper secondary qualifications will have more than halved from 27.6% to 13% between 1995 and 2015.

Other trends may also address the perception that older employees are more expensive. For example, the shift from DB to DC pension arrangements should make it easier for employees to take less responsible and lower-paid jobs with the same employer without this adversely affecting their pension entitlement. The movement that is occurring towards having DB pensions based on a measure of average lifetime salaries rather than final salary would also have a similar beneficial impact. Changes in employer/employee attitudes and pension fund rules that allow individuals to work in another job rather than be offered early retirement on ill-health grounds would also help.

There are now some encouraging signs that employers are beginning to adopt a more flexible approach to the employment of older people in advance of the introduction of age discrimination legislation. For example, the *EEF/Aon Consulting 2004 Pensions Survey* showed that a quarter

of those EEF members who responded had some full-time employees over the age of 65 and nearly a third of them had some part-time employees over 65.

An increased focus on rehabilitation and employment guidance to improve the employability of people in their fifties and sixties is also vital. Research by the Public Accounts Committee shows that the unemployment of those over 50 costs between £19 billion and £31 billion each year in lost output, taxes and higher benefit payments. Its report called for targets to be set for job centres and regional development agencies to raise the number of older people receiving employment guidance and to set targets for employability just as much as finding people jobs. We also welcome efforts by the DWP to test 'pathways to work' programmes for older people, which include the use of personal advisers, return to work credits and greater access to assistance with rehabilitation, for which early results are said to be encouraging.

People do not want to keep working

There will always be a group of people who simply do not want to continue working because they have simply had enough of it or have earned enough to provide for their retirement. However, the evidence suggests that more imaginative and flexible approaches by employers could encourage more of these people to continue working. For example, older people often cite the lack of flexibility offered to them in terms of hours of work and leave arrangements as a reason for not continuing to work.

International studies also show a correlation between the proportion of older employees in different countries reporting that they feel a degree of control over what they do in their jobs and levels of participation in work. In this respect, employers face a difficult management task in providing rewarding work for people who opt to take a less senior role within the same company once they reach a certain age.

Recommendations for action

We suggest that the government adopts the following measures to address the constraints on raising the employment rates of older people:

- **Lifelong learning.** Take steps to improve the access of older people to education and training and encourage providers to develop styles of learning that suit them better.
- **Careers advice.** Address the limited and fragmented provision of careers advice available to older people.
- **Rehabilitation.** Take measures to expand the role that rehabilitation can play in maintaining the physical and mental capacity for work of those in their fifties and sixties. This should involve improving access to physiotherapy, changing the tax rules so that physiotherapy for non-work injury is no longer treated as a taxable benefit, raising awareness of the benefits of rehabilitation and seeking to change the culture so that doctors focus on what patients can do rather than on their incapacities.
- **Reform incapacity benefit.** Linked to the above, the government should press ahead with reforms of incapacity benefit that seek to reduce its £12 billion annual costs and also return as many as possible of its 2.7 million recipients to work. According to the DWP's five-year plan, 2 million benefit recipients say they would like to work.

In addition, it would be fruitful to look closely at Finland's Maintenance of Work Ability (MWA) programme to examine what lessons can be learned from their approach and what aspects of it could be applied in the UK. Between 1997 and 2004, Finland's employment rate for those aged 55 to 64 rose from 36% to 50%, at a time when it was falling in most other OECD countries. Finland's MWA programme is an integrated approach, based around employees and their health, job design, work environment and skills and competence. It has been based on collaboration between the Ministries of Social Affairs and Health, employers, unions and the Institute of Occupational Health. Key features include an extensive network of occupational health centres, training managers in age management, and a databank that compares progress in raising work ability between jobs, industries and companies.

7 Costing our proposals

Any durable solution to the pensions issues facing the UK will come with a price tag. It is inevitable that some sacrifices will have to be made by employers and individuals unless, as a society, we are prepared to allow the living standards for those in retirement to decline substantially.

EEF has commissioned the Pensions Policy Institute (PPI) to look at three aspects of our proposals:

- the cost of raising the value and improving the coverage of the basic state pension (BSP);
- the cost of our proposal that the government makes 'employee' contributions into the second pillar pension for those on less than 25% of average earnings or in receipt of certain labour market-related benefits;
- the percentage of national average earnings and the replacement rates (i.e. retirement income as a percentage of final earnings) that the BSP and second pillar pension would generate under our proposal for seven different categories of people.

In this section we present a summary of the main results from the PPI's analysis. Appendix 1 looks in greater detail at the assumptions behind this analysis and the results. A more detailed account of the PPI's analysis will be published by the PPI shortly and will be available on its website (www.pensionspolicyinstitute.org.uk) or on request.

Costs of enhanced basic state pension

Table 2 looks at the government's estimates for the cost

of retaining the current pensions system, which are based on information published in the Department for Work and Pensions' 2005 budget. The cost of government spending includes the BSP, past and future accrued rights to SERPS and S2P, the Pension Credit and contracted out rebates.

These government estimates are subject to some uncertainty because of the trends that will drive the increase in the number of people who will qualify for Pension Credit and its likely take-up. Government projections assume that state and private pension income taken into account for Pension Credit grows in line with average earnings and that take-up remains at 75%. The PPI's higher estimates (shown in the third column of Table 2) are based on all pension income taken into account for Pension Credit growing more slowly than average earnings and take-up increasing to 100%. For comparisons with our proposals, the PPI has used a more likely scenario that is

Table 2 Future cost of current pension system
Government expenditure as % of GDP

	<i>Government estimate</i>	<i>PPI comparative estimate</i>	<i>PPI upper estimate</i>
2015	5.7	5.5	5.7
2025	5.6	5.5	6.0
2035	5.9	6.4	7.1
2045	5.8	6.5	7.4
2055	6.0	6.8	7.8

Source: Pensions Policy Institute for EEF, 2005

closer to the government's projections, with state pension income growing in line with prices, private pension income growing slightly slower than earnings and a conservative increase in take-up for Pension Credit.

In practice, it seems unlikely that government expenditure on pensions will grow as slowly as is being projected by the government. For example, continuing to increase the BSP in line with prices would leave it at just 9% of average earnings by 2035 and between 5% and 6% by 2055. This seems to be an unrealistic scenario as it would imply a substantially expanded role for means-tested benefits to prevent poverty in retirement for large numbers of people. It also ignores the growing strength of the 'grey' lobby that is pressing for state pension improvements.

Table 3 compares the cost of our proposals for enhancing the BSP at both age 65 and age 75 with the PPI's comparative estimate for government expenditure in the second column of Table 2. The difference in cost increases over time as the impact of increasing our proposed enhanced BSP in line with average earnings (rather than prices) compounds over a period of 40 years. In practice, this difference in cost is likely to build up more slowly than is shown in Table 3. This is because the PPI's model assumes, for simplicity, that women's entitlement to our enhanced BSP is improved (to that of men's) immediately. In practice, this improved entitlement is likely to build up gradually over time and, therefore, the costs of our proposals in the earlier years are likely to have been overestimated in Table 3.

The PPI has not allowed for any changes in the cost of tax relief on private pension savings. We have assumed that our proposed changes to tax relief on private pension savings would be broadly fiscally neutral. However, this will depend on how these changes are introduced and to what extent they affect the overall level of private pension savings.

The comparisons in Table 3 show that the cost of our proposals, as well as the difference between this cost and the PPI's comparative estimate of projected government expenditure, broadly stabilise from 2025 to 2045 and then decline slightly. This is because the increase in costs resulting from indexing state pensions in line with average earnings is offset by our working assumption of increasing

Table 3 Cost of EEF proposals compared with current system

Government expenditure as % of GDP

	<i>EEF proposals</i>	<i>PPI comparative estimate</i>	<i>Difference</i>
2015	6.5	5.5	1.0
2025	7.2	5.5	1.7
2035	7.9	6.4	1.5
2045	8.2	6.5	1.7
2055	8.0	6.8	1.2

Source: Pensions Policy Institute for EEF, 2005

the age at which the BSP is paid to 67 in 2035 and 68 in 2055.

In practice, however, the difference in costs is unlikely to be as large as is shown in Table 3 and there will be other ways to limit the need to increase taxation. As we have already stated, the government's projections of future expenditure on pensions seem to be unrealistically low. In addition, it should be possible to finance some of these costs over time by limiting the growth of other forms of government expenditure. We are wary of making specific proposals that seek to fund increased government expenditure on pensions by making cuts elsewhere. However, the long period over which these pension costs will build up gives the government ample opportunity to reconsider its spending priorities, as well as make serious progress in raising the efficiency of the public sector. For example, it could start to make serious inroads into future public spending by reforming public sector pension schemes in a meaningful way as we have advocated earlier in this report.

The cost of our proposals would also be reduced if the government acted on our recommendations to boost the employment rate for those aged 55 to 64. This would generate higher taxation/National Insurance revenues, save on welfare expenditure and generate a higher level of GDP. However, any increase in the employment rate could push up the rate of growth of average earnings and, therefore, increase the annual cost of raising the level of our proposed enhanced BSP. This is a difficult one to judge because most economic models would project this effect but the UK's practical experience over the past ten

years has been of a considerable increase in employment with no apparent impact on the rate of growth of average earnings. Increasing the level of GDP could also be seen as having no overall impact on costs if we use the framework in the Pensions Commission's interim report, which looks at the shares of GDP going to the working age and retirement age population. Using this framework, increasing the level of GDP simply increases the size of the cake but has no impact on the costs of dividing it up.

Because of these uncertainties, no allowance has been made for reduced costs, particularly from boosting employment rates among older people. However, we believe that concerted action on this front would reduce the need to raise taxation in the future to finance our proposals. It is also important to remember that raising the BSP age higher than our working assumption of 68 by 2055 would substantially reduce the need to increase taxation. Fifty years ahead is a long time and it may well be that future advances in health, longevity and working patterns make it sensible to increase the BSP age higher than 68. This will be a choice for the government to take nearer the time, based on the recommendations of the independent body that we have proposed should be set up to examine this issue.

If the government fails to capitalise on the above opportunities to reduce its expenditure and increase its income, one possible way of meeting the cost of our proposals would be to raise NIC rates. The PPI has estimated that this would require an increase in the rates for both employers and employees of between 2% and 3% by 2055. It is very important to note that EEF is not advocating that NIC rates are raised by between 2% and 3% for both employers and employees by 2055 to finance higher government spending on our pensions proposals. It simply illustrates one possible way of financing our proposals and assumes no offsetting savings of the type described above.

One of the key concerns relating to increasing NIC rates or, indeed, any other form of taxation on business is its potential impact on international competitiveness. This is a real concern given the growing intensity of international competition. International comparisons of taxation are extremely difficult to make as comparable data is often several years out of date, taxation systems are quite

Table 4 Implications of higher NIC rates for competitiveness of UK taxes

Employer social security contributions as % of GDP (2002)

<i>Country</i>	<i>% of GDP</i>
UK 2002	3.4
UK 2005	3.8
UK with EEF proposals, 2055	4.55
EU15	6.8
OECD	5.6
France	11.1
Germany	7.1
Italy	8.7
Spain	8.9
US	3.4

Source: EEF, OECD Revenue Statistics

different (e.g. payroll taxes play a smaller role in the tax mix in the UK than in much of the rest of Europe) and various exemptions and allowances often make straight comparisons of taxation rates meaningless.

The best source of this comparative data is the OECD *Revenue Statistics*, which looks at employer social security contributions as a share of GDP. Unfortunately, the latest OECD publication only contains data up to 2002 and we have therefore had to estimate the latest UK position. The PPI's estimates in Table 3 show that EEF's proposals would cost 1.5% of GDP more than the government's projected expenditure on pensions in 2055. Because these costs could be shared equally between employers and employees if higher NIC rates were used to fund any necessary higher government spending on pensions, this would mean that an extra 0.75% of GDP would have to be raised from higher employer NIC rates. This would then increase the share of GDP that was raised by employer NICs to 4.55% by 2055.

Table 4 shows that, even with this increase, the UK would still remain well behind other EU and OECD countries in its use of payroll taxes but that the gap would have narrowed. However, this assumes that other countries have not also been forced to increase their taxation rates. This seems unlikely, as many

Table 5 Cost of government paying ‘employee’ contributions to second pillar pension for low earners and those on certain benefits

Estimated cost in 2015/16 in 2005/06 prices (£ mn)

	<i>2% employee contribution</i>	<i>4% employee contribution</i>
Cost for low earners	320	640
Unemployment benefit and jobseeker’s allowance	40	80
Maternity allowance/statutory maternity pay	30	60
Statutory sick pay	***	***
Total cost for those in receipt of out-of-work benefits	70	140
Incapacity benefit	130	270
Disability living allowance	100	200
Severe disablement allowance	20	30
Industrial disablement benefits	10	20
Invalid care allowance/carer’s allowance	20	40
Total cost for those on disability and caring benefits	280	560
Total cost	670	1,340

Source: Pensions Policy Institute for EEF, 2005

Note: Figures have been rounded to the nearest £10 million and those of less than £5 million have been marked ***

of them will face greater pressure on government expenditure on pensions due to a combination of their more generous state pension arrangements and demographic trends over the next 50 years. Furthermore, it will not, in every case, be politically possible for them to contain these rising costs by reducing pension entitlements. In addition, and as we have already stated, there are alternatives to taxation to fund increased expenditure on pensions.

Costs of including non-employed in second pillar pension

The PPI has also estimated the cost of our proposals for the government to pay ‘employee’ contributions into the second pillar pension on behalf of those on less than 25% of average earnings and those in receipt of certain labour market-related benefits (see Table 5). In practice, these costs may turn out to be lower than the PPI estimates if the government adopts our recommendations to improve the employability of people in their fifties and those in receipt of incapacity benefit: the PPI has assumed that benefit expenditure will increase in line with prices between now and 2015/16.

Replacement rates

Reforming the current pension system so that the result produces no overall ‘losers’ would be either prohibitively expensive or highly complex – and probably a combination of both. However, it is important to analyse whether particular groups of individuals would be hit hard by our proposals. We have therefore asked the PPI to look at the impact of our proposals on seven groups of people in 2055. These are:

- **Low-earning man** – has worked mainly full-time from age 21, unemployed for two years in his twenties and worked part-time between age 55 and 60. When in full-time work he earned at the 10th percentile of distribution of age-specific earnings for men.
- **Median-earning man** – as above, but when in full-time work he earned at median age-specific earnings for men.
- **Median-earning man with a period of self-employment** – as above, but self-employed between age 40 and 50 during which he made only the ‘employee’ contribution to the second pillar pension.
- **High-earning man** – as low and median-earning man but he earned at the 90th percentile of distribution of age-specific earnings for men when in full-time work.

Table 6 Impact of EEF proposals on different income groups*Income as % of national average earnings at ages 68 and 78*

	<i>Current system with no private saving</i>	<i>Current system with voluntary contributions</i>	<i>EEF proposal</i>
Low-earning man – 68	17–27 %	23–31 %	28 %
Low-earning man – 78	14–26 %	19–29 %	31 %
Median-earning man – 68	18–28 %	30–35 %	34 %
Median-earning man – 78	15–27 %	24–32 %	35 %
Median-earning man with some self-employment – 68	15–26 %	25–32 %	32 %
Median-earning man with some self-employment – 78	12–25 %	20–30 %	34 %
High-earning man – 68	19–29 %	42 %	46 %
High-earning man – 78	15–27 %	34–38 %	45 %
Low-earning woman – 68	14–26 %	17–27 %	26 %
Low-earning woman – 78	12–25 %	14–27 %	29 %
Median-earning woman – 68	15–26 %	20–29 %	28 %
Median-earning woman – 78	13–25 %	17–28 %	31 %
High-earning woman – 68	16–26 %	26–33 %	33 %
High-earning woman – 78	13–26 %	21–31 %	35 %

Source: Pensions Policy Institute for EEF, 2005

- **Low-earning woman** – started work at 21, in full-time work until 28, career break for children for six years but this did not coincide with the financial year so she lost two credits to the BSP and the State Second Pension. Returned to work part-time for five years and then worked full-time until a five-year career break in her fifties to care for an elderly relative, for which she received no carer benefits or credits. Returned to full-time work again until reaching BSP age. When in full-time work, earned at the 10th percentile of distribution of age-specific earnings for women.
- **Median-earning woman** – as low-earning woman but earned at median age-specific earnings for women when in full-time work.
- **High-earning woman** – as low-earning woman but earned at the 90th percentile of distribution of age-specific earnings for women when in full-time work.

For each of these seven examples, the PPI has estimated the replacement rates that are generated by our proposals for increasing the BSP and for compulsory contributions into our proposed second pillar pension. These are based on individuals who reach the state pension age of 68 in 2055.

The results are compared with the current pension system on the assumption that its current structure and uprating methods remain unchanged. This may not be realistic given that rates of Pension Credit are set annually at the discretion of the government and are therefore subject to uncertainty in looking 50 years ahead. The PPI has shown these estimates as ranges to reflect the fact that the level of income from Pension Credit depends on the rate of take-up of this benefit and the uncertainty surrounding levels of voluntary saving. The comparison of our proposal against the current system is based on two different scenarios – one where there is no private saving and one where the level of private savings matches EEF's proposed compulsory contributions into the second pillar pension.

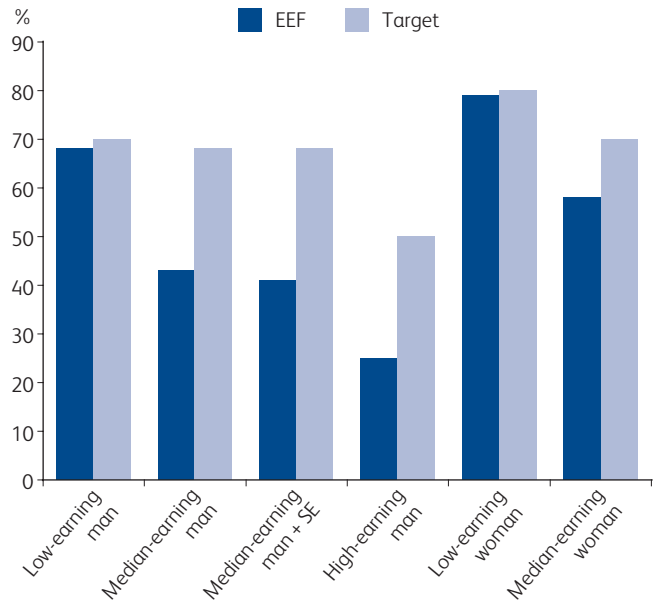
The levels of income generated by our proposals have been compared with those resulting from the current system under the PPI's two scenarios. The PPI has also looked at the replacement rates generated by our proposals compared with the target rates set out in the Pensions Commission's interim report. These results are summarised in Table 6 with the more detailed results set out in Appendix 1.

Table 6 shows the ranges of income in retirement that are generated by the current system, making it hard to make unequivocal comparisons with EEF’s proposals. However, it is possible to draw out a number of key points:

- Most groups of people would be better off under EEF proposals at age 78.
- At age 68, most groups of people are marginally better off or roughly the same, although this depends on whether they claim Pension Credit. Because not everybody who qualifies for Pension Credit currently claims it, our proposal therefore reduces the risk of poverty in retirement for people on low incomes.
- A low-earning woman will be only marginally better off at 68, although she would no longer need to claim Pension Credit.
- A high-earning man is likely to be slightly better off.

Another way of testing our proposals is to examine the replacement rates that they generate compared with the target rates set out in the Pensions Commission’s interim report. Chart 2 compares replacement rates for the seven groups shown in Table 6. These show that replacement rates at age 68 are high for low earners and hit the Pensions Commission’s target rate almost spot on (67% vs. 70% for men and 78% vs. 80% for women). As income levels rise, replacement rates fall, although a median-earning woman (57%) and man (43%) would still

Chart 2
Replacement rates for different groups at age 68
 Target replacement and pension income under EEF proposal as % of final salary



Source: Pensions Policy Institute for EEF 2005

see a healthy rate of earnings replacement. This analysis suggests that median and higher earners would need to make additional voluntary savings if they want to achieve the Pensions Commission’s target replacement rates.

8 Managing the transition

Our report has looked in significant detail at how to establish a lasting solution to the pensions issues facing the UK as well as the costs associated with our proposals and their implications for different groups of people. What we have not addressed is how to get from where we stand today to our vision for the future. This is because we have focused our contribution to the debate on how we respond to the pensions challenges facing the UK. Analysing how to manage the transition would require another report almost as long as this one. We plan to undertake further work on this important issue but we also believe that this should be a key part of what the Pensions Commission should examine next.

Key transition principles and issues

We therefore simply comment on some broad principles for managing the transition and set out some key issues that we feel will need to be addressed:

1 The transition period should be as short as possible.

This will help to reduce the complexity and cost of administering more than one system. Faster transition will also aid understanding of the new system and help deliver buy-in to this new approach from employers, employees and financial services providers. Developing a high level of buy-in and understanding should also make it harder for succeeding governments to introduce repeated changes to the pensions system – an issue that has dogged the UK for decades.

2 We must avoid creating large numbers of winners and losers among different social groups. No system

of reform will be totally fair to everyone or be seen as such. However, it will be important to limit as far as possible any feelings of unfairness if a new approach is to gain widespread acceptance. For example, addressing the problems of under-provision by low and middle-income households will involve the transfer of resources, such as funds for tax relief, towards this group. However, care will be needed to avoid heavy-handed redistribution that leaves higher-income groups feeling substantially worse off.

3 We must avoid creating significant numbers of winners and losers among different generations.

The concerns about avoiding potential inequality will apply equally when looking at how successive generations are affected by proposed reforms. Inevitably, as the Pensions Commission and many others have pointed out, there will have to be some element of ‘sacrifice’ by people of working age unless we are willing to allow the living standards of those in retirement to decline substantially. However, care must be taken in timing the introduction of new entitlements and any increases in taxation or NIC rates to avoid creating significant numbers of winners and losers among different generations. For example, it would be a mistake for the entitlement to our proposed enhanced BSP to kick in at the same time as the current generation – which, in general, is fairly well covered by occupational pensions – moves into retirement. Similarly, the timing of introducing both compulsory contributions into our second pillar pension and their subsequent increase will have to be carefully phased in alongside any increases in taxation that are required

to pay for a higher BSP. This will avoid employers and employees facing a sudden increase in the costs associated with pension provision.

4 Limit avoidable damage to existing coverage. The trends outlined in this report (and in many others) mean that completely preserving current pension provision, such as more generous defined benefit schemes, is likely to be a forlorn hope. At the same time, we must ensure that we do not unintentionally undermine existing

pension arrangements that would otherwise have continued to provide substantial numbers of people with a secure income in retirement. Detailed work will therefore be required on the interrelationship between our proposed system of government co-contribution to employee contributions in our second pillar pension; tax relief arrangements for employers and employees; and pension scheme regulation so that they will allow our second and third pillars to work alongside each other.

Appendix 1: Detailed assumptions and costings by the Pensions Policy Institute

Assumptions

Economic assumptions

The key economic assumptions are:

- prices grow by 2.5% per year;
- earnings grow by two percentage points more than prices each year;
- GDP expands in line with average earnings and the size of the working population;
- the age, sex and marital structure of the population follows the Government Actuary Department's 2003-based projections;
- employment rates for women over 50 move closer to those of younger women as the BSP age for women increases between 2010 and 2020;
- contracting out halves in the private sector between now and 2035 as DB schemes are closed, but remains at current levels in the public sector; this assumption impacts on the benchmark costs of the current state pensions system going into the future;
- unchanged assumptions used in setting contracted-out rebates;
- the amount of non-state pension income taken into account in the Pension Credit rises with growth in average earnings;
- the aggregate amount of state pension income taken into account rises with the aggregate model (the model used for costings) projections; and
- take-up of Pension Credit remains at current levels except when stated otherwise.

Enhanced basic state pension

The key assumptions modelling our proposed enhanced BSP are:

- a single BSP is introduced in 2015 and indexed to average earnings;
- the BSP is set at 21% of national average earnings (NAE) for those aged under 75 and at 25% of NAE for those aged 75 and over;
- women's entitlement to BSP is improved to that of men's immediately;
- accruals to the State Second Pension cease from 2015;
- Savings Credit is abolished from 2015;
- BSP age is increased to 67 for those under 75 by 2035 and to 68 by 2055;
- qualifying age for higher BSP is increased to 77 by 2035 and to 78 by 2055;
- allowance is made for higher-income tax receipts resulting from the increased BSP and savings in Council Tax Benefit, Housing Benefit and Pension Credit; and
- income tax thresholds are uprated in line with growth in average earnings.

Second pillar compulsory contributions

The following assumptions are also made to analyse the impact of the proposed compulsory contributions into our second pillar pension:

- real annual investment returns of 3%;
- management charges of 1% a year;
- annuity rates are calculated consistently with the assumed investment return and the mortality

- underlying current market annuity rates, adjusted to allow for future mortality improvements;
- the capital generated by the compulsory contributions are used to purchase a life annuity at age 68, although some people might use it to purchase a term annuity to bridge the ten-year gap until their higher-age BSP can be accessed; and
- the impact of EEF’s proposals are shown assuming no voluntary savings on top of compulsory contributions. This is for simplification as, in practice, some people (particularly those on median and higher incomes) are also likely to make voluntary savings.

Impact on retirement incomes of different groups

Table A1 Impact of EEF proposals on low-earning man at age 68 and at age 78

Income as % of national average earnings

	Current system with no private saving	Current system with voluntary contributions	EEF proposal
BSP at age 68	6%	6%	21%
State Second Pension at age 68	11%	11%	1%
Compulsory pension at age 68	n/a	n/a	6%
Voluntary pension at age 68	0%	6%	0%
Pension Credit at age 68	0–10%	0–8%	0%
Total income at age 68	17–27%	23–31%	28%
Total income at age 78	14–26%	19–29%	31%

Source: Pensions Policy Institute for EEF, 2005

Table A2 Impact of EEF proposals on median-earning man at age 68 and at age 78

Income as % of national average earnings

	Current system with no private saving	Current system with voluntary contributions	EEF proposal
BSP at age 68	6%	6%	21%
State Second Pension at age 68	12%	12%	1%
Compulsory pension at age 68	n/a	n/a	12%
Voluntary pension at age 68	0%	12%	0%
Pension Credit at age 68	0–10%	0–5%	0%
Total income at age 68	18–28%	30–35%	34%
Total income at age 78	15–27%	24–32%	35%

Source: Pensions Policy Institute for EEF, 2005

Table A3 Impact of EEF proposals on low-earning man with spell of self-employment at age 68 and at age 78*Income as % of national average earnings*

	<i>Current system with no private saving</i>	<i>Current system with voluntary contributions</i>	<i>EEF proposal</i>
BSP at age 68	6%	6%	21%
State Second Pension at age 68	9%	9%	1%
Compulsory pension at age 68	n/a	n/a	10%
Voluntary pension at age 68	0%	10%	0%
Pension Credit at age 68	0–11%	0–7%	0%
Total income at age 68	15–26%	25–32%	32%
Total income at age 78	12–25%	20–30%	34%

Source: Pensions Policy Institute for EEF, 2005

Table A4 Impact of EEF proposals on high-earning man at age 68 and at age 78*Income as % of national average earnings*

	<i>Current system with no private saving</i>	<i>Current system with voluntary contributions</i>	<i>EEF proposal</i>
BSP at age 68	6%	6%	21%
State Second Pension at age 68	13%	13%	2%
Compulsory pension at age 68	n/a	n/a	23%
Voluntary pension at age 68	0%	23%	0%
Pension Credit at age 68	0–10%	0%	0%
Total income at age 68	19–29%	42%	46%
Total income at age 78	15–27%	34–38%	45%

Source: Pensions Policy Institute for EEF, 2005

Table A5 Impact of EEF proposals on low-earning woman at age 68 and at age 78*Income as % of national average earnings*

	<i>Current system with no private saving</i>	<i>Current system with voluntary contributions</i>	<i>EEF proposal</i>
BSP at age 68	5%	5%	21%
State Second Pension at age 68	9%	9%	2%
Compulsory pension at age 68	n/a	n/a	3%
Voluntary pension at age 68	0%	3%	0%
Pension Credit at age 68	0–12%	0–10%	0%
Total income at age 68	14–26%	17–27%	26%
Total income at age 78	12–25%	14–27%	29%

Source: Pensions Policy Institute for EEF, 2005

Table A6 Impact of EEF proposals on median-earning woman at age 68 and at age 78*Income as % of national average earnings*

	<i>Current system with no private saving</i>	<i>Current system with voluntary contributions</i>	<i>EEF proposal</i>
BSP at age 68	5%	5%	21%
State Second Pension at age 68	10%	10%	2%
Compulsory pension at age 68	n/a	n/a	5%
Voluntary pension at age 68	0%	5%	0%
Pension Credit at age 68	0–11%	0–9%	0%
Total income at age 68	15–26%	20–29%	28%
Total income at age 78	13–25%	17–28%	31%

Source: Pensions Policy Institute for EEF, 2005

Table A7 Impact of EEF proposals on high-earning woman at age 68 and at age 78*Income as % of national average earnings*

	<i>Current system with no private saving</i>	<i>Current system with voluntary contributions</i>	<i>EEF proposal</i>
BSP at age 68	5%	5%	21%
State Second Pension at age 68	11%	11%	2%
Compulsory pension at age 68	n/a	n/a	10%
Voluntary pension at age 68	0%	10%	0%
Pension Credit at age 68	0–10%	0–7%	0%
Total income at age 68	16–26%	26–33%	33%
Total income at age 78	13–26%	21–31%	35%

Source: Pensions Policy Institute for EEF, 2005

Appendix 2: EEF's Pensions Strategy Group – terms of reference and membership

Terms of reference

'To describe the pensions structure and arrangements that will be appropriate for the UK in 2015 and will be sustainable into the future, including the identification of the issues that will have to be addressed in making the transition from the UK's current pension arrangements.'

Membership

Chairman

Paul Lester
Chief Executive
VT Group plc

Members

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Andrew Cochrane	Finance Director Kesslers International
Chris Cundy	Group Finance Director VT Group plc
Geoff Edwards	Vice-President UK Operations B&W Loudspeakers Limited
Stuart Fell	Chairman West Bromwich Tool & Engineering Co. Limited
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About EEF

EEF, the manufacturers' organisation, has a membership of 6,000 manufacturing, engineering and technology-based businesses and represents the interests of manufacturing at all levels of government. Comprising 11 Regional Associations, the Engineering Construction Industry Association (ECIA) and UK Steel, EEF is one of the UK's leading providers of business services in employment relations and employment law, health, safety and environment, manufacturing performance, education and skills, and information and research.

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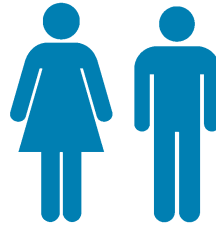
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