May 2006

Security in retirement:
towards a new pensions system

Department for Work and Pensions

Security in retirement: towards a new pensions system

Presented to Parliament by
the Secretary of State for Work and Pensions
by Command of Her Majesty
May 2006

Cm 6841 £27.00

Contents

Regulatory Impact Assessments and technical appendices are published alongside this document.

Prime Minister's Foreword

I am proud of what the Government has achieved for pensioners. We said our first priority would be tackling pensioner poverty. There is more to do, but since 1997 two million pensioners have been lifted out of poverty. Thanks to measures like the Pension Credit, Winter Fuel Payments, free TV licences and above-inflation increases in the basic State Pension, pensioners are now less likely to be poor than the population as a whole.

But while pensioner poverty was the most pressing problem, we also have to address, like countries across the world, the long-term challenges and opportunities of an ageing society. In particular, we need to put in place an affordable and sustainable pension system which meets the needs of generations to come and encourages people to save for their retirement. It was to chart the way to meet these challenges that we set up the independent Pensions Commission four years ago.

The reforms we are proposing are based on its report. They take forward our modernisation of the welfare state and simplify the pension system and its contributory principle, create and reward a new culture of saving, are fairer to women and carers and continue to target most resources on those most in need.

It is a bold blueprint. It involves difficult decisions for everyone – Government, business, the pensions industry and individuals. But thanks to the work of the Pensions Commission, we know already that there is wide support for the principles behind these reforms.

Over the coming months, we will work to build on this support to forge a national consensus. We know this will not be easy but tackling long-term challenges rarely are. Our objective is to put in place a sustainable, affordable and trusted pensions system which will meet the needs of those in retirement and our country in the future.

Tony Blair

The Rt Hon Tony Blair MP

Foreword

Today we face the challenge of profound social and demographic change that demands a new kind of policy response. The immediate crisis of pensioner poverty is being successfully addressed, but the next challenge is just around the corner. In the next 50 years, the number of people over pension age will increase by more than half and there will be only two people working for every one person in retirement – compared with four today.

Millions of people today are not saving enough for their futures. And our pension system suffers from structural problems. Because of the historical legacy of complexity few people understand how it fits together. It is unfair to many who are caring for others, and particularly to women. It reflects a view of family relationships that dates back to the early years of the State Pension itself.

As the Pensions Commission has made clear, we face some stark choices about the path ahead. We don't want the retirees of the future to be worse off than those today. But neither should our response be simply to spend more public money on the State Pension alone. A new balance must be struck between State, employers and individuals to share the responsibility to save and provide for the future.

To meet these new challenges any reforms must meet five key tests. They must promote personal responsibility, be fair – particularly to women and carers, and provide greater simplicity so that roles are clear. They must be affordable, and offer a sustainable solution that commands a national consensus. Our proposals for reform are designed to meet these fundamental requirements.

The proposals in this paper set out a new structure for the UK pensions system for the long term. I'd like to thank the Pensions Commission for their hard work in creating the basis for consensus. We can now lay the foundation on which this generation and the next can work and save for a long and healthy retirement. And they can do so in confidence that the reforms we are proposing will last between the generations.

The Rt Hon John Hutton MP

Executive summary

Executive summary

Progress since 1997

Tackling pensioner poverty – our first priority

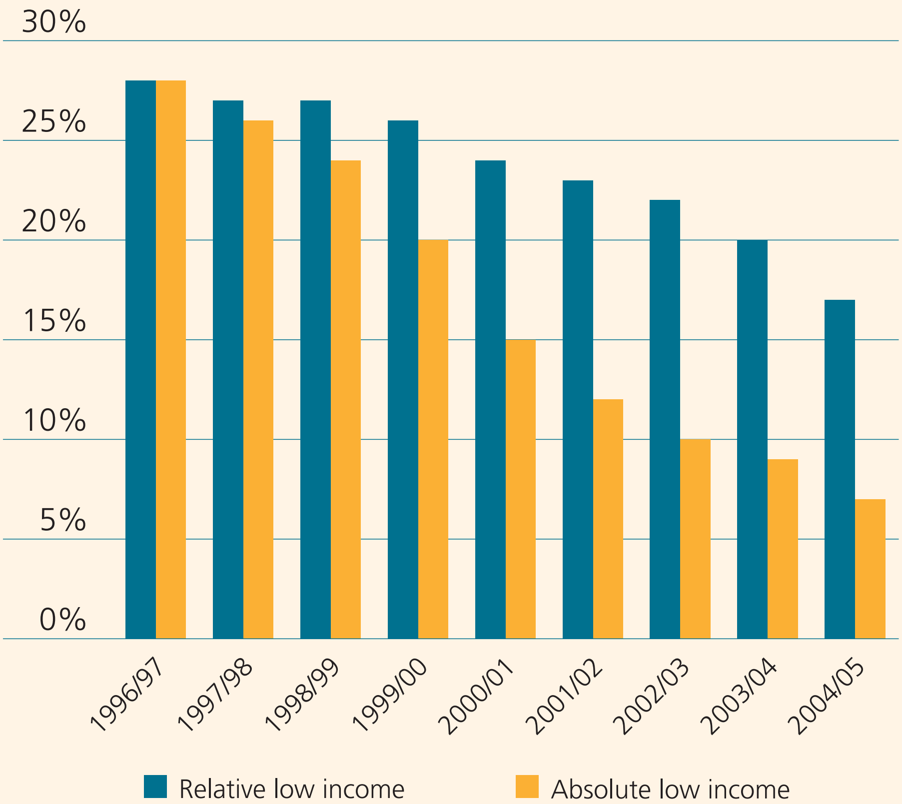
1. Government has a responsibility to protect its citizens against poverty and insecurity in retirement. The actions we have taken since 1997 – establishing Pension Credit, Winter Fuel Payments and real terms increases in the value of the basic State Pension – have helped pensioners escape from poverty.

2. This Government introduced the Minimum Income Guarantee for pensioners, now part of the Pension Credit, which has raised the minimum income pensioners are entitled to from £68.80 a week in 1997 to over £114 today. More than 2 million pensioners have been lifted out of absolute poverty, and 1 million out of relative poverty. And we have seen sustained increases in pensioner incomes, with the poorest benefiting most. Pensioners are now less likely to be poor than younger people. In addition, the savings reward in Pension Credit has tackled the penalty of the 100 per cent marginal deduction rate that many savers faced, for the first time rewarding 1.9 million pensioner households who saved for retirement.

3. The years of economic instability and high unemployment in the 1980s and early 1990s were damaging to pensions and pensioners. High inflation eroded the value of savings. Unemployment, which hit 3 million twice, denied millions the opportunity to build additional pension entitlements. Uneven and unsustainable growth made it harder to plan for the future with confidence. Thanks to the Government's commitment to maintain economic stability, invest in Jobcentre Plus and the New Deal, and make work pay, Britain now has the highest employment rate of any of the G8 countries. Some 2.3 million more people are now in work compared to 1997.

4. These policies have brought significant benefits for pensioners. The high rate of employment has given more people the opportunity to save for their retirement, and has helped contribute to stable growth in the economy. The Government is committed to maintaining this macroeconomic stability.

Figure 1 Percentage of pensioners in relative and absolute low income



Source: Households Below Average Income

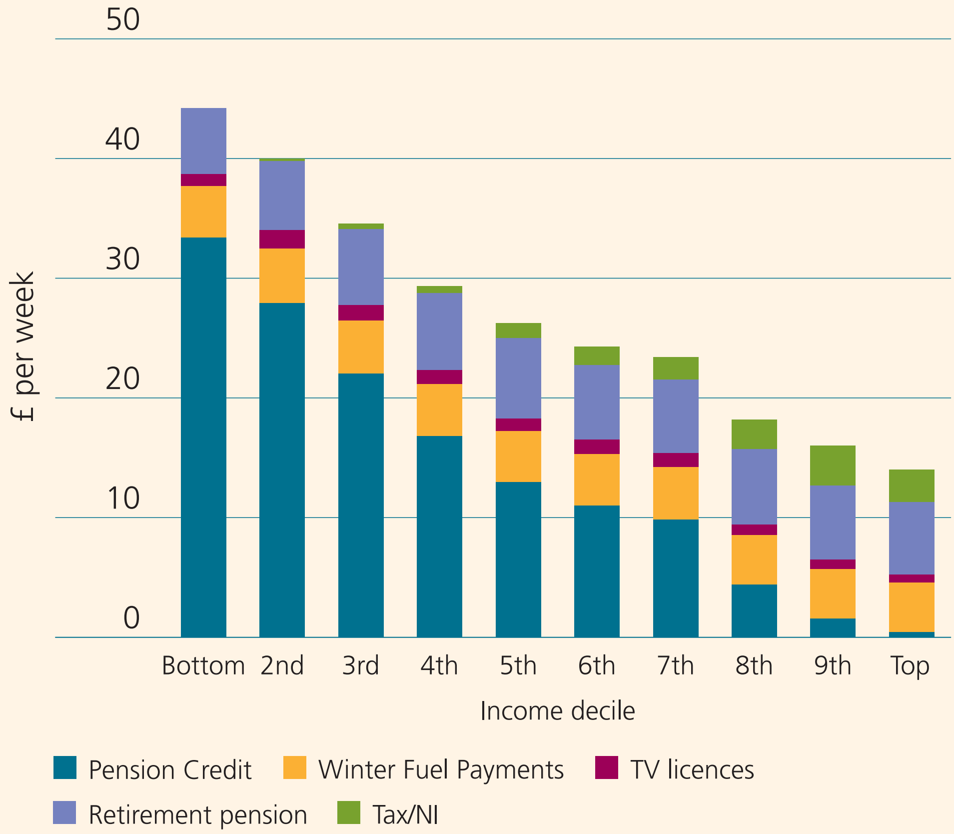
Notes: Relative low income gives the numbers below 60 per cent of contemporary median net income.
Absolute low income gives the numbers below 60 per cent of 1996/97 median net income held in constant real terms.
In each case income is measured after housing costs.

Improving the pensions system

5. We now spend £10.5 billion a year (nearly 1 per cent of GDP)[1] more on pensioners than we would have done if we had simply continued the policies we inherited in 1997. Combined with growth in private pension saving, this has meant pensioner incomes have risen across the board, with the poorest benefiting most. We have achieved these gains while maintaining the affordability of the system as a whole.

[1] Throughout this paper and the accompanying Regulatory Impact Assessment, the costs of reform of private pensions are presented on a 2005/06 price base (the latest year for which actual prices are available). Estimates of expenditure on state pensions are presented on a 2006/07 price base, consistent with our latest estimates of long-term public expenditure projections. Both reflect best practice for their respective purposes. The difference in base year has a slight impact on costs in £, but the estimates are consistent when looked at in terms of percentage of GDP.

Figure 2 Gains for pensioners from this Government's policies since 1997



Source: DWP Policy Simulation Model – see technical appendix for more details

Notes: Gains from 2006/07 policies compared with the 1997/98 system of benefits indexed to 2006/07 prices.
Pension Credit includes Housing Benefit and Council Tax Benefit knock-on effects.

6. In addition to tackling pensioner poverty, the Government has taken significant steps to improve other aspects of the pensions system since 1997.

7. We introduced the State Second Pension in 2002, crediting in low earners and some carers who missed out on its predecessor, the State Earnings-Related Pension Scheme (SERPS). Consequently, some 4 million people now have the chance to build up a decent additional pension for the first time. We introduced stakeholder pensions and required that all employers with five or more employees should provide access either to a stakeholder pension or to an occupational scheme, as an important step towards encouraging more private saving and bringing down the cost of saving.

8. The Pensions Act 2004 has improved security and confidence for occupational pension scheme members. The Pension Protection Fund (PPF) means that over 10 million members of salary-related pension schemes know that they will receive compensation if their employer becomes insolvent and the pension scheme is under-funded. The Financial Assistance Scheme (FAS) will help groups close to retirement who lost out before the PPF was established. Following the Prime Minister's announcement to expedite the review of the FAS planned for CSR07, the Government has decided to extend the FAS so that it will assist eligible people who were within fifteen years of their scheme pension age on or before 14 May 2004. This should ensure that up to a further 30,000 people who lost significant amounts when their pension schemes were wound up, will benefit from the new arrangements. Under this extension, scheme benefits will be tapered so that the Government will pay the full 80 per cent to those within seven years of scheme pension age, 65 per cent to those within eight to eleven years of scheme pension age and 50 per cent to the remainder.

9. The Pensions Regulator will help to protect members' benefits and promote good administration of work-based pension schemes. It has wide powers to investigate schemes and take action where necessary and takes a proactive, risk-focused approach to regulation. The Regulator also provides practical support for the regulated community. And the Finance Act 2004 swept away the complexity of many separate taxation regimes, replacing them with a single, flexible regime based on the simple concept of a lifetime allowance of £1.5 million for tax-privileged pension saving.

10. We have also supported private saving by helping people to make better informed choices about their retirement, introducing a range of pension forecasts to give individuals an understanding of the income they are likely to receive in retirement. Since their introduction, the Government has issued just over 20 million of these forecasts and we are developing web-based retirement planning services.

11. We have taken steps to outlaw age discrimination and promote older working. We have set a long-term aspiration to reach an employment rate equivalent to 80 per cent of the working-age population, including a million more older workers.

12. As the Pensions Commission made clear, private pension incomes are at an all-time high. Living standards have risen for all, but, over the past 25 years at least, more for pensioners than for working-age adults.

The case for further reform

13. So we have already made great strides to tackle the immediate problem of low pensioner incomes and put in place necessary reforms to help people plan for the future. But we have long recognised that further steps would be needed to ensure that people could get the retirement income they expect in the future. In December 2002 we established the independent Pensions Commission, to review the regime for UK private pensions and long-term saving. We asked it to consider the longer-term

challenges faced by the pensions system and whether the existing voluntary pensions regime represented an adequate response. The Pensions Commission concluded that there is no immediate ‘pensions crisis’, but it outlined those key longer-term challenges, and the need for early action.

Demographic and social change

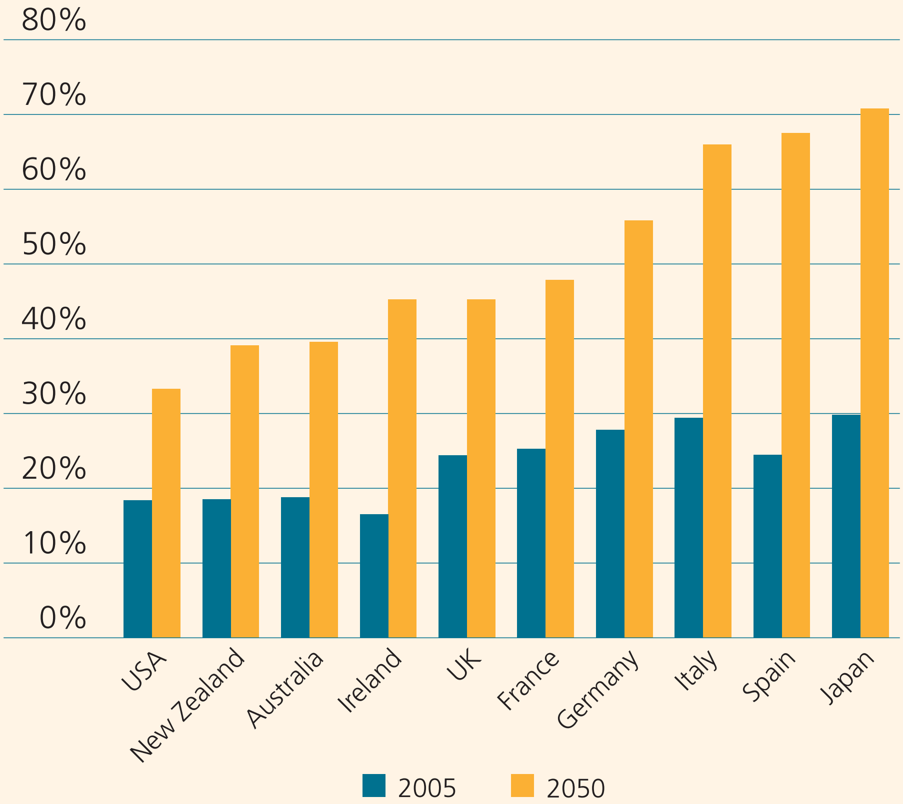
14. Today, people can expect to live longer than ever before. In 1950, a man aged 65 could expect on average to live to the age of 76. Today, he can expect to live to 85, and by 2050 to 89. Women will live for even longer – on average, perhaps, into their early nineties. This is a huge change, ranking among the greatest social achievements of the last century.

15. At the same time, lifestyles and expectations for working life and retirement have changed dramatically since the UK state pension system was first created. In 1948, divorce and remarriage were relatively rare, and it was not unusual for a man or woman to spend their whole working life with one employer.

16. Today, men and women work throughout their lives, and we recognise the value of the service that carers, both of children and of people with disabilities, contribute to society. It is much more common for people to be involved in more than one long-term relationship in the course of a longer life. And it is more likely that people will work for a number of different employers, and mix periods of working, caring, and studying during the course of their lives.

17. Increasing longevity is something that we should celebrate, but it also raises significant challenges. These challenges aren’t unique to the UK or specific to governments. Ageing societies are a challenge facing most of the industrialised world, and in many countries state spending is projected to rise to meet that challenge. Figure 3 illustrates the rising dependency ratio for other countries. Some of these countries have also shown the dangers of establishing unsustainable policies, requiring them to reduce commitments.

Figure 3 Worldwide dependency ratios



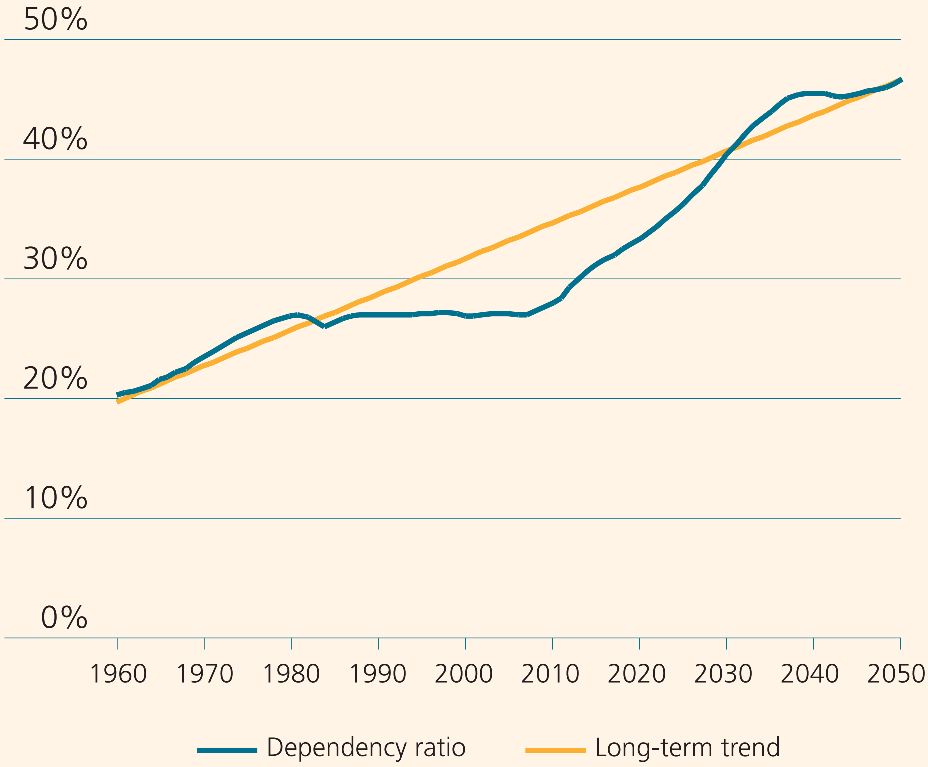
Sources: For non-EU countries, Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: The 2004 Revision; for EU countries, Ageing Society Indicators, EUROSTAT 2005

Note: Dependency ratios for EU and for non-EU countries are taken from two separate projection exercises based on different assumptions and methodologies, and thus are not strictly comparable. The definition of the dependency ratio in this chart differs slightly from that used elsewhere in the White Paper in that it represents the ratio of the population aged 65 years or over to the population aged 15–64 (rather than to that aged 20–64).

18. In addition, we are about to experience a dramatic acceleration in the dependency ratio – the balance between the numbers of people of working age and those over State Pension age. Rising longevity means this is on a long-term upward trend. However, with the large cohort of baby-boomers born just after the Second World War swelling the workforce, this ratio has been artificially depressed in recent decades. As that generation goes through to retirement, we will rapidly catch up with the long-term trend.

19. Figure 4 shows the pensioner population as a percentage of the working-age population. In 1950, this ratio stood at just 19 per cent. Today, it has risen to around 27 per cent. By 2050, once the ratio has caught up with the underlying trend, it might be 47 per cent. This demographic shift is transforming the context for pensions policy.

Figure 4 Old-age dependency ratio



Source: DWP estimates based on Government Actuary's Department's 2004-based principal projection, UK

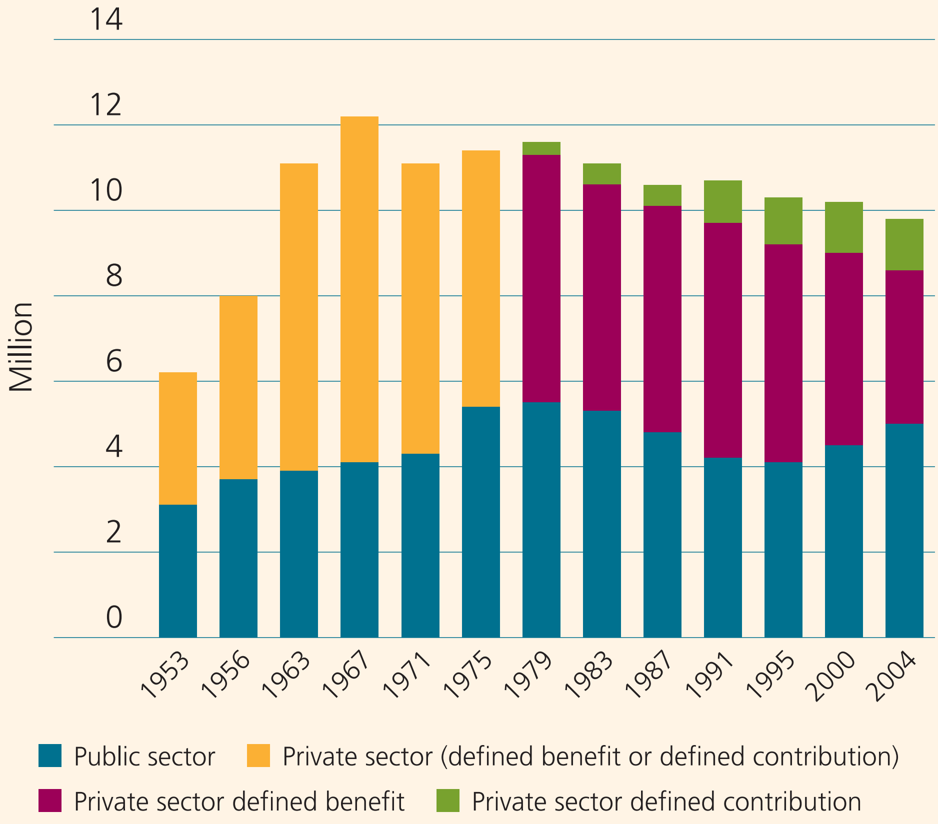
Notes: The old-age dependency ratio shows the number of people aged 65 and over divided by the number of people of working age (ie men and women aged between 20 and 64). The long-term development of this ratio was captured using a modified linear trend.

Undersaving for retirement

20. Retirement undersavers can be defined as those who are likely to receive an income that does not provide for their reasonable expectations of quality of life during retirement. These expectations will vary to reflect different circumstances and aspirations – and consequently a single, fully comprehensive measure of undersaving for retirement is not easily identifiable. However, some analysts have used the idea of replacement rates, that is income in retirement as a percentage of an individual's final salary. In providing an income for their retirement, individuals will have different intentions regarding their retirement age and different types of assets at their disposal. In addition to pensions, they may have other financial and non-financial assets, including property. Total net wealth is now higher than it has ever been before, having risen by around 60 per cent in real terms since 1997. However, the numbers of people saving in pensions vehicles are declining.

21. Since the 1970s, employers have been retreating from occupational pensions as rapid increases in life expectancy and then the end of the high equity market in the late 1990s pushed costs higher than had been anticipated when occupational pension schemes were designed. This trend has continued, with 2 million fewer members of open private sector occupational pension schemes in 2004 than in 2000.[2]

Figure 5 Active members of occupational pension schemes



Source: Government Actuary's Department's Occupational pension schemes survey

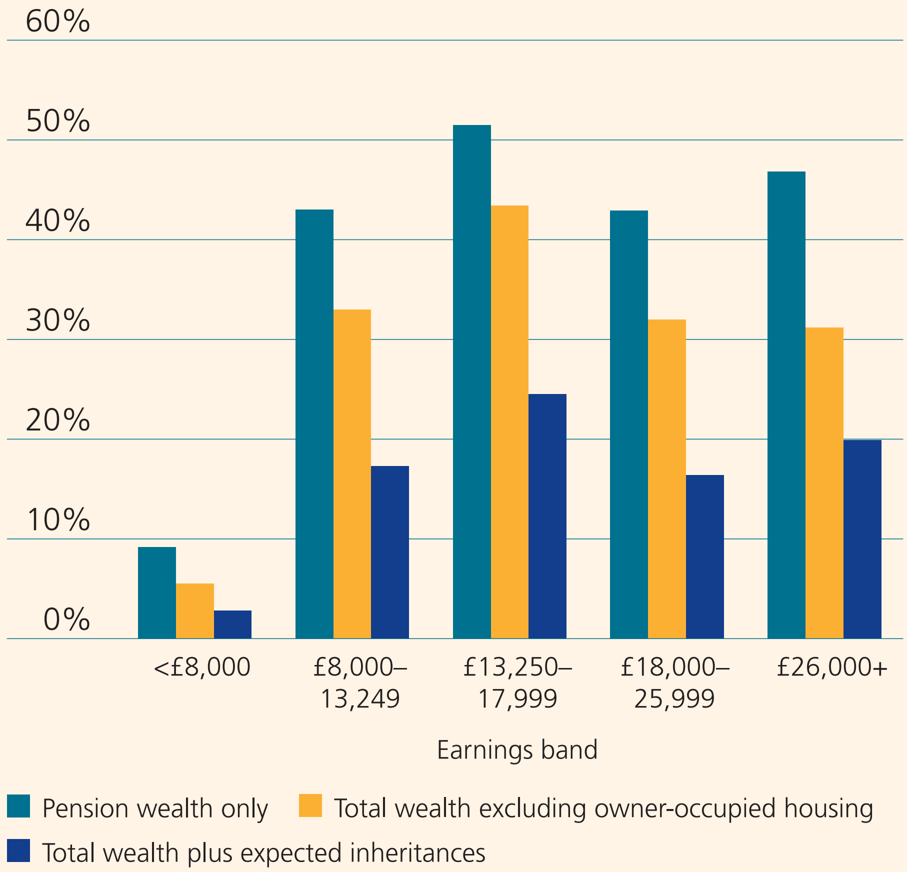
Notes: The 2004 split between private and public sectors is not perfectly comparable with splits in earlier years, since from 2000 onwards the public sector figures have included only those members who are in public service schemes. It follows that, from 2000 onwards, figures for the private sector also include members in the wider public sector (such as the Post Office and the BBC).

22. Occupational schemes have changed in nature as well as decreasing in scale, with a shift from defined benefit (DB) to defined contribution (DC).

2 GAD survey.

23. The Pensions Commission suggested benchmark replacement rates which vary by in-work income. Their analysis found that between 9.6 million and 12 million people were saving at a rate which would not deliver them retirement incomes in line with those benchmark rates.

Figure 6 Percentage of people aged between 50 and State Pension age at risk of falling below the Pensions Commission's benchmark replacement rates[3]



Source: Further analysis of those at risk of inadequate resources in retirement (Emmerson and Tatlow, Institute for Fiscal Studies, forthcoming)

Notes: Percentages refer to percentage of individuals in families with some earned income. Includes those not in paid employment whose partner has employment income. Earnings bands represent equivalised family gross earned income, including any profits from self-employment.

24. Retirement undersaving has arisen for a variety of reasons: because individuals have not trusted private pensions, because suitable savings vehicles have not been available to them, and because, in the face of a historically complex pensions system, financial short-sightedness and inertia have left inaction as the default option.

[3] IFS analysis of ELSA (to be published 2006).

25. Stakeholder pensions reflect our belief that the workplace provides the best environment for delivering private pensions. But although over 2.7 million stakeholder pensions have been sold, they have highlighted the areas where further action needs to be taken, especially for those people not traditionally served by the savings market. Barriers to saving mean that, unprompted, people often do not take the decision to start saving – and as people move jobs, persistency in pension saving is low. This means that administration, advice and sales costs for providers are high, and makes it difficult for them to serve some sectors of the market profitably.

26. We need to do more to overcome these barriers to saving and drive costs down still further. Information and significant financial incentives are often insufficient. A long-standing feature of the UK pensions system has been its complexity, which can confuse both employers and individuals trying to make the best financial decisions for the long term. The high cost of saving for those without good employer-based provision and a lack of access to suitable products remains problematic. In other words, and as the Pensions Commission has concluded, the current structures need to be reformed to address the challenges of an ageing population.

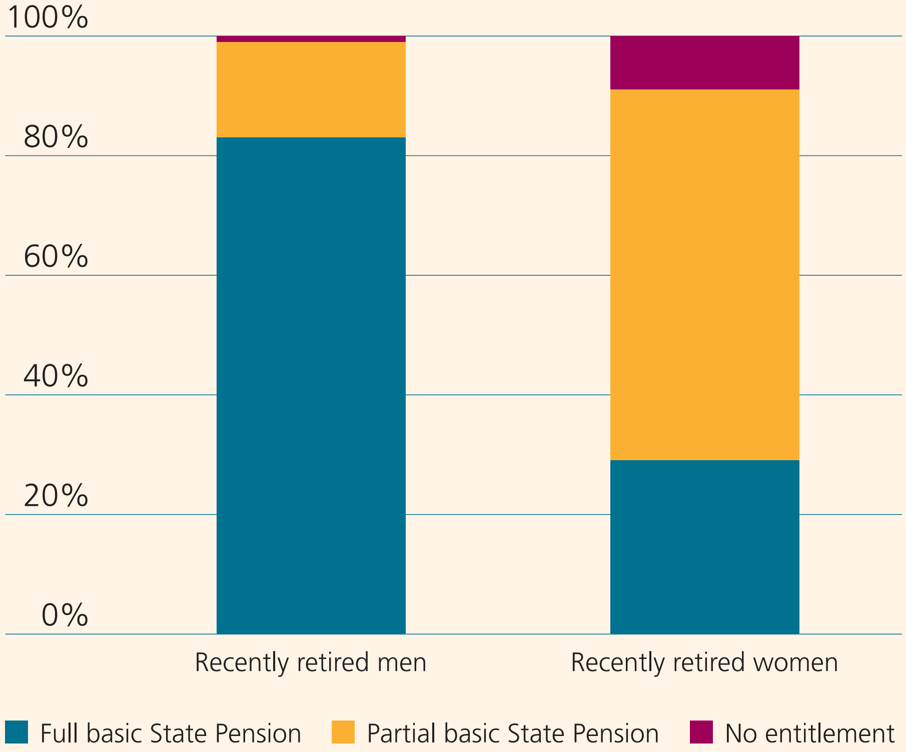
27. As well as saving more in response to increased life expectancy, many individuals will choose to work longer in order to build up a retirement income that meets their expectations. More years in work can enable greater accruals of state pension entitlements as well as providing the opportunity to save more. Since 1997, the employment rate of those aged between 50 and State Pension age has increased from 65 per cent to over 70 per cent, and there are now more than a million individuals over State Pension age who are in work.[4]

Inequalities in the state pension system

28. The pensions system we have today is rooted in the society of the 1940s. Society has moved on and, unless we act now, women and carers retiring in the next two decades will continue to suffer the effects of the system of contributions which applied during their working lives. Figure 7 shows that among those recently reaching State Pension age, around 85 per cent of men have entitlement to a full basic State Pension, compared with only about 30 per cent of women. The introduction of Pension Credit has improved the position of women, who represent two-thirds of those to have benefited from its introduction. We published a detailed analysis of the pensions position of women – past, present and future – with an analysis of the effect of existing National Insurance rules in the Department for Work and Pensions Research Report *Women and pensions: The evidence*, in November 2005.

[4] LFS 2005 spring quarter.

Figure 7 Basic State Pension entitlement of people reaching State Pension age in 2005



Source: Government Actuary's Department's Retirement Pension Model, GB

Notes: Women's entitlement is based on their own and their husband's contribution record. Includes widow's pension over age 60 and deferrers.

Complexity

29. The first State Pension – a means-tested scheme for those aged 70 or over – was introduced in 1908. Since then, a series of legal and other changes have modified, reformed and adjusted that simple provision, towards a pensions system today described by the Pensions Commission as the most complex in the world.

30. Our changes to the state pension system since 1997 have been essential to tackle the immediate problems that we found, and, as we have set out, they have been very successful. Incentives to save in the current system remain strong. Recent research has shown that incentives for many on low incomes have improved as a direct result of the introduction of Pension Credit.[5]

[5] Weale M, van de Ven, J, Sefton J, and 2005, *The effects of means-testing pensions on savings and retirement,* National Institute of Economic and Social Research (NIESR).

31. Problems with incentives could, however, develop if a pensions system evolved in which a significant majority of pensioners were entitled to Pension Credit in the long term. That has never been the intention of this Government.

History of pensions legislation

1908 The Liberal Government came forward with a plan for a non-contributory pension. Implemented from **January 1909**, this **'Lloyd George Pension'**, worth 5 shillings, was payable equally to men and women from age 70.

1911 The **National Insurance Act** required workers and employers to pay compulsory flat-rate contributions for health and unemployment cover. The insurance scheme was extended in 1926 to provide contributory pensions for old-age, widows and orphans.

1948 The **basic State Pension** was introduced as a universal State Pension in return for flat-rate contributions paid by all workers and their employers (except by married women, who could opt out).

1961 Graduated Retirement Benefit (GRB) introduced three new concepts to state provision: earnings-related contributions, an earnings-related pension, and contracting out of GRB for those with occupational pensions.

1974 A legal base for regular uprating (by the best of prices or earnings) was introduced. The 'best of' legislation ended in **1979** and was replaced by a prices link.

1978 The **State Earnings-Related Pension Scheme (SERPS)** was introduced to replace GRB, which had been wound up in 1975. **Home Responsibilities Protection (HRP)** was introduced for carers.

1995 The **Pensions Act** established an equal State Pension age of 65 – to be phased in between 2010 and 2020 – strengthened the regulation of occupational pensions, and altered the terms for contracting out of SERPS.

2002 SERPS was replaced by the **State Second Pension** providing low earners with around twice the pension they would have earned under SERPS.

2004 Pensions Act (see paragraph 8)

Alongside the contributory system, a comprehensive means-tested pension has developed. Means-tested **Supplementary Pensions** were introduced in **1941**. **National Assistance**, introduced in **1948**, was replaced with **Supplementary Benefit** in **1966**, then with **Income Support** in **1988** (developing into the **Minimum Income Guarantee** in **1999**), and with **Pension Credit** in **October 2003**.

Looking to the future

32. To address these challenges, we established the Pensions Commission in December 2002. We asked it to review the operation of the UK pensions system and make recommendations for reform. In November 2005 the Commission published its recommendations.

33. The Government has set five tests for the reform package, building on our successes and principles for reform to date. Any reformed pension system must:

- **promote personal responsibility:** tackling the problem of undersaving for retirement;
- **be fair:** protecting the poorest, and being fair to women and carers, to savers, and between generations;
- **be simple:** clarifying the respective roles of the State, the employer and the individual;
- **be affordable:** maintaining macroeconomic stability and striking the right balance for provision between the State, the employer and the individual; and
- **be sustainable:** setting the basis of an enduring national consensus, while being flexible to future trends.

34. Having assessed the recommendations of the Pensions Commission, we will:

- Introduce low-cost personal accounts to give those without access to occupational pension schemes the opportunity to save. People will be automatically enrolled into either their employer’s scheme or a new personal account, with the freedom to opt out. Employers will make minimum matching contributions.
- Improve the foundation for all while continuing to tackle pensioner poverty. We will reform the state pension system by uprating both the guarantee element of Pension Credit and the basic State Pension in line with earnings growth, rather than prices. We will make the State Pension fairer and more widely available and we will raise the State Pension age in line with increasing longevity.

35. The reforms set out here will make an immediate difference to those working and saving for retirement, striking a new balance of responsibility between employer, State and individual. At the same time, we will continue to protect the poorest pensioners from poverty, and we will ensure that all pensioners share in rising national prosperity. We will bring forward legislation on these reforms during the second session of this Parliament.

A new pensions settlement: our proposals for reform

Our first priority is to make it easier for more people to save more for their retirement. To achieve this, in 2012 we will introduce the following:

36. A new scheme of personal accounts, which will provide a straightforward opportunity to contribute to a high-quality, low-cost savings vehicle. The scheme will have the following key features:

- Employees will contribute 4 per cent of a band of earnings of between around £5,000 a year and £33,000 a year.
- Employers will make minimum matching contributions of 3 per cent on the same band of earnings.
- A further 1 per cent will be contributed in the form of normal tax relief.[6]
- There will be support for all employers during the introduction of compulsory employer contributions:
  - their contributions will be phased in over a three-year period, at the rate of 1 per cent each year;
  - the contribution rate will be set out in primary legislation to create stability;
  - the priority is to design the scheme and the transition phase so that burdens on employers are minimised; and
  - we will consult on transitional support for the smallest businesses and whether a longer phasing period is needed.
- Automatic enrolment for employees into either the new personal accounts scheme or their own employer's occupational scheme providing it meets a minimum standard:
  - Employees will be able to opt out of this provision, in which case the employer would not contribute;
  - Non-employees, including the self-employed and non-workers, will be able to opt into the scheme.

The new system of personal accounts with automatic enrolment will provide a simple and straightforward way for people to take personal responsibility for the income they want in retirement.

[6] 1 per cent represents basic rate tax relief on individuals' contributions – in addition, individuals may be entitled to higher-rate tax relief and neither employers nor employees pay tax or National Insurance contributions on employer contributions.

Initial analysis suggests that the best delivery model for the personal accounts scheme is that proposed by the Pensions Commission, but the Government will conduct further analysis of this, and industry alternatives, in order to strike the right balance between value for money for the taxpayer and value for money for the saver. We will bring forward proposals later this year.

Secondly, in order to make the system of personal accounts effective, we will provide a solid foundation on which people can save. To achieve this, we will reform state pensions so that they are simpler and more generous, and will ensure that pensioners share in rising national prosperity.

37. During the next Parliament, we will re-link the uprating of the basic State Pension to average earnings. Our objective, subject to affordability and the fiscal position, is to do this in 2012, but in any event by the end of the Parliament at the latest. We will make a statement on the precise date at the beginning of the next Parliament.

    We will also:

    - reform the State Second Pension so that it becomes a simple, flat-rate weekly top-up to the basic State Pension. Accruals will gradually start to become flat rate at the same time as we start to uprate the basic State Pension by earnings. We estimate that the State Second Pension will become completely flat rate around 2030 or shortly afterwards; and
    - ensure that, before implementing the earnings link of the basic State Pension, means-tested provision continues to be focused on those with small savings, by taking steps from 2008 to target the Pension Credit on this group.

Thirdly, from 2010, we will make the State Pension fairer and more widely available.

38. We will radically reform the contributory principle, by recognising contributions to society while retaining the link between rights and responsibilities. This will be achieved by the following measures:

    - streamlining the contribution conditions to the basic State Pension by reducing the number of years needed to qualify to 30;
    - replacing Home Responsibilities Protection with a new weekly credit for those caring for children;
    - introducing a new contributory credit for those caring for severely disabled people for 20 hours or more per week;

- abolishing the initial contribution conditions to the basic State Pension, so that caring for children or the severely disabled will build entitlement to the basic State Pension, without having to make a minimum level of contributions; and

- making a number of other simplifications to the rules for entitlement to the basic and State Second Pensions, and abolishing a number of complicated and out-dated provisions such as adult dependency increases and autocredits.

The current system is unfair to those with caring responsibilities, who tend to be women, and means that their social contributions are not fully recognised by the state pension system. This modernised contributory system will better reflect the different ways in which people contribute to society, and will ensure that carers have improved opportunities to build State Pension entitlements.

Fourth, we will support and encourage extended working lives.

39. We will:

- gradually raise the State Pension age in line with gains in average life expectancy. The State Pension age for women is already due to rise from 60 to 65 between 2010 and 2020, to equalise with men's State Pension age. There will be a subsequent rise for both men and women which will follow the same approach, beginning with a rise from 65 to 66 over a two-year period from 2024, then again by one year over a two-year period from 2034 and from 2044; and

- take measures to support longer working, as set out in the publication *A new deal for welfare: Empowering people to work*, and consider greater flexibility around, and communication of, State Pension deferral.

We note the Pensions Commission's suggestion that the age at which people become entitled to the Guarantee Credit in Pension Credit could remain at 65, in order to protect those with the lowest life expectancies. We think this is an issue that must be considered nearer the relevant time in the light of the available evidence about inequalities in life expectancy and trends in working among older people.

We also propose to periodically commission reviews, drawing on a range of independent expert advice in the light of emerging evidence on demographic change.

40. The increased State Pension age will share the growth in life expectancy between time spent in work and time spent in retirement, and it will secure the financial stability and sustainability of the state pension system for the long term.

Finally, we will streamline the regulatory environment.

41. We will do this by:

- abolishing contracting out for defined contribution schemes at the same time as re-linking the uprating of the basic State Pension to average earnings;
- reducing burdens on schemes by bringing forward legislation to allow schemes to convert Guaranteed Minimum Pension rights into scheme benefits;
- introducing a rolling deregulatory review of pensions regulation, in light of the Pensions Act 2004;
- piloting a Pensions Law Rewrite Project; and
- re-examining the existing regulatory landscape.

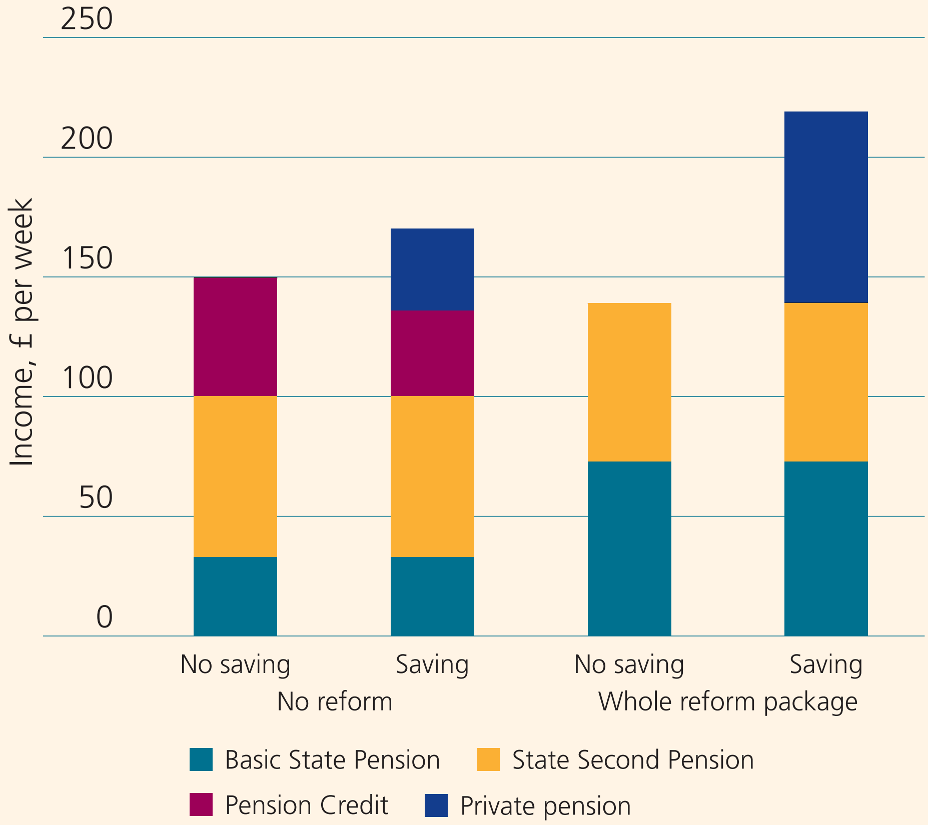
Any such simplifications will be aimed at easing the regulatory burden on employers who provide good occupational pensions. They, and other measures in the proposed reform package, will be taken forward with regard to the Government's wider agenda to promote better regulation and reduce the administrative burdens on business.

Key outcomes of the reforms

- Everyone will be able to enrol into a new, low-cost personal account;
- Automatic enrolment ensures that employees will be saving for a pension unless they actively decide not to do so;
- Up to 10 million people could be saving in a personal account;
- By retirement, their pension funds could be worth up to around 25 per cent more because of lower charges;
- In 2010, 70 per cent of women reaching State Pension age will be entitled to a full basic State Pension, compared to 30 per cent now;
- By 2025, over 90 per cent of women and men reaching State Pension age will be entitled to the full basic State Pension – compared to about 80 per cent without reform;
- By 2050, the basic State Pension could be worth twice as much as if it had been linked to prices;
- Anyone who has been in employment or caring throughout their working life could receive £135 a week at retirement in state pensions – which is £20 a week above the guaranteed income level;[7]
- Fewer pensioners – down to around a third by 2050 – could be entitled to Pension Credit.

[7] These figures are relative to average earnings. If expressed in 2005/06 prices, following these reforms, an average earner retiring in the 2050s will receive £340 per week in state pensions.

Figure 8 Income for median earner – with and without reform – outcomes in 2050/53



Source: DWP modelling

Notes: In 2005/06 earnings terms, income shown before tax.
Saving under no reform assumes saving 5% of salary between the Primary Threshold and Upper Earnings Limit into a stakeholder pension, with a 1.5% annual management charge. This is equivalent to the employee-only contribution rate into the new personal accounts.
Saving under reform package assumes saving 8% of salary between the Primary Threshold and Upper Earnings Limit into a personal account (which includes 3% employer contribution, and has 0.5% annual management charge).
No reform assumes 40 years of saving and working, retiring in 2050.
'Whole reform package' assumes 43 years of saving and working, retiring in 2053.

Meeting the five tests for reform

We believe the reform package set out in this Paper meets the five tests for reform:

Personal responsibility

42. **Automatic enrolment** will ensure that employees have automatic access to a retirement savings vehicle. We will also ensure that the self-employed and non-workers have access to the scheme of personal accounts. Everyone will have the opportunity to save easily, as an essential step towards tackling undersaving for retirement.

43. We need to be clear that **individuals must be responsible for their own plans for retirement**. The reforms will ensure the provision of high-quality savings vehicles, and a solid state foundation to private savings. But the choice of how much to save, the level of risk to take with investments, and how long to work must be available to the individual. That provides the **right balance of choice and support** for individual responsibility.

44. Through these reforms people should see greater return from their private savings than they would under today's system.

Fairness

45. **Protecting the poorest**. We are committed to uprating the Guarantee Credit for pensioners in line with earnings growth. This means that the value of the £114 guaranteed minimum income for single pensioners today will continue to keep pace with the growth in national wealth.

46. We are creating a system which establishes **a new contributory principle for state pensions**. We are committed to the principle of giving 'something for something', rewarding those who have worked and cared for decades before retiring. Our measures to reform the contributory rules for the basic State Pension and State Second Pension will achieve that.

47. Cutting the number of qualifying years required for entitlement to the basic State Pension will immediately give fairer outcomes, particularly for women. All those who have worked or cared for 30 years will get full entitlement to the basic State Pension. Under the current system, around half of women reaching State Pension age in 2010 would have received a full basic State Pension. Under our reforms, that proportion will rise to around 70 per cent. And, by 2025, over 90 per cent of people reaching State Pension age will get a full basic State Pension.

48. We will **widen access to high-quality private savings schemes.** We expect that around 6 to 10 million people might be enrolled in the new scheme of personal accounts once it is fully rolled out.

49. We have set the rate of contribution for the new scheme of personal accounts so as to strike a fair balance between the contribution needed from **employers and from employees**. We are also setting a fair and lasting balance **between the generations**. Current workers must both pay for provision for today's pensioners (through National Insurance) and save more for their own future. We have had to strike a balance between what it is right and reasonable for them to provide in order to improve the situation for those retiring in the next decades, the rate at which we can afford to uprate the basic State Pension, and the expectation on today's and tomorrow's workers to save more for themselves.

Simplicity

50. The Pensions Commission observed that "the UK has the most complex pensions system in the world". The combination of our reforms to state and private pensions will dramatically simplify the system, and make the decision to save a very straightforward one for individuals.

51. Our reforms of state provision will **simplify** the system considerably. The earnings-linked foundation of the basic State Pension will ensure that the decision to save can be more straightforward. Our reforms to coverage will ensure that many more people can be confident of entitlement to the full basic State Pension.

52. **Automatic enrolment gives access to private savings vehicles** to people of working age. For eligible employees, unless they choose to opt out, joining that scheme will be automatic. Taken together, these reforms will mean that it is much simpler for individuals to save.

53. We will also **simplify the rules and structure for private provision** through:
    - changes to contracting out which will help to simplify the savings decision; and
    - a review of current legislation and the regulatory landscape.

Affordability

54. Figure 9 shows the latest cost figures based on a 2012 start-date for the earnings uprating of the basic State Pension. As paragraph 37 sets out, our objective, subject to affordability and the fiscal position, is to uprate the basic State Pension by earnings from 2012 but in any event at the latest by the end of the Parliament. We will make a statement on the precise date at the beginning of the next Parliament.

Figure 9: Projected costs of State Pension reform, UK

Cost of state reform package (£ billion, 06/07 prices)

£bn, cash	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2030	2040	2050
Reform costs:																
Pension Credit reforms	0.6	1.2	1.8	2.9	4.2	5.5	6.8	8.1	9.4	10.7	12.1	13.5	15.1	38.6	86.0	201.7
Basic State Pension reforms	0.0	0.0	0.0	0.0	0.7	1.4	2.2	3.1	3.9	4.9	5.9	6.9	8.2	34.2	84.9	157.6
State Second Pension reforms	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.3	3.5	13.2	26.9
State Pension Age change	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	–11.4	–35.2	–104.0
Total costs of State Pension reform	0.6	1.2	1.8	2.9	4.9	6.9	9.1	11.1	13.3	15.6	18.0	20.5	23.6	64.9	148.8	282.4
Total pensions expenditure with reform	74	78	82	85	90	95	100	106	111	117	123	129	136	248	434	728
£ bn, 2006/07 prices																
Reform costs:																
Pension Credit reforms	0.6	1.1	1.6	2.6	3.6	4.6	5.5	6.3	7.1	7.9	8.7	9.5	10.3	20.0	33.8	60.1
Basic State Pension reforms	0.0	0.0	0.0	0.0	0.6	1.2	1.8	2.4	3.0	3.6	4.2	4.8	5.6	17.7	33.3	47.0
State Second Pension reforms	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.2	1.8	5.2	8.0
State Pension Age change	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	–5.9	–13.8	–31.0
Total costs of State Pension reform	0.6	1.1	1.6	2.6	4.2	5.7	7.3	8.7	10.2	11.6	13.0	14.4	16.1	33.6	58.4	84.1
Total pensions expenditure with reform	70	72	73	75	77	79	81	83	85	86	88	90	93	128	170	217
per cent of GDP																
Reform costs:																
Pension Credit reforms	0.0	0.1	0.1	0.2	0.2	0.3	0.4	0.4	0.4	0.5	0.5	0.5	0.6	0.9	1.3	1.9
Basic State Pension reforms	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.2	0.2	0.2	0.2	0.3	0.3	0.8	1.3	1.5
State Second Pension reforms	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.2
State Pension Age change	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	–0.3	–0.5	–1.0
Total costs of State Pension reform	0.0	0.1	0.1	0.2	0.3	0.4	0.5	0.5	0.6	0.7	0.8	0.8	0.9	1.6	2.2	2.6
Total pensions expenditure with reform	5.2	5.2	5.2	5.1	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.9	6.5	6.7

Notes:

- Source: The figures are based on DWP long-term projections of United Kingdom benefit spend consistent with the Budget Report 2006 and DWP estimates of the costs of reform measures.
- Pension Credit reform costs include cost of earnings uprating the Guarantee Credit from 2008/09 and reforms to Savings Credit.
- Basic State Pension reform costs include net cost of earnings uprating the basic State Pension, improvements to BSP coverage, and reforms to ADIs.
- State Second Pension reform costs include net costs of changes to S2P accrual and coverage.
- State Pension age reform costs include savings on pensioner benefits and additional spending on working age benefits.
- Pensions expenditure includes Basic State Pension, State Second Pension, Pension Credit and other pensioner benefits: Winter Fuel Payments, over 75s TV licences, age-related payments and Christmas Bonus. Costs of State Pension reform also include changes in spending on Housing Benefit and Council Tax Benefit among pensioners and additional spending on working age benefits that results from increasing state pension age.
- Costs associated with Personal Accounts have not been included.
- Figures exclude administrative costs and tax revenue implications of reform.
- Abolition of Contracting Out for DC schemes from 2012 decreases Contracting Out rebate revenue foregone – by £4bn to £5bn per year in 2006/07 prices; this is not included in the figures. Abolition also increases S2P expenditure in the future – this is included in the figures.
- The savings from SPA equalisation in the period 2010 to 2020 are reflected in the expenditure totals.
- Figures refer to financial years – 2020 is 2020/1.
- Increases in GDP from higher employment as State Pension age rises after 2020 are not taken into account.

Sustainability

55. Fundamental to the problems we face with pension provision today is a lack of trust and understanding between individuals, employers and the state as to their respective roles and responsibilities in pension provision. We need to reset that balance. But we also need to reform the system so as to give trust and confidence to all parties that this is **a sustainable deal for the long term**. We need consensus that this is a sensible way to strike the balance. And we need to set up the system in such a way that it can respond flexibly to future societal changes.

56. The **National Pensions Debate** was established in February 2005, with the second phase beginning in December that year. Overall, the Government has heard the views of nearly 10,000 people in face-to-face discussions and via DWP's website.

57. This was just part of an extensive programme of Government consultation with stakeholders. We are confident that the solution we have reached strikes the right balance between the views of all those parties affected. The National Pensions Debate clearly shows that out of the four alternatives identified by the Pensions Commission, people want a solution that strikes a balance between saving more, redirecting state spending on pensioners, and a rise in the average retirement age. Our proposed reforms strike exactly that balance.

Northern Ireland

58. The provision of social security and pensions in Northern Ireland is governed by the long-established and widely accepted policy of parity with Great Britain. The Government believes that this should remain the basis of future provision in Northern Ireland and will have regard to it in implementing any proposals set out in this paper.

Conclusion

59. These reforms set the direction for the long-term future of pensions and retirement savings. They will create a system that is coherent, comprehensive and which will stand the test of time. The reforms meet our five key tests and strike the right balance between the responsibilities of the state, the individual and the employer.

60. We welcome comments on these proposals.

The National Pensions Debate

The National Pensions Debate was launched in February 2005 with the publication of *Principles for reform: The national pensions debate*. Over the course of 2005, Ministers from the Department for Work and Pensions (DWP) met with members of the public and regional stakeholders across the UK, aiming to:

- raise awareness of the tough decisions that society faces in ensuring a fair and adequate retirement income for all in the future; and
- allow the UK public to have their say on emerging options for reform of the UK pensions system.

Background
Between June and November 2005, Ministers held eight National Pensions Debates in different regions across the country, to raise awareness of the tough pensions choices we face and to allow the public to engage in the debate and share their thoughts and experiences regarding pensions. At the same time, Ministers engaged with regional stakeholders on these issues.

With the publication of the independent Pensions Commission's proposals for reform in November 2005, the focus of the National Pensions Debate switched to deliberative consultation, using the broad framework of the Pensions Commission's second report as a basis for discussion with both stakeholders and the general public.

Stakeholders
In order to build consensus for a long-term pensions settlement, on 18 January 2006 DWP Ministers held the first of two seminars with Age Concern, the Association of British Insurers, the Confederation of British Industry, Help the Aged, the Investment Management Association, the National Association of Pension Funds and the Trades Union Congress. These and other organisations were also engaged in the debate through meetings with Ministers.

At an event on 28 February 2006, representatives of the pensions industry presented for in-depth debate alternative models to the Pensions Commission's proposed National Pension Savings Scheme. The event was attended by DWP Ministers, MPs, Lords, Pensions Commissioners, Regulators and representatives of employers, consumers, the financial sector, and government departments.

National Pensions Day
As part of the ongoing National Pensions Debate, regional events were held in Southampton on 18 February 2006 and in Manchester on 25 February 2006. These events were also used to inform the development of a National Pensions Day. Materials at the events were refined following feedback from participants and observers.

A Citizens Advisory Panel was set up to consider the materials and provide a realistic viewpoint on their content. The panel was made up of members of the public and matched the demographic profile of the sample that was used for the deliberative events.

The National Pensions Day, which took place on Saturday 18 March 2006, was a deliberative consultation exercise organised by DWP in conjunction with the research-based consultants, Opinion Leader Research. Over 1,000 participants attended six events held simultaneously across the UK. These events took place in London, Birmingham, Newcastle, Glasgow, Belfast and South Wales. Those attending were asked to consider and vote on the broad framework of the Pensions Commission's proposals.

Views were also collected through an online debate and via feedback from stakeholder-run events.

Chapter 1: Encouraging and enabling private pension saving

Chapter 1: Encouraging and enabling private pension saving

Summary

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

The Government will respond to that challenge with a radical reform of private pension saving in the UK.

First and foremost, we need to tackle at source these barriers to saving, to create an environment in which individuals take personal responsibility for ensuring that their aspirations for retirement income are met.

In order to achieve this, we will:

- introduce a new pension saving scheme of **low-cost, portable personal accounts**, making private saving truly accessible for all;
- introduce **automatic enrolment** into a private pension for all employees, to maximise coverage and combat savings inertia;
- set a **national minimum employer contribution of 3 per cent**, between earnings of around £5,000 and £33,000 a year; and
- set a **minimum overall level of contribution of 8 per cent** for the personal accounts of employees and encourage additional contributions from employees.

These reforms are a key part of our strategy to meet the five tests for pension reform. In particular they will help to promote **personal responsibility**, by helping to overcome the barriers to saving; **simplify** the system for individuals, by clarifying the savings decisions they need to take; and make the system **fair**, by ensuring access to high-quality, low-cost provision for all.

The challenges facing the pensions system

Current pensioners are relatively well provided for

1.1 As the Pensions Commission made clear, private pension incomes are at an all-time high and, for the first time ever in a period of economic growth, pensioners are less likely to be at risk of poverty than younger people.[1]

1.2 A key driver of improvements in pensioners' incomes has been private pension coverage and generosity. Recent retirees have benefited from relatively generous defined benefit (DB) occupational pensions and also from historically good rates of return in defined contribution (DC) pensions.

1.3 Other factors have also boosted the income and assets of current pensioners. The State Earnings-Related Pension Scheme (SERPS) was introduced in 1978, and people retiring today are benefiting from its most generous provision. In addition, the value of housing wealth has doubled as a percentage of GDP since 1980, and home ownership among recently retired people has increased from under 50 per cent to approaching 80 per cent since 1981.[2]

Recent trends in private pension provision

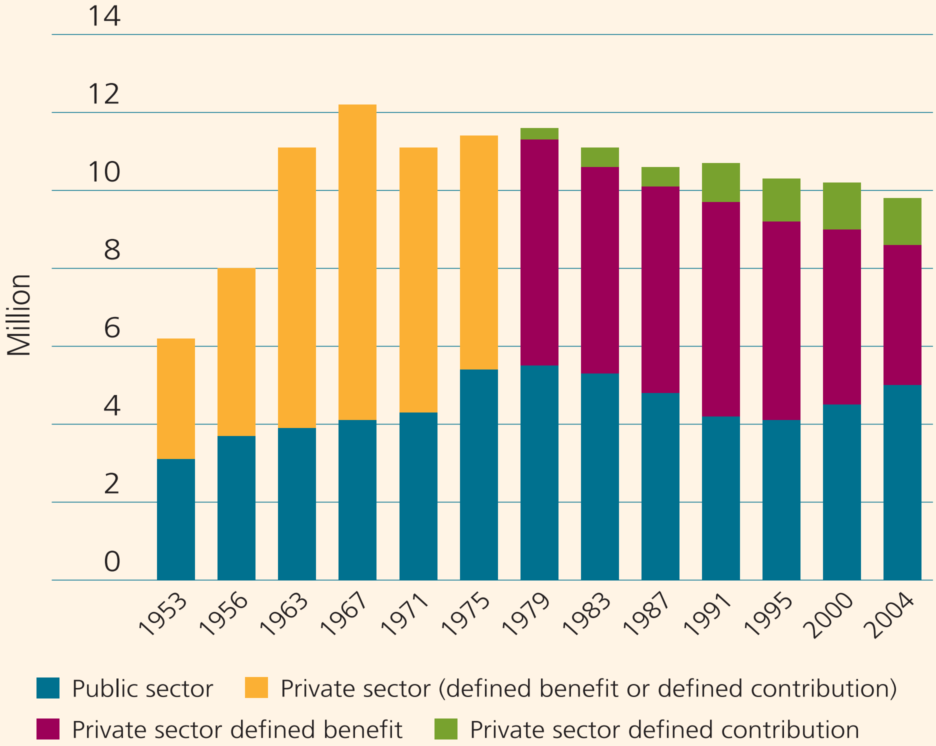
1.4 But the Pensions Commission also made clear that private pension saving is in decline, and that this decline has been an underlying trend for a number of years. This is despite household net wealth having risen by around 60 per cent in real terms since 1997. Even at the peak of private saving, many people were not making sufficient provision for their retirement. But while there were 12.2 million active members of occupational schemes in 1967, the number has been decreasing so that, in 2004, there were around 9.8 million members remaining, of which over half were in the public sector.[3]

[1] *Pensioner Income Series*, DWP.

[2] *Economic and fiscal strategy report* and *Financial statement and budget report,* March 2006.

[3] GAD, *Occupational Pension Schemes 2004*.

Figure 1.i Active members of occupational pension schemes



Source: Government Actuary's Department's Occupational pension schemes survey

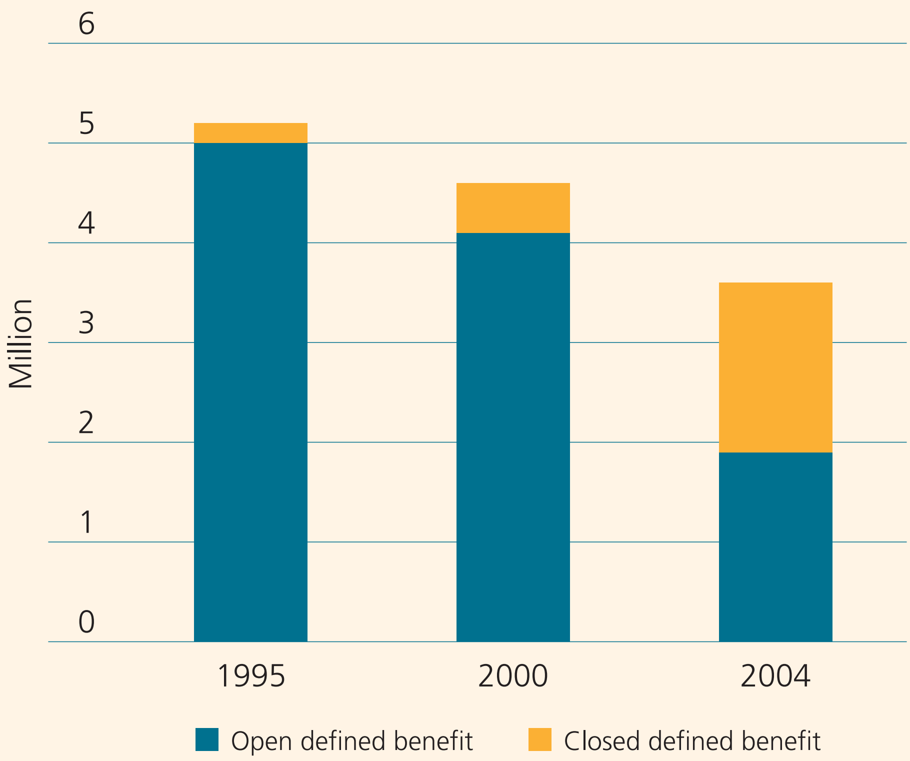
Notes: The 2004 split between private and public sectors is not perfectly comparable with splits in earlier years, since from 2000 onwards the public sector figures have included only those members who are in public service schemes. It follows that, from 2000 onwards, figures for the private sector also include members in the wider public sector (such as the Post Office and the BBC).

1.5 Contributions to occupational pensions have fallen from above 3 per cent of GDP in the early 1980s to less than 2 per cent in 2002. And the proportion of private sector employees participating in occupational schemes has fallen from around 37 per cent in 1991 to around 26 per cent in 2004.[4]

1.6 There has also been a recent acceleration of some trends. In particular, recent years have seen the closure of many DB occupational schemes, although some of these have been replaced with DC schemes. This has led to a rapid fall in the number of active members of DB schemes.

[4] Pensions Commission, 2004, *Pensions: challenges and choices: The First Report of the Pensions Commission.*

Figure 1.ii Active members of private sector defined benefit pension schemes by scheme status



Source: Government Actuary's Department's Occupational pension schemes survey

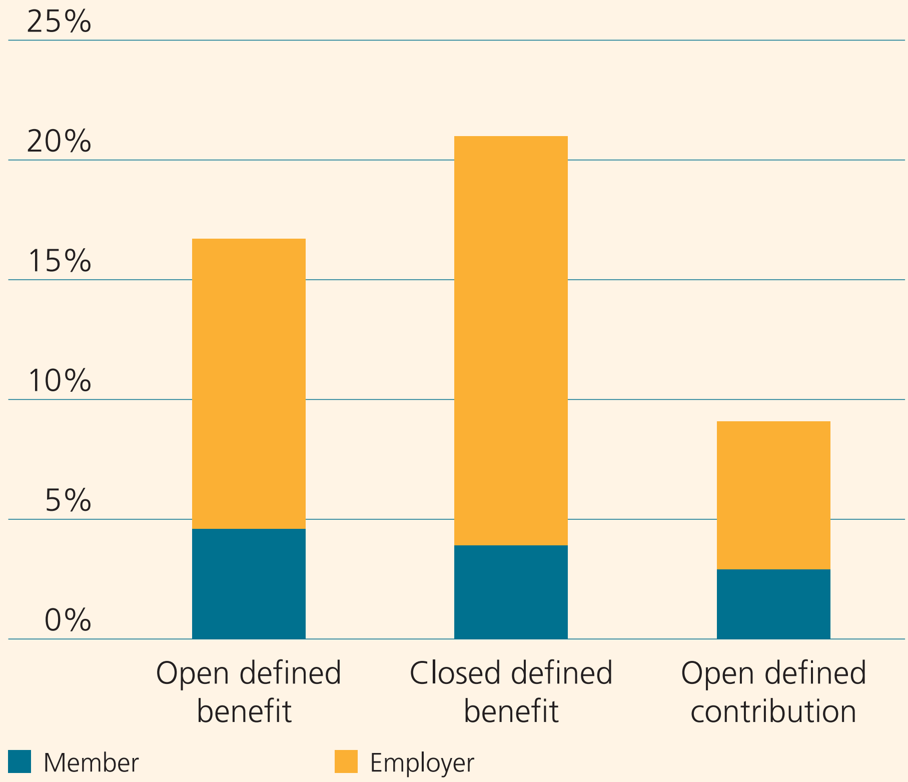
1.7 DB schemes are those that offer a pension based on a certain formula (usually years worked and final salary). They are not necessarily better than DC schemes, where the pension depends on the performance of underlying investments such as shares. For many people the greater flexibility of DC provision better matches the greater mobility in the labour market and the increase in the number of jobs people may expect to do during their lives.

1.8 However, a shift from DB to DC provision is often associated with a cut in average pension contribution rates, particularly those made by the employer. This means that people are likely to end up with significantly lower pensions when they come to retire. On average, total contributions into DB schemes are currently around 19 per cent of earnings, compared to 9 per cent for DC schemes.[5] Figure 1.iii shows average contributions into DB occupational pensions (split between open and closed schemes) and DC occupational pensions. But a simple comparison of contributions to DB and DC schemes is not appropriate, as contribution levels to DB schemes can vary over

[5] GAD, *Occupational pension schemes 2004*. The recently published *Employers' pension provision survey 2005* has similar findings for occupational schemes (with ten or more members) – in 2005, employers contributed 10 per cent to open DB schemes on average (median) and only 5 per cent to open DC schemes; employees contributed on average 6.9 per cent to open DB schemes and 5 per cent to open DC schemes.

time and DC schemes are more likely to be contracted in (so the pension is received in addition to State Second Pension rather than instead of State Second Pension).

Figure 1.iii Contribution rates for occupational pension schemes, 2004



Source: Government Actuary's Department's Occupational pension schemes survey

Notes: Data covers private sector schemes, including schemes where standard contributions were zero.

Weighted average contribution rates, across all schemes with 12 or more members, are calculated on the basis of the number of active members.

Undersaving for retirement

1.9 Many people are not saving enough to generate the level of income they will want in retirement. A number of studies have used a range of data to estimate the number of people who are not saving enough to reach a level of income they might consider adequate.

1.10 Measures of retirement income adequacy are based on replacement rates, which measure people's retirement income as a percentage of their income in work. Typically people are content with a modest fall in income at retirement because they tend to see a fall in the cost of living (for example, travel to work and housing costs). However, few people are likely to be content with a retirement income that is dramatically less than that which they had while working. While there is scope for debate around the appropriate target replacement rates, the Pensions Commission proposed a 'sliding scale' of 80 per cent for the lowest earners, to two-thirds for average earners and 50 per cent for the highest earners.[6]

Figure 1.iv Pensions Commission benchmark replacement rate range

Source: Pensions Commission First Report

1.11 Estimates of the current level of undersaving for retirement are difficult to construct because they rely on poor data and there are measurement difficulties, such as whether to measure income at a household or individual level and whether to include estimates of non-pension financial assets and inheritance. However, key recent studies find the following.

- New information has recently become available from the English Longitudinal Study of Ageing.[7] For the first time this allows us to use comprehensive data on people's accrued pension rights and non-pension financial assets (though it is available only for people aged 50 and over). Using this data, it is possible to estimate that, based on the Pensions Commission's replacement rate benchmarks, there are 7 million people undersaving for retirement. However, there are questions about whether individuals would access some of these non-pension financial assets to create a retirement income and whether the trends for older workers will persist for younger generations.

[6] These replacement rates are based on gross income. Replacement rates based on net income would be higher.

[7] IFS, 2005, *Prepared for retirement? The adequacy and distribution of retirement resources in England*, with DWP internal adjustments. More detail on the figures is provided in Annex A.

- In 2002[8] the Department for Work and Pensions (DWP) estimated that up to 3 million people were seriously undersaving for their retirement or planning to retire too soon, based on a 50 per cent desired replacement rate. DWP found that a further 5 to 10 million may want to consider saving more and/or working longer, depending on their expectations for retirement, based on a two-thirds replacement rate.
- The Pensions Commission's first report[9] argued that 9.6 to 12 million people are not saving enough for retirement. This was based on the replacement rate benchmarks discussed above.
- The Association of British Insurers (ABI)[10] has estimated that 12.1 million people are undersaving for retirement, also based on the Pensions Commission's replacement rate benchmarks.

1.12 Although estimates vary, the story is clear: many millions of people are not saving enough to provide retirement incomes they are likely to consider adequate. These people will need to save more or will approach retirement faced with the choice of an income they will consider inadequate or having to work longer than they had planned.

Reforms since 1997

1.13 A number of reforms since 1997 have sought to address the problem of undersaving for retirement.

Stakeholder pensions

1.14 In April 2001, stakeholder pensions introduced a simple, flexible and low-cost product into the personal pensions market. They have improved workplace access to pensions where an employer-based scheme is not available.

1.15 Stakeholder pensions have a limit on annual management charges and they are flexible and portable. This means that individuals can contribute intermittently if their circumstances require it, and change provider, without fear that they will have to pay penalties or see their contributions swallowed up by high charges. They are available to the self-employed and those not in paid employment (such as carers), as well as to employees.

1.16 Employers with five or more employees are required to provide their workforce with access to a stakeholder pension scheme unless they already offer an occupational pension scheme to the whole of their workforce or pay employer contributions of at least 3 per cent of basic earnings into personal pensions.

[8] DWP, 2002, *Simplicity, security and choice: Working and saving for retirement*.

[9] Pensions Commission, 2004, *Pensions: challenges and choices: The First Report of the Pensions Commission*.

[10] ABI, 2005, *The state of the nation's saving*.

1.17 Over 2.7 million stakeholder pensions have been sold since their introduction in April 2001,[11] the majority to their target group of moderate earners. Of those stakeholder pension plans that received a contribution in the 2003/04 tax year, over three-quarters were for people earning under £30,000 a year and around two-thirds were for people earning less than £20,000 a year. Total contributions to stakeholder pension schemes in the 2004/05 tax year were around £2.4 billion.

1.18 The low charges in stakeholder pensions have also helped to exert downward pressure on personal pension charges in general. The impact of this has been dramatic: charges on personal pensions fell by around a third between 1999 and 2001 to around the stakeholder pension charge cap level.[12]

Information and education

1.19 Since 2002, the Informed Choice programme has looked at ways to raise awareness and understanding of retirement provision, and to promote individual responsibility for retirement planning.

1.20 To ensure that everyone has timely information about their own circumstances, we have introduced a range of pension forecasts as part of this programme. The forecasts give individuals an understanding of the income they are likely to receive in retirement based on their National Insurance contributions or credits. They are supplemented by leaflets that set out options for improving their position – such as working longer and deferring receipt of their pensions or making additional contributions.

1.21 DWP now issues the following types of forecasts:

- Combined Pension Forecasts (CPFs): Issued in partnership with employers and pension providers, CPFs show State Pension information alongside a forecast of an individual's current private pension. By the end of March 2006, over 2,700 employers or pension providers had signed up to issue CPFs and over 6.3 million CPFs had been produced.

- Individual Pension Forecasts (IPFs): IPFs are tailored to an individual's circumstances, taking into account factors such as marital status, current employment status, or any periods spent abroad. IPFs can also address the impact of options such as working longer, going abroad or getting married or divorced. Over 7 million IPFs had been issued by the end of March 2006.

- Real-Time Pension Forecasts: In October 2004 we launched a service whereby individuals can contact DWP electronically to obtain an online IPF. DWP had received more than 107,000 requests by the end of March 2006.

[11] Source: ABI.

[12] Source: Financial Services Authority (FSA).

- Automatic State Pension Forecasts (APFs): First issued in 2003, APFs are unsolicited forecasts sent by DWP to all working-age people who have not received any other type of forecast in the previous 12 months. By the end of March 2006, over 12 million APFs had been issued.

Tax simplification and the Finance Act 2004

1.22 The Government provides generous tax relief to encourage people to save for an income in retirement. From 6 April 2006 (A-Day), the many existing sets of rules governing the taxation of pensions were replaced with a single, unified regime.

1.23 The new regime introduced simplified rules around the tax treatment of pensions, offering less complex and more flexible retirement arrangements for individuals and employers.

1.24 There is now no limit on the amount of pension saving an individual can build up in a pension scheme or the number of pension schemes they can save in – although there are limits on the amount of tax relief individuals can get.

1.25 The two key features of the new regime are a single lifetime allowance and an annual allowance for the amount of tax-privileged savings. The single lifetime allowance is currently set at £1.5 million (rising to £1.8 million by 2010/11 and to be reviewed subsequently). A tax charge is made where an individual has an excess above the £1.5 million allowance. Individuals can also get tax relief on contributions up to 100 per cent of annual earnings up to the annual allowance, currently £215,000 (rising to £255,000 by 2010/11 and to be reviewed thereafter).

1.26 Additionally, if scheme rules allow, individuals can take up to 25 per cent of their pension fund as a tax-free lump sum.

Member protection

1.27 We recognise that people will only save if they have confidence that when they have done so the pension will be there when they need it. The Government has worked to ensure that the environment is safe enough to give people the confidence they need.

The Pension Protection Fund

1.28 The Pensions Act 2004 established the Pension Protection Fund (PPF) to protect members of final salary pension schemes by paying compensation should the employer become insolvent and the pension scheme underfunded. It also pays compensation to pension schemes that are unable to meet their obligations due to fraud. The PPF went live on 6 April 2005 and is funded through compulsory levies imposed on schemes that are eligible to apply for PPF assistance.

1.29 To reduce cross-subsidy and promote fairness, the PPF charges a risk-based levy, so that schemes that pose a higher risk pay more for the PPF compensation cover, and costs are kept down for good employers with well-funded schemes. The Financial Assistance Scheme will help some of those who lost out before the PPF was established.

The Pensions Regulator

1.30 The Pensions Act 2004 also established a new regulatory body for work-based pensions, The Pensions Regulator (TPR). The new regulator has a defined set of statutory objectives:

- to protect the benefits of members of work-based pension schemes;
- to promote good administration of work-based pension schemes; and
- to reduce the risk of situations arising that may lead to claims for compensation from the PPF.

1.31 TPR was developed to take a proactive, risk-focused approach to regulation. Resources are concentrated on schemes where the greatest risk to the security of members' benefits is identified, so well-run schemes have a lighter regulatory burden than before. It also provides practical support for the pensions community.

Remaining problems

1.32 These reforms have clearly changed the pensions landscape and introduced choice and flexibility for pension schemes, but the issue of undersaving for retirement among today's workers still remains.

Unclear incentives to save

1.33 Pension Credit has successfully boosted the income of millions of pensioners and has also ensured that they are better off for having saved. In addition, it has improved incentives to save for some people. For example, research commissioned by DWP[13] estimated that the introduction of Pension Credit led those on low to middle incomes (comprising 12 per cent of the population) to have better incentives to save and to work longer.

[13] National Institute for Economic and Social Research, 2005, *The effects of means-testing pensions on savings and retirement*.

1.34 However, the way in which elements of the State Pension and Pension Credit system are uprated means that the coverage of Pension Credit is spreading. If current indexation arrangements continued, the proportion of pensioner households entitled to Pension Credit would increase from around 45 per cent today to around 70 per cent by 2050. This is discussed further in Chapter 3.

1.35 The potential future spread of Pension Credit could reduce incentives to save for some people. However, it has never been the Government's intention to move over the long term towards a system where a significant majority of pensioners are entitled to Pension Credit.

1.36 People are less likely to engage with long-term financial planning if the decisions they need to make and the system within which they make them are overly complex. The Pensions Commission concluded that the UK pension system is the most complex in the world. A recent survey found that two-thirds of people agreed – they find all pensions confusing.[14] This complexity is likely to further affect undersaving for retirement.

1.37 There is relatively low awareness of the financial incentives to save in a pension. In the same survey, only a quarter of people (26 per cent) spontaneously mentioned tax relief as an advantage of pensions, and even when prompted, only 43 per cent were aware of the tax benefits of saving in a pension.

Understanding undersaving for retirement

1.38 Behavioural economists[15] have conducted research on how people make financial decisions, including why people may not join a pension even when it is in their interests to do so. Traditional economics suggests that people make decisions based on a rational assessment of the costs and benefits to themselves. However, in reality many people find pensions difficult and complicated, and have a tendency to disengage from savings decisions. Even though most people realise they need to save for retirement, for a number of reasons many never get round to doing it. We know that the difficulty of making financial decisions often leads to individuals not acting at all. Box 1a explains some of the reasons why people may not join a pension.

[14] Marketing Sciences Ltd, *Retirement planning monitor 2005*.

[15] Notably Choi, Laibson, Madrian, Thaler and Benartzi.

Box 1a: Reasons for undersaving for retirement

Conventional economics suggests that people will try to smooth their spending over their lifetime. Thus, when people are young, they may choose to borrow money to fund their education or to buy a house, spending more than their income; as they get older and their income increases, they can pay off their debts and start to save, so spending less than they earn. However, actual spending tends to track income more closely than these theories would suggest.

Behavioural economics is the combination of psychology and economics, and helps to explain people's decision making. It has identified a number of reasons why people do not save for retirement, even when it is their interest to do so.

People may realise they should save for retirement but lack the willpower to change their behaviour appropriately. Inertia often leads people to follow the path of least resistance in decision making, making the easiest rather than necessarily the best decision, and procrastination can lead to them not making any decision at all.

In addition, people often live for today and struggle to see what their future needs might be. When presented with the option of having money now or more money in the future, people frequently choose to take the money now, even though they would be better off if they waited. This is reinforced by the fact that people often don't understand that inflation can erode the value of any money they have 'under the mattress'. This behaviour is influenced by aversion to losses, since people are often only willing to accept a loss to their income when the potential gains are very high and they feel losses more intensely than they feel gains.

1.39 The FSA's baseline survey of financial capability in the UK[16] shows that many people are failing to plan ahead adequately for their retirement or for an unexpected expense or drop in income. For example, 37 per cent of people who said the State Pension would not provide them with the standard of living they hope for in retirement had no additional pension saving. And 39 per cent of people say they tend to live for today and let tomorrow take care of itself. However, even today when pensioner incomes are historically high, 21 per cent of people who have already retired do not find their income sufficient to give them the standard of living they hoped to have.

[16] Atkinson A, McKay S, Kempson K and Collard S, 2006, *Levels of financial capability in the UK: Results of a baseline survey*, FSA Consumer Research 47.

High costs of delivering to those on low and moderate incomes

1.40 The fact that pensions need to be sold in a regulated market to protect consumers has led to a relatively expensive sales and marketing process for personal pensions.[17] The Pensions Commission's research suggests that it costs around £800 to sell a personal pension to somebody working for a medium-sized employer. In addition, consumers often do not persist in making pension contributions for long, even once they have begun making them. The Pensions Commission found that, on average, consumers persist in saving for only around five years.

1.41 This combination of high up-front costs and non-persistency means that providers have a relatively short period in which to recoup relatively large sales costs. This has two effects on consumers.

1.42 **Firstly**, it leads to relatively high charges. Although the cost of saving in a personal pension has fallen considerably with the introduction of stakeholder pensions, it remains high compared with most occupational pensions. Few personal pensions sold to individuals have charges significantly below the stakeholder charge cap (1.5 per cent per year of funds under management, falling to 1 per cent after ten years).

1.43 By contrast, many occupational pensions and some group personal pensions are able to achieve administration charges equivalent to around 0.3–0.5 per cent or less. The impact that this can have on the size of someone's pension fund is considerable. Someone saving 8 per cent of median earnings for 40 years at the higher level of charge might expect to have a pension fund on retirement worth around 20 per cent less than an equivalent person saving at the lower level.

1.44 **Secondly**, it means that it is more economic for providers to sell to some consumers than others. Higher earners, who will have more funds in the scheme generating higher revenue, or those who work for larger employers, where providers can achieve sales and marketing economies of scale, are more attractive. The financial services industry does not generally seek to sell personal pensions to low to moderate earners, particularly if they work for smaller employers, because it is not economic to do so.

1.45 Further reform is needed to tackle the problem of undersaving for retirement, reverse the decline of private pension provision and overcome these barriers.

[17] Pickering A, 2006, *A simpler way to better pensions: An independent report*.

Personal accounts: a low-cost savings scheme

1.46 To address the problem of undersaving for retirement, and in line with the Pensions Commission's recommendation, the Government proposes in 2012 to introduce a new, low-cost scheme of personal accounts for those people currently without access to adequate pension savings. Eligible employees will be automatically enrolled into the new scheme and, along with their employers and the State, will make contributions into the scheme on a DC basis. Individuals will have appropriate levels of choice over how to invest their funds. The accounts will be portable between employers and between periods of employment, self-employment and economic inactivity.

1.47 The new scheme will:

- significantly increase the number of people currently saving for retirement; and
- have low charges so that individuals keep more of their savings.

1.48 The key features of the scheme will be:

- an organisational structure that ensures **low charges** and **good-quality service** for individuals;
- **automatic enrolment** for all eligible employees but with the freedom to opt out;
- a **minimum overall level of contribution** from employers, employees and the government, to promote a minimum level of pension saving, with people encouraged to contribute more;
- a **national minimum employer contribution**, increasing incentives to save;
- **opt-in access** available to, among others, the self-employed and those not currently in paid work; and
- **portable and flexible accounts**, to fit in with modern life and the greater likelihood of people moving between jobs.

1.49 Together these measures will provide individuals with a low-cost means of building private retirement income in addition to their state pension entitlement, with a presumption to save for many. The following sections discuss the key elements of our reforms in more detail and indicate areas where we intend to consult further.

Box 1b: How many people will be in the personal accounts scheme?

Around 10 million employees will be eligible for automatic enrolment into a personal account. There are uncertainties about the number of people who might choose to opt out but we estimate that between 5 and 8 million employees will remain in personal accounts. Women, those working part-time, low and moderate earners are those less likely to have current pension provision and therefore will be well represented in our target group.

Others may choose to opt in to the scheme. The scheme will be available to both the self-employed and those not in paid work. It is difficult to estimate how many individuals in these groups will want to join the scheme but, in the long term, over 1 million of these individuals may opt in to personal accounts.

In total, we estimate that when up and running, the personal accounts scheme might have between 6 and 10 million members.

In addition, we estimate that over half a million people will be newly automatically enrolled into their employer's existing scheme.

The design of personal accounts

1.50 The key objectives in designing a system to deliver personal accounts are that:

- the administrative burden on employers should be minimised;
- accounts should be fully portable for people moving between employers, periods of employment, self-employment and economic inactivity;
- individuals should have the appropriate level of choice to take personal responsibility for saving for their retirement;
- government involvement in delivery should be minimised;
- people should receive high and consistent standards of service; and
- costs and charges should be as low as possible.

1.51 The Pensions Commission recommended the introduction of a new, high-coverage, low-cost National Pension Savings Scheme (NPSS). They suggested that the NPSS should be established as a non-departmental public body with the administration, servicing and fund management functions outsourced to private contractors.

Box 1c: The Pensions Commission's proposal

- Automatic enrolment (with the option to opt out) for all employees into either a high-quality employer scheme or into a new National Pension Savings Scheme (or personal account).
- Minimum total default contributions of 8 per cent on a band of earnings (between the Primary Threshold and the Upper Earnings Limit for National Insurance contributions), with encouragement to save more.
- A low-cost national savings scheme, with a suggested annual management charge of 0.3 per cent in the long run.
- Individuals choose how to invest their funds and a small number of bulk-bought options are available.

1.52 After the publication of the Pensions Commission's second report, the Government invited the pensions industry to consider this proposal and, if appropriate, to suggest alternative ways in which the same broad outcomes of wider coverage and low-cost pension saving could be achieved. The Government is grateful for the effort and engagement shown by the pensions industry to meet the challenges set out by the Pensions Commission.

1.53 All of the alternative proposals we received agreed with the Pensions Commission that automatic enrolment should be the key entry mechanism into the scheme and that a modest minimum employer contribution should be introduced at the levels proposed.

Box 1d: A challenge to the pensions industry

Following the publication of the Pensions Commission's report, the Government challenged the pensions industry to come up with ways to deliver personal accounts.

The **National Association of Pension Funds (NAPF)** proposed a model of Supertrusts, which built on existing multi-employer occupational schemes. There would be between 10 and 20 Supertrusts, which would each be overseen by a board of governors who would outsource operations. Under the scheme, employers would choose which Supertrust their employees joined. Employees would not be able to choose their investment strategy – the board of governors would do that for all members.

The **Association of British Insurers (ABI)** put forward Partnership Pensions as a way of delivering personal accounts. This system built on the existing stakeholder pension platform, where collections were paid directly from employers to pension providers through the BACS system of collection. In addition, they proposed a Retirement Income Commission to oversee the system and ensure that it worked for individuals. Again, they proposed that the initial choice of providers lay with employers but that individuals could make a different choice if they wished.

The **Investment Managers Association (IMA)** put forward an option based largely on the Pensions Commission's proposals, but focusing on how some of the processes, such as governance and fund management, could work in practice.

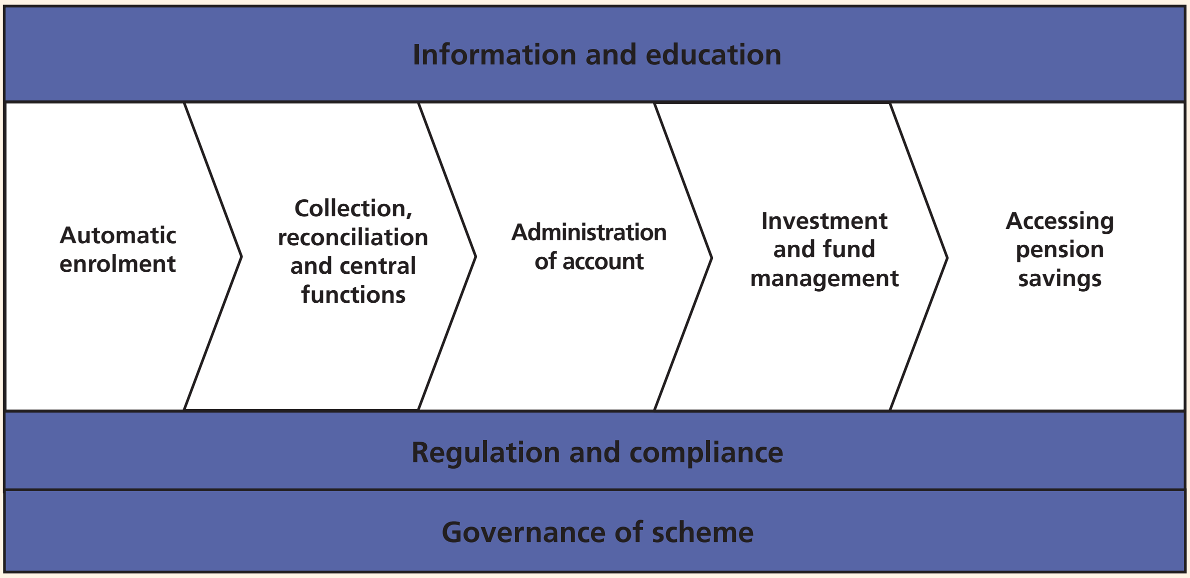
The Government has carefully considered these options and concluded that neither Supertrusts nor Partnership Pensions contain all of the features needed for personal accounts. We believe that a successful system must be designed around personal responsibility and appropriate levels of choice. In addition, the burden on employers must be minimised.

However, we have used features of all of these proposals to refine and improve the models we are outlining in this paper. Moreover, in the next phase of reform, we want to continue to work with the pensions industry to find the best solution to deliver personal accounts. We are also interested in looking at whether Supertrusts could work alongside personal accounts to offer more choice in pension provision.

Delivering personal accounts

1.54 We have analysed carefully the proposals put forward by the Pensions Commission and key stakeholders for delivering a personal accounts scheme. In the light of that analysis and the objectives set out above we have identified the features and functions that will need to exist in any new system.

Figure 1.v An overview of a personal account scheme



Collection and reconciliation

1.55 After individuals have joined the system, they will need to start contributing to their personal account. We propose that there should be a simple, low-cost payment-collection system. This will be delivered in a way that does not place an undue burden on employers. We will be working with employers to ensure that they have confidence in the collection mechanism and that the process of collection is as straightforward as possible.

1.56 In addition to central collection of contributions, we believe that further personal account scheme functions will need to be centralised in order to:

- allocate a default pension provider or pension fund for those individuals who do not make an active choice;
- ensure that individuals can continue to contribute to a single personal account as their circumstances change;

- provide information from a single point to assist the regulator as it monitors scheme compliance; and
- ensure individuals receive a consistent level of service.

Transferring between employers

1.57 One of the key functions of personal accounts is that contributions will continue when individuals move between participating employers. Research[18] suggests that the ability to move the account between employers was thought to be a particularly important feature: people felt that this would increase a sense of ownership of the pension, would encourage those people who change jobs frequently to participate and would overcome the current problem many people face of keeping track of pensions from different jobs. Research with employers similarly revealed that they view this as an important feature. They thought a pension that individuals could take with them as they moved employers would be both popular with employees and encourage them to stay opted-in to a scheme.[19]

Compliance

1.58 Employees will gain important new rights under the proposals – automatic enrolment into either a personal account or qualifying workplace scheme and access to an employer contribution. It will be important to safeguard those rights by putting in place an effective compliance regime which remains light-touch, risk-based and proportionate.

1.59 It is important that employers get the help and support they need to move to the new scheme. We would seek to make it as easy as possible for employers to comply with the new requirements. We will develop a full employer communications and education package to support the introduction and implementation of personal accounts.

1.60 However, a range of enforcement powers will also be needed to enable regulatory authorities to respond to the minority of employers who persistently fail to comply with their obligations.

1.61 We are giving careful consideration to the precise nature of the regulatory approach, the necessary enforcement powers and how they might be applied.

[18] Research by Ipsos MORI for DWP (Hall S, Pettigrew N and Harvey P, forthcoming in 2006, *Public attitudes to personal accounts: Report of a qualitative study*).

[19] Research by BMRB for DWP (Marshall H and Thomas A, forthcoming in 2006, *Employer attitudes to personal accounts: Report of a qualitative study*).

Administering personal accounts: two distinct approaches

1.62 As outlined above, the core elements of a new personal accounts system will be automatic enrolment, a simple mechanism for collecting contributions and some centralised functions. However, there is one remaining issue – the administration of the accounts, on which we would like to consult further. The decision we take on this issue will depend, among other things, on the appropriate role for consumer choice in this area of retail financial services.

1.63 Whichever delivery mechanism is favoured, individuals will have a number of choices to make in personal accounts.

- Do I opt out of the scheme?
- What sort of investments should I make?
- Should I make additional contributions?

1.64 In answering all these questions, people can adjust their decisions to save and invest to meet their own personal needs, their preferences and their aspirations for retirement.

1.65 As part of our consultation and discussions with commentators, a number of people have suggested that there is value in offering individuals a further choice:

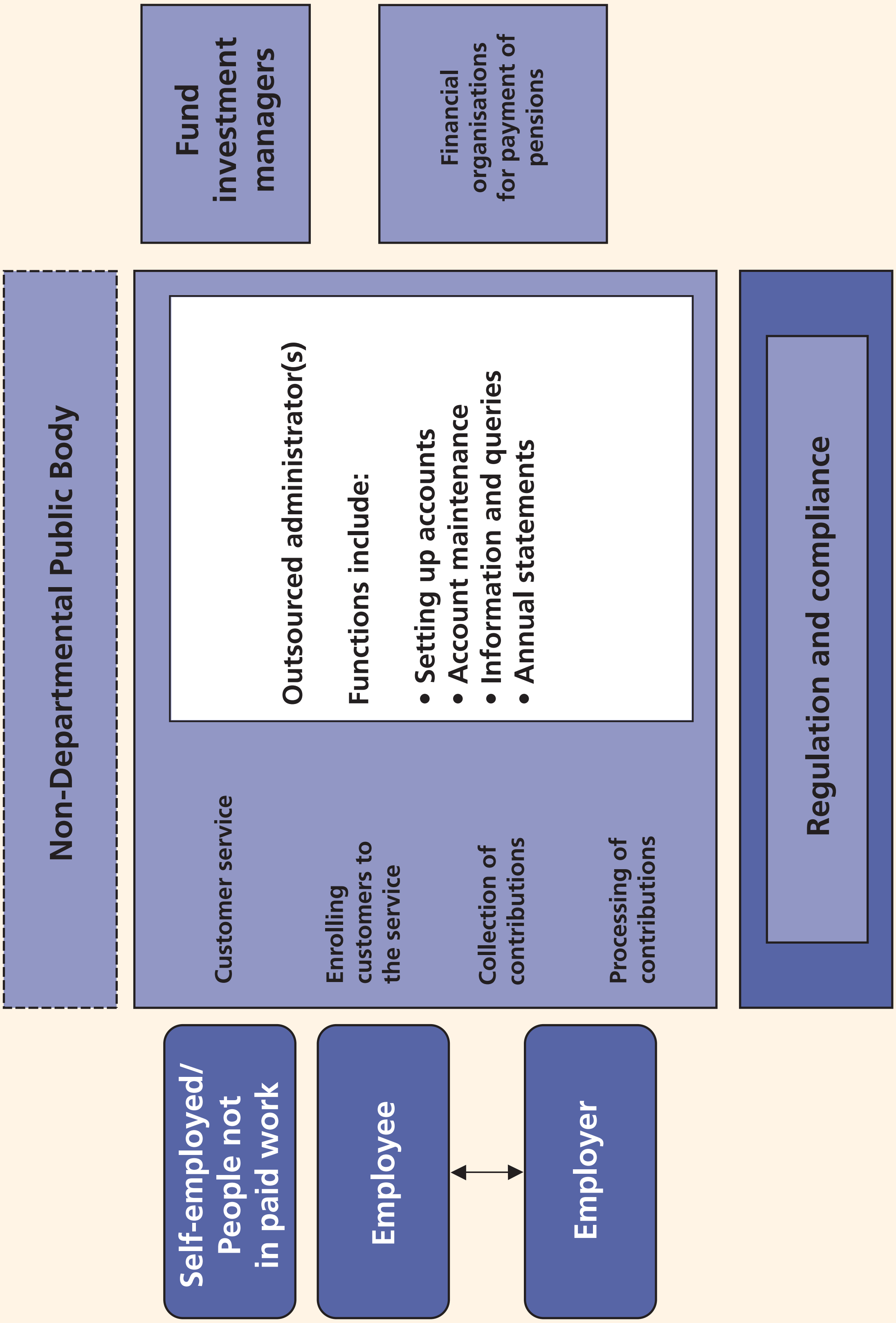
- Who do I want to **administer** my pension?

1.66 Therefore, we are outlining two possible approaches to administering personal accounts.

Option 1: The Pensions Commission's approach – competition for contracts

1.67 The Pensions Commission suggested that all personal accounts should be provided by a single organisation. The day-to-day running of the scheme would be outsourced to a number of pension administrators. Everyone would deal with the NPSS and would receive consistent service standards and outcomes. Individuals would be able to make decisions about whether to opt out of the scheme, whether to contribute above the minimum and their preferred approach to investment.

Figure 1.vi The Pensions Commission's approach: competition for contracts

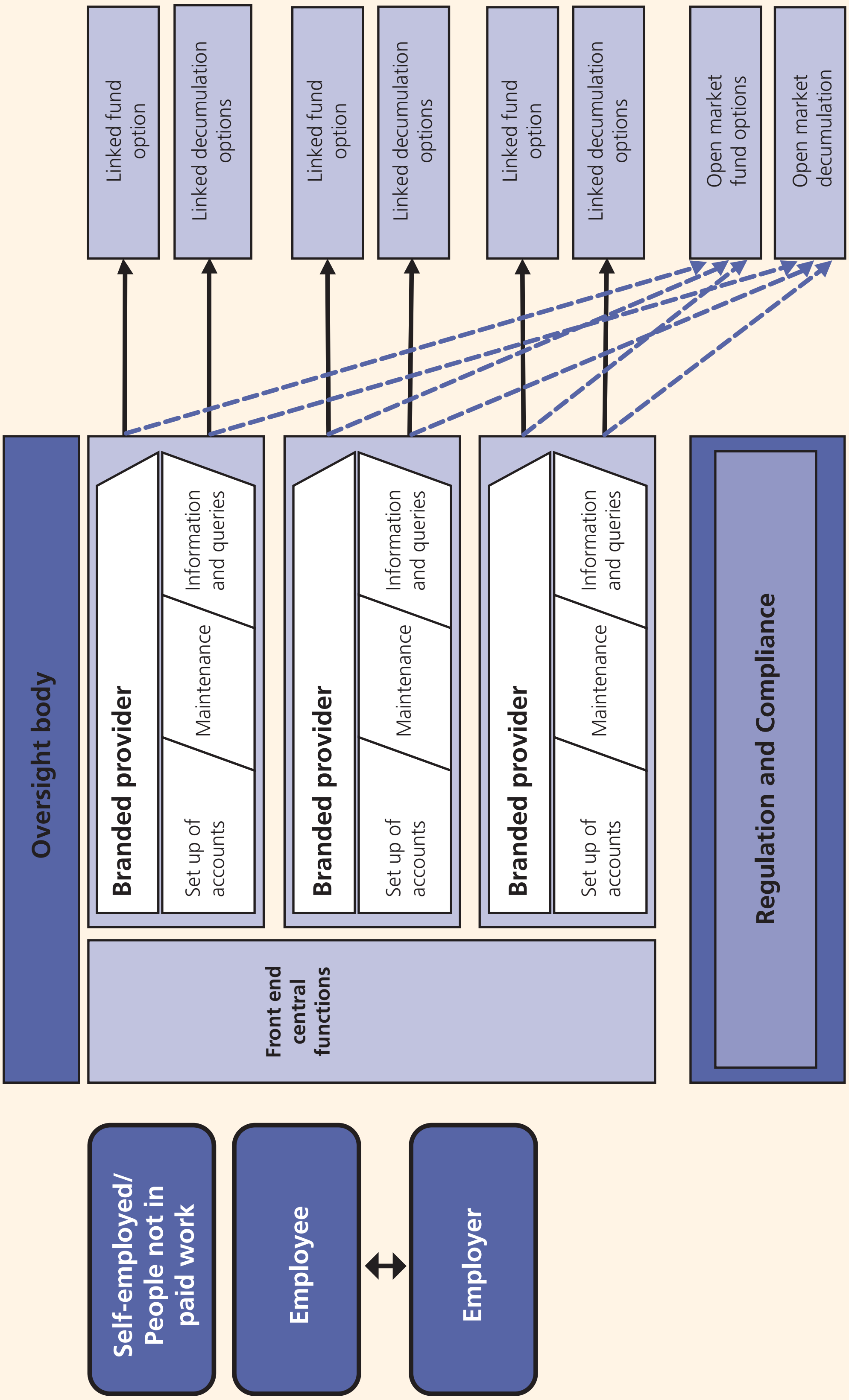


Option 2: An alternative approach – competition through branded providers

1.68 Another option to deliver personal accounts would be to build on existing pension provision. Automatic enrolment, collection and compliance would be as outlined in this paper. However, rather than using a single organisation, a number of pension providers would offer personal accounts. This option has a number of differences to the one proposed by the Association of British Insurers (outlined in Box 1d). For example, it would have a centralised function to collect and reconcile contributions, allocate default providers and collate information. People would be able to choose the provider that was right for them (or they would be allocated one).

1.69 A model in which individuals have a choice of provider is likely to be more expensive to administer. We would also need to consider whether introducing additional choice for the consumer would add risks that may require regulatory intervention with consequent costs. This could have an impact on the final individual fund size. However, the advantage of this approach is that it would rely to a greater extent on the existing infrastructure and could therefore have advantages when coming to implementation.

Figure 1.vii An alternative approach: competition through branded providers



1.70 We are interested in views on whether this is a choice that people would benefit from making.

- Would offering a choice of branded provider add value for the consumer?
- Would a choice of branded provider give individuals greater confidence in the system and greater ownership of their accounts?
- What is the connection between type of choice and cost?
- On what basis would individuals make a choice of pension provider?
- What are the pros and cons of vertically integrated providers, offering both administation and fund management?
- With multiple providers how could charges be set in a way that encourages competition to thrive?
- Would it be possible to restrict the number of providers in the scheme to provide scale economies and drive down costs?
- In each approach what information would individuals need?

Box 1e: The importance of individual choice in personal accounts

In the Pension Commission's approach, the NPSS would be responsible for day-to-day administration of all accounts, though consumers would still be able to make a choice between investments. In the alternative approach consumers would face two choices. The first would be between branded pension providers to administer their personal accounts, and the second would be a choice between investments offered by that provider. (In both approaches, in the absence of a consumer choice the individual would be allocated into the default option(s).)

These differences are set out in the figures below. Figure 1.viii shows the choices confronting the consumer in the Pensions Commission's approach, Figure 1.ix the choices confronting the consumer in the alternative approach.

Figure 1.viii Facing fund choice

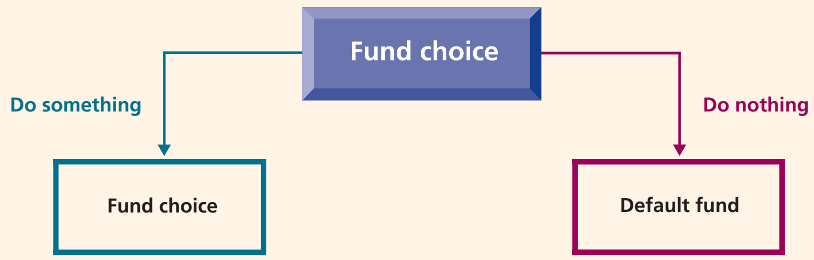
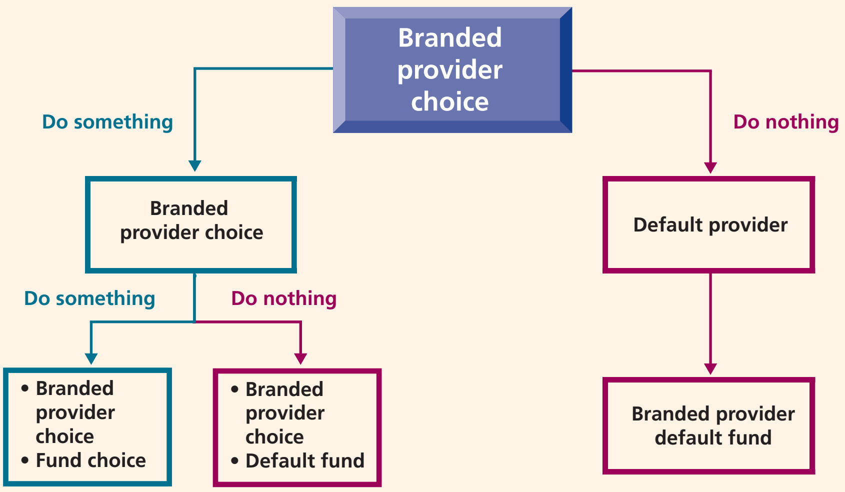


Figure 1.ix Facing brand choice



Box 1e: The importance of individual choice in personal accounts *(continued)*

If consumers are well informed, choice can help drive competition, innovation and quality. However, evidence indicates that many people do not make well-informed choices or shop around when purchasing financial products. Survey evidence[20] indicates that people feel overwhelmed and confused by the amount of information available and the complexity of the choices they face; 20 per cent of people reported that they had made a decision without seeking any advice or information to help them make their decision.

People tend to choose financial products on the basis of familiarity: for example BMRB[21] found that 58 per cent of products were bought from a company where the respondent was already a customer.

Consumers tend to prefer less choice when purchasing pension products; too much choice leads to inaction and confusion. For example, recent focus groups on personal accounts suggested that having a choice of providers would add a layer of complexity and would not generally be welcomed by people.[22] UK qualitative research[23] also suggests that less financially informed respondents wanted a simplified product.

1.71 Initial analysis suggests that the best delivery model is that proposed by the Pensions Commission. However, the Government will conduct further analysis of this and the alternatives in order to strike the best balance between value for money for the taxpayer and value for money for the saver. We wish to consult further on the administration of personal accounts. In assessing approaches, our key objectives will be minimising the cost to members of the scheme and maximising effective competition between firms involved in the provision of the scheme. In conducting this consultation, we will analyse options against the following criteria:

- the level of charges, both in the short and long term;
- value for money for the taxpayer;
- the appropriate type of consumer choice;
- simplicity for employers and individuals;
- the promotion of personal responsibility;

[20] Atkinson A, McKay S, Kempson E and Collard S, 2006, *Levels of financial capability in the UK: Results of a baseline survey*, FSA Consumer Research 47, Financial Services Authority (FSA); www.fsa.gov.uk/pubs/consumer-research/crpr47.pdf

[21] FSA, 2000, *Better informed consumers: Assessing the implications for consumer education of research by BMRB.*

[22] Research by Ipsos MORI for DWP (Hall S, Pettigrew N and Harvey P, forthcoming in 2006, *Public attitudes to personal accounts: Report of a qualitative study*).

[23] For example ABI, *The pensions annuity market: Consumer perceptions*.

- the administrative burden on employers;
- implementation timetable;
- the level of overall risk;
- the governance of the scheme;
- consumer protection; and
- maximising effective competition between firms.

1.72 We will bring forward proposals on the approach to administration in personal accounts later this year.

Governance of the scheme

1.73 Regardless of which approach to delivery is taken forward, a personal accounts scheme requires a robust governance and regulatory regime. Such a regime will need to be transparent, sustainable and create consumer confidence. Personal accounts would be managed independently from government, including decisions on the range of fund choices and the structure of the default fund.

1.74 In seeking the right structure to achieve these goals, we will be drawing on expertise from the financial sector, existing regulatory organisations and international experience. Irrespective of who administers personal accounts, our focus will be on ensuring that the governance body will provide an overriding duty of care to scheme members. It will provide them with assurances that their accounts are being administered efficiently and will inform individuals about their investment choices.

Investment and fund management

1.75 Personal accounts will build funds on a defined contribution basis. As with all defined contribution products, the value of the individual's fund can fluctuate over time due to changing investment performance. For example, the value of stocks and shares can decrease as well as increase. The risk that investments do not do as well as expected lies with the saver, though this risk can be mitigated by an investment strategy that progressively moves funds into less volatile investments as the individual nears retirement (often referred to as 'lifestyling'). There is no absolute guarantee that the value of the fund would be more than the value of the contributions invested, and that there would be investment growth. The value of these investments therefore cannot be underwritten by government.

1.76 Funds will be passed on to professional and independent fund managers for investment, as in current industry practice. We will ensure that a range of investment options, including socially responsible investment, will be provided under personal accounts.

Accessing pension savings

1.77 Personal accounts will be subject to the same annuitisation rules as other pension schemes. We expect that most individuals will buy an annuity when they come to take their pension. This reflects the current system, which enables individuals to decide when to annuitise and to shop around for the best product and a price to suit their personal circumstances.

Box 1f: Annuities

The Government considers that annuities are the most appropriate way to secure an income in retirement and this applies equally to personal accounts.

The Government provides tax incentives to encourage people to save for retirement. A 25 per cent tax-free lump sum can be taken from the pension pot but the rest must be converted into a secure retirement income for life by age 75, usually by buying an annuity. This protects people from the risk of running out of money in retirement as people tend to underestimate how long they will live.[24] Research shows that pensioners want 'security', 'a guaranteed income level' and 'little or no risk'[25], and so it is not surprising that studies show annuities offer good value for money, since this is what they provide.[26]

The Pensions Commission endorsed the fundamental principle of an income in retirement being secured by an annuity. It suggested consideration of changes to encourage a market for draw-down products,[27] compulsory annuitisation being limited in amount and ages of first and last possible annuitisation rising in line with life expectancy.

The Government discussed the economics of mass market draw down with stakeholders and found it was likely to remain viable only for those with large pension pots or sufficient other assets to bear investment risk. However, other new products might be suitable for the mid market and the Government has provided the framework under the current tax and regulatory regime for the market to develop these. The Government is encouraged by the emergence of such 'mid-market' products.

The Government has ruled out allowing an upper limit on the amount individuals have to annuitise. Such a change would only affect a small number of better-off individuals and would add considerable complexity.

[24] Women aged 60–69 underestimate their life expectancy by more than four years, and men by more than two years. Source: O'Brien, Fenn and Diacon, 2005.

[25] ABI, 2004, *The pensions annuity market: Consumer perceptions*.

[26] Discussed in Cannon and Tonks, *Annuities pricing survey*, DWP Research Paper.

[27] Draw down exists as an alternative to annuitisation until 75, whereby people can leave their pension fund invested and draw an income by cashing in portions of their fund. Draw down is currently only economic for larger funds.

Box 1f: Annuities *(continued)*

The age of first annuitisation is already increasing from 50 to 55 from 2010. Latest available evidence suggests that 75 is the appropriate upper age limit. The Government is prepared to monitor and review any new evidence as to whether the first and last age limits should be changed in the future.

The Pensions Commission said that the focus of policy should be to encourage later annuitisation. While the age of annuitisation is a decision for individuals, the Government agrees that delaying annuitisation may be beneficial for some, particularly as the current flexibility is only used by a minority[28] and evidence suggests the benefits of later annuitisation are poorly understood.[29] The Government will work with stakeholders to improve information and will be setting out more technical details on annuities and the underlying evidence base later in the year.

Low charges

1.78 The Pensions Commission suggested that there could be an annual management charge of 0.3 per cent in the long run. The Government believes that it is critical that charges for personal accounts are maintained at as low a level as possible. Under a 1.5 per cent management charge, an individual saving for 40 years will lose around 20 per cent of their pension compared with a charge of 0.5 per cent.

1.79 In the long term, we are confident that we can deliver a system that radically reduces charges, and which will be self-financing. In the short term, charges will need to reflect the choice of delivery mechanism, funds under management, contract specification and financing arrangements. We will also consider other funding structures for personal accounts.

[28] Only 5 per cent choose to annuitise between ages 70 and 74. Source: *The future of the pension annuity market*, 2003.

[29] ABI sources already cited.

Box 1g: Why are low charges important?

A higher annual management charge (AMC)[30] means that, for a given rate of pension contribution and fund growth, less money is accumulated in an individual's pension fund each year. Consequently, less growth is accrued and compounded each year, ultimately resulting in a smaller pension fund and, all else being equal, a smaller pension income upon retirement. Furthermore, this effect is more significant the longer the duration of saving. This is because deductions are made from a pension fund that is accumulated over the years, which affects the return earned from fund growth each year, thereby affecting the size of the final fund.

Figure 1.x illustrates this for a median earner (£23,000) who saves in a pension for 40 years.[31] Under a 0.5 per cent charge, their pension fund at retirement is worth £73,000, meaning that £8,000 of their fund has been lost in charges; whereas under a 1.5 per cent charge, their pension fund is worth £59,000 and £22,000 is lost in charges.[32] This individual's pension fund is therefore approximately 20 per cent smaller purely as a result of the difference in charges. This pattern of variation across charges is similar for all earnings levels, although the absolute size of pension funds varies proportionately according to different income levels.

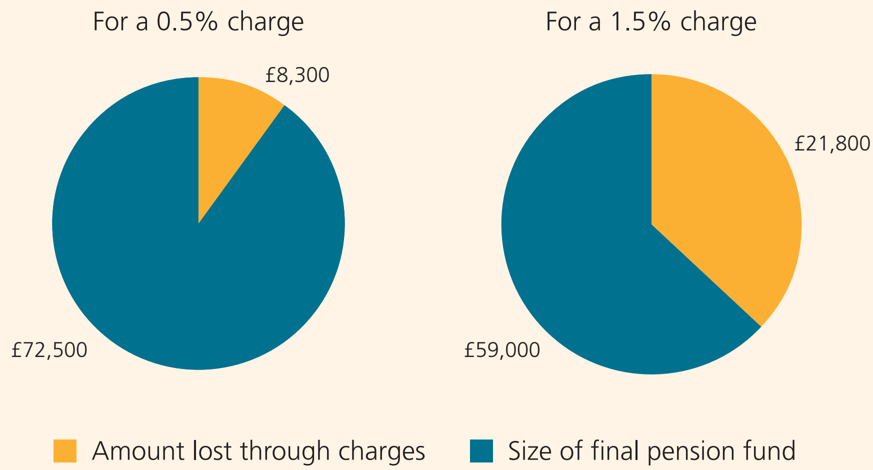
[30] An annual management charge is a charge made each year by managers of a pension fund to each pension account holder, to cover the expenses associated with running the individual's fund. Although it is conventionally expressed as a percentage of funds under management, it is usually deducted from individual accounts monthly. Other charging structures can be used, for example charges on contributions or on early termination of contracts. Not all of these structures are permissible on all products, for example stakeholder pensions cannot impose an exit charge.

[31] In this analysis we assume that there is no relationship between annual management charges and the returns achieved by managers for investors. 'Active' fund managers usually charge much higher fees compared with 'passive' fund managers, but evidence to date suggests that both types of fund managers achieve a similar rate of return. Research on this area is ongoing.

[32] The amount lost in charges was calculated as the difference between the fund size under the relevant charge compared to what the size of the fund would be under a zero charge.

Box 1g: Why are low charges important? *(continued)*

Figure 1.x How higher charges reduce the pension fund size of a median earner (£23,000) who saves for 40 years



Source: DWP modelling

Notes: The amount lost through charges was calculated as the difference between the pension fund size under the relevant charge compared with what the fund size would be under a zero charge.
Assumes total contribution rate of 8%, and pension fund growth of 6.5% per year.
Figures have been rounded to the nearest £100.

Is 0.3 per cent achievable?

1.80 Much of the debate since the publication of the Pensions Commission report has focused on whether a system of personal accounts could be delivered at such low costs.

1.81 The current system of private saving has a number of costs that can be reduced or eradicated in the system we are proposing. The use of automatic enrolment should drive down the costs of marketing and acquisition. The establishment of a central body would increase portability, reducing the number of times high start-up costs for accounts would be incurred. And the establishment of a central body would ensure that persistency of saving is increased, further reducing the costs of saving through fewer, but larger, pension funds.

1.82 The exact cost of the scheme will be dependent on the final design, the financing of the scheme and the service it offers to consumers. We believe that 0.3 per cent may be achievable in the long term, depending on decisions we take on scheme design. We invite views on this and will put forward proposals later this year.

Automatic enrolment for employees

The case for automatic enrolment

1.83 Automatic enrolment introduces a presumption to save but does not mean that employees will be compelled to save – they will be able to opt out of the scheme if they wish. But unlike the present situation in most pension schemes, where an active decision must be taken to join, with automatic enrolment people need to take an active decision to opt out. People who want to save but do not get around to making the decision to start will no longer lose out.

1.84 The principle that automatic enrolment should form a key part of the new national pensions saving scheme has generated widespread support and consensus from stakeholders and interest groups.[33] Since the publication of the Pensions Commission's second report, there have been expressions of support for the proposal from representatives of employees, consumers and employers. Preliminary findings from our survey of employers[34] indicate that the majority of employers agree that automatically enrolling employees into a pension scheme is a good idea.

[33] Research by Ipsos MORI for DWP (Hall S, Pettigrew N and Harvey P, forthcoming in 2006, *Public attitudes to personal accounts: Report of a qualitative study*).

[34] Research by BMRB for DWP (Bolling K, Grant C and Fitzpatrick A, forthcoming in 2006, *Employer attitudes to personal accounts: Report of a quantitative survey*).

Box 1h: Automatic enrolment: the evidence

Evidence suggests that automatic enrolment is one of the most effective ways of combating people's tendency not to act when faced with difficult financial decisions. It will play a key role in achieving high participation rates for personal accounts.

The *Employers' Pension Provision Survey 2005* findings show a link between automatic enrolment and increased levels of pension scheme membership. Within private firms with 20 or more employees, the proportion of employees that were in a pension averaged 60 per cent (median 77 per cent) where the firm used **automatic enrolment**. This compared with 41 per cent for **traditional opt-in**.

In case studies of four private sector schemes, automatic enrolment was associated with increased participation rates.[35] For example, in one firm the participation rate went from 25 per cent for existing employees, to 80 per cent for new joiners who were automatically enrolled.

Automatic enrolment has the greatest impact among groups where participation rates are low. American research into 401(k) schemes showed that automatic enrolment had the largest effect among people with low incomes, minority ethnic groups and women.[36] Given the low pension provision among these groups, we would expect their participation rates to increase most from the introduction of automatic enrolment.

Research with employers showed that a majority of them (60 per cent) were in favour of automatic enrolment. This support was across firms of all sizes. Among those with less than five employees, 60 per cent of employers were in favour, and 72 per cent of employers with more than 50 employees were in favour.[37]

There is equally strong support among individuals. At the National Pensions Day, 92 per cent of people were in favour of automatic enrolment.[38]

"It saves you the hassle of trying to sort out pensions really."

"People who are out there thinking, 'Oh, I'll get round to it' – it's there, it's done for them."

Participants in research for DWP on attitudes to personal accounts.[39]

[35] Horack and Wood, 2005, *An evaluation of scheme joining techniques in workplace pension schemes with an employer contribution*, DWP Research Report 292. Note: other factors including a required employee contribution, supporting communications and employer commitment may have influenced the outcomes achieved.

[36] Madrian and Shea, 2002, in Munnell and Sunden, 2004, *Coming up short: The challenge of 401(k) plans*, The Brookings Institute.

[37] Bolling K, Grant C and Fitzpatrick A, forthcoming in 2006, research by BMRB for DWP, *Employer attitudes to personal accounts: Report of a quantitative survey.*

[38] Opinion Leader Research, 2006, *National Pensions Debate Final Report* prepared for DWP.

[39] Hall S, Pettigrew N and Harvey P, forthcoming in 2006, research by Ipsos MORI for DWP, *Public attitudes to personal accounts: Report of a qualitative study.*

Who should be automatically enrolled?

1.85 All eligible employees will be automatically enrolled into a pension scheme, either the new national scheme of personal accounts or an employer scheme offering equivalent or greater benefits.

1.86 We have looked closely at the age and income level at which automatic enrolment should begin, from the point of view of both employees and employers. We have concluded that employees should be automatically enrolled when their earnings are above a lower threshold of around £5,000 a year. This is also when contributions would begin to be paid (contribution band levels are explained in paragraph 1.103).

1.87 This is a suitable point to automatically enrol employees because we want to bring as many employees into the scheme as possible, at a level of contributions they are likely to be able to afford. Because contributions will be calculated on a band of earnings starting at around £5,000 a year, costs will be low for people earning just above this level. Low earners will be brought into pension saving, will get into the savings habit, will see their savings increase as their earnings grow and, of course, they will have the right to opt out.

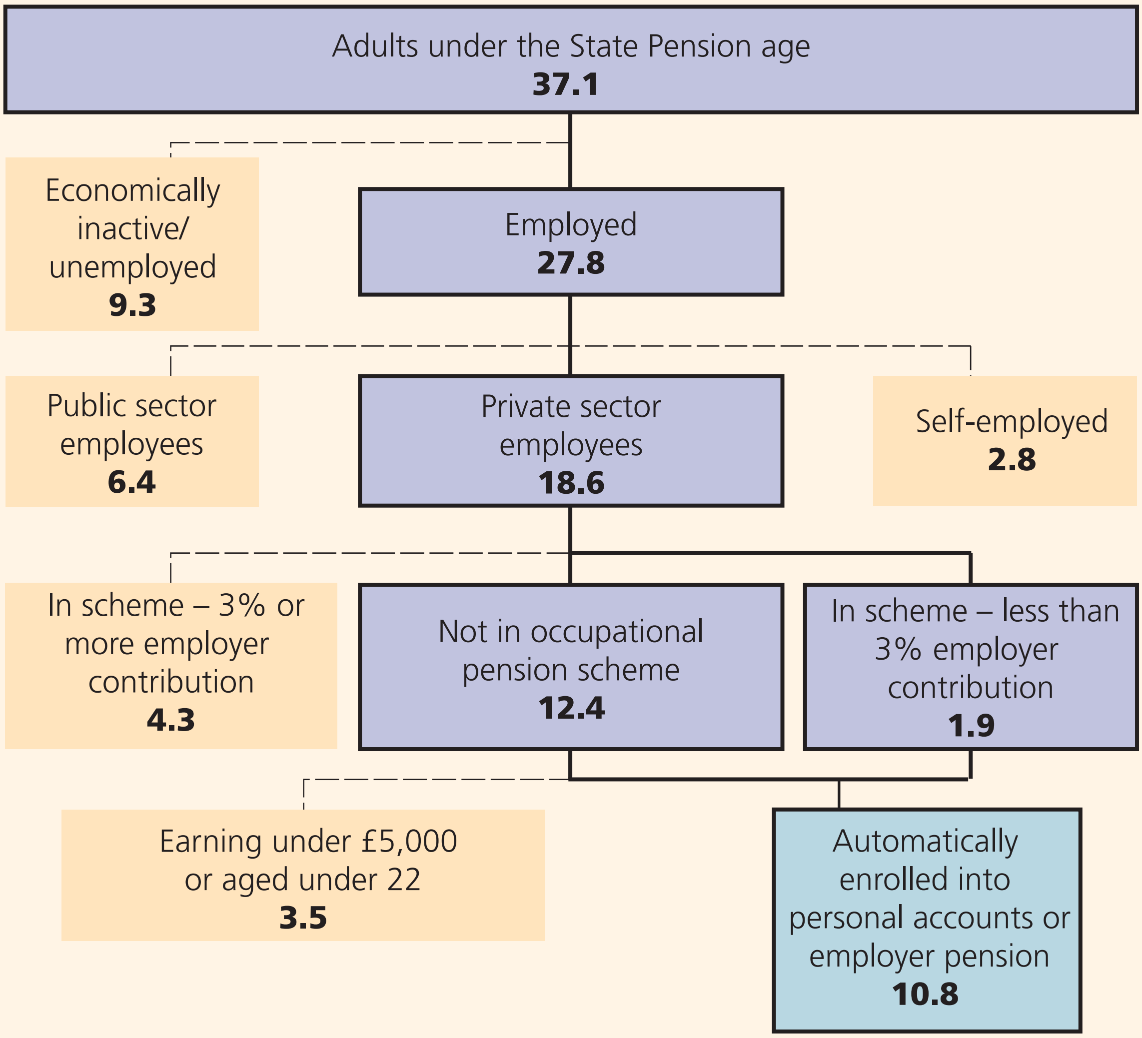
1.88 The Pensions Commission recommended that employees should be automatically enrolled from the age of 21. We have looked closely at this issue. Our judgement is that, to maximise the simplicity of the scheme and minimise administrative burdens on employers, there is a case for aligning the age at which people are automatically enrolled at 22 – the age at which the adult rate for the National Minimum Wage is payable.

1.89 We intend that:

- employees aged 22 or over will be automatically enrolled into a personal account when commencing employment, or into alternative workplace provision, if it is available to them;
- employees will be automatically enrolled on changing employer, and then every three years, should they initially choose to opt out and continue to work for the same employer; and
- employees will be automatically enrolled when their earnings reach the lower threshold.

1.90 We estimate that starting automatic enrolment at this age and level of earnings will mean that around 10 million employees will be eligible for enrolment into the scheme, including many part-time workers (as shown in Figure 1.xi).

Figure 1.xi Eligibility for automatic enrolment, millions



Source: DWP modelling based on Family Resources Survey 2004/05, Employers' Pension Provision Survey 2005, and Annual Survey of Hours and Earnings 2004 and Small and Medium-sized Enterprise Statistics 2004

Note: Figures may not sum due to rounding.

Opt-in access to personal accounts

1.91 Automatic enrolment will not apply to people who are:

- self-employed;
- not in paid work;
- over State Pension age; or
- under 22 years of age.

1.92 As we want to encourage all individuals to save for their retirement, these groups will be able to join personal accounts on an opt-in basis, with individuals taking an active decision to participate.

1.93 The self-employed and those not in paid work, by definition, have no access to an employer contribution and so may need to think carefully about pension saving decisions. We think it is important that they should have access to low-cost personal accounts if they wish to save.

People who are self-employed

1.94 The self-employed make up a key segment of our target group. Box 1i looks in more detail at the self-employed and pension-saving behaviour.

Box 1i: Pension saving and the self-employed

There are currently approximately 3 million working-age self-employed people in the UK.[40] There has been a steady long-term decline in the proportion of self-employed people who are contributing to private pensions. This is illustrated in the *General Household Survey*, which shows that 66 per cent of full-time self-employed males belonged to a personal pension in 1991/92 but this had declined to 49 per cent by 2003/04.

As a group and across the income distribution, self-employed people aged 50 to State Pension age have, on average, lower state and private pension wealth but higher non-pension wealth than the employed.[41] In terms of total wealth (given by the sum of State Pension, private pension and non-pension wealth), the self-employed as a group have much higher total wealth than the employed.

1.95 We recognise that participation rates for personal accounts could be affected if the self-employed are not able to join the scheme easily. After detailed consideration, we have concluded that there is no practical way of providing an automatic enrolment process for this group. This is because it would not be possible to deduct personal account contributions from income, or to presume a minimum contribution rate. Therefore, we propose to offer membership on an opt-in basis. To encourage participation levels, access to the scheme will be straightforward and simple, helping to minimise the effort required to join and contribute. And the tax benefits of pension savings will be clearly signalled.

[40] All figures are derived from the *Family Resources Survey* (FRS) 2005 unless otherwise stated.

[41] Non-pension wealth, broadly speaking, consists of owner-occupied housing and non-housing wealth. Non-housing wealth consists of financial wealth (like savings and shares) and physical wealth like a business or investment property.

People who are not in paid work

1.96 Those people who are not active in the labour market, including those with caring responsibilities, may want to start or continue to save in personal accounts during these breaks from the labour market. We propose that people who are not in paid work should be able to contribute to personal accounts.

1.97 Tax relief on pensions is payable to people outside of the labour market. Receiving £28 from the Government for every £100 they contribute, up to a maximum of £3,600 of total contributions a year, could provide an incentive for the individuals in this group to join the personal accounts scheme.

People over State Pension age and young employees

1.98 It is appropriate that those who want to continue to work and save after State Pension age can make a conscious decision to do so. People over State Pension age who are in employment will not be automatically enrolled but will be entitled to opt in to personal accounts and receive an employer contribution. People still in employment with a personal account when they reach State Pension age will remain within it unless they choose to opt out. People over 74 will not be able to remain in the scheme, since in line with other defined contribution schemes, funds held in the scheme must secure an income by the age of 75. Young people aged between 16 and 21 will be able to save in a personal account on an opt-in basis and have access to an employer contribution.

Contribution levels

1.99 Everyone will have their own view of the level of income they want to have in retirement. Therefore personal accounts need to be as flexible as possible. The Pensions Commission suggested a minimum total contribution of 8 per cent on a band of earnings. Our analysis and research suggests that this is the right level.

1.100 The Pensions Commission research[42] suggested that most median earners expect replacement rates in the range 45–67 per cent and, crucially, very few want less than 45 per cent. Contributions of 8 per cent, combined with a State Pension as outlined in Chapter 3, should be enough on average to deliver replacement rates of around 45 per cent for lifetime median earners who start saving at around age 30, and more for those starting to save at a younger age.

[42] Pensions Commission, 2005, *A new pension settlement for the twenty-first century: The second report of the Pensions Commission,* Appendix D.

1.101 We propose to set minimum contribution levels at 8 per cent to help individuals align with the lower end of the replacement rate range identified in the research. We recognise that people have different expectations of retirement income, and may have other savings and assets that can add to their retirement income. The aim of our policy is to provide people with a simple, low-cost way of pension saving which results in a reasonable level of retirement income and provides the flexibility for additional savings.

1.102 We have set the rate of contributions for the new scheme of personal accounts in such a way that it could achieve a replacement rate of around 45 per cent of earnings for a median earner with a reasonably full working life. Actual replacement rates can vary substantially depending on earnings, employment status, the age at which saving starts, National Insurance record, investment choices and returns, and annuity choices. These replacement rates should therefore be seen as a guide for setting contribution rates rather than implying certainty about replacement rate outcomes.

The band of earnings on which contributions are paid

1.103 The Pensions Commission proposed that the earnings band should start at the Primary Threshold for National Insurance purposes (currently £5,035) and finish at the Upper Earnings Limit (currently £33,540).

1.104 By calculating contributions on a band of earnings from around £5,000 to around £33,000 rather than all earnings:

- the cost of contributions will be lower for the lowest earners and their employers, and costs will be limited for those employing higher earners;
- it will avoid the 'cliff edge' that would arise at the point of automatic enrolment if contributions were based on all earnings; and
- contributions will begin at around the same point as tax and National Insurance contributions, the earnings level at which individuals begin to take responsibility for retirement saving by contributing to their State Pension.

1.105 We have looked at this issue carefully and agree with the Pensions Commission that the minimum contribution levels proposed are the right ones and that the band proposed is broadly right. In research, the majority of employers thought that the proposed levels of employer and employee contributions were about right and there was support for the idea that these should be based on banded earnings.[43]

[43] Bolling K, Grant C and Fitzpatrick A, forthcoming in 2006, research by BMRB for DWP, *Employer attitudes to personal accounts: Report of a quantitative survey*. And Marshal H and Thomas A, forthcoming in 2006, research by BMRB for DWP, *Employer attitudes to personal accounts: Report of a qualitative study.*

In other research individuals agreed that the contribution levels were about right.[44] The Commission recommended that the value of contributions in relation to earnings over time should be maintained, and we are exploring ways to achieve this.

The balance of responsibilities between individuals, employers and the State

1.106 The Pensions Commission suggested that the 8 per cent contribution should comprise:

- employers contributing 3 per cent;
- employees contributing 4 per cent; and
- the State contributing 1 per cent as normal tax relief, as under the current rules.[45]

1.107 Our research showed that people think the recommendations set out by the Pensions Commission offer a fair balance of responsibilities between individuals, their employers and the State.[46]

The case for a national minimum employer contribution

1.108 The Pensions Commission made a strong case for the need for an employer contribution to pensions. We propose that employees will have access to contributions from their employer on a band of earnings if they are saving in a qualifying workplace scheme or a personal account. This will give a new group of employees a real incentive to save and will mean that millions of people, for the first time, will have access to a minimum employer contribution to supplement their own savings.

1.109 This is not a decision that has been taken lightly but we have been convinced that an employer contribution has two main advantages:

- It increases participation rates – driving down costs and helping more individuals to build up pension savings.
- It makes savings more attractive – increasing the incentives to save and making saving decisions more straightforward.

[44] Hall S, Pettigrew N and Harvey P, forthcoming in 2006, research by Ipsos MORI for DWP, *Public attitudes to personal accounts: Report of a qualitative study.*

[45] 1 per cent represents basic rate tax relief on individuals' contributions – in addition, individuals may be entitled to higher-rate tax relief and neither employers nor employees pay tax or National Insurance contributions on employer contributions.

[46] Hall S, Pettigrew N and Harvey P, forthcoming in 2006, research by Ipsos MORI for DWP, *Public attitudes to personal accounts: Report of a qualitative study.*

Increasing participation rates

1.110 The Pensions Commission noted in its final report that the employer contribution is an essential element of the personal accounts package, and that without it, participation rates would be significantly lower.

1.111 There is a growing body of evidence which clearly demonstrates that there is an association between an employer contribution and increased participation rates, and that an employer contribution helps people to save. The key to a successful personal accounts system will be high levels of participation. It is only by making it an attractive system to a large part of our target group that we can drive down costs significantly.

Box 1j: Evidence for a minimum employer contribution: increase in scheme membership

- The *Employers' Pension Provision Survey 2005* suggests a positive relationship between an employer's pension contributions and levels of scheme membership. In firms with at least one scheme member, where there was no employer contribution, 28 per cent of employees were members; with a contribution of less than 3 per cent, 47 per cent of employees were members; with a contribution of more than 3 per cent but less than 6 per cent, 53 per cent of employees joined; and with an employer contribution of 6 per cent or more, membership levels rose to 60 per cent.[47]

- The Employer Task Force reported that 72 per cent of employees with access to an employer's pension scheme with an employer contribution are saving in a pension. Only 21 per cent of those who do not have access to an employer contribution are saving privately.[48]

- Preliminary findings from our research with employers indicate that the majority of employers were in favour of a minimum level of employer contribution. Larger employers tend to be more likely to be in favour than smaller ones (just over seven in ten of those with 250 or more employees are in favour compared with just over half of those with less than 50 employees).[49]

Making saving more attractive

1.112 Employer contributions offer a simple and transparent incentive to start saving in a pension. Employees only receive the contribution if they are in the scheme, providing a clear benefit from pension saving. Evidence clearly shows that the idea of an employer contribution is attractive to employees.

[47] This finding was supported by regression analysis which controls for the effects of other factors. These findings are indicative only, because of missing data on contribution and membership levels and because comparisons were based on very few employers in the survey (12) who made zero contributions.

[48] Employer Task Force on Pensions, 2004, *Report to SoS for DWP*.

[49] Bolling K, Grant C and Fitzpatrick A, forthcoming in 2006, research by BMRB for DWP, *Employer attitudes to personal accounts: Report of a quantitative survey.*

Box 1k: Evidence for a minimum employer contribution: employee and employer views

- At National Pensions Day, 85 per cent of people thought that employers should make a contribution.

- Quantitative research to gauge people's first reactions to the Pensions Commission report found a majority (70 per cent) of those surveyed believed that all employers should be made to contribute to a pension for their employees. Among employees in the survey who were not members of an employer's pension scheme, 62 per cent said they would begin to contribute to a company pension if their employer did.[50]

- DWP focus group research in November 2005 explored public reactions to pension reform options. In line with other research, the main reason given for joining an employer's scheme was an employer contribution.[51]

- Qualitative research exploring initial reactions to personal accounts found that the concept of additional contributions (from employers and the Government) was seen by most as a strong incentive to participate.[52]

- Research with employers found that a majority of employers were in support of a minimum employer contribution. The reasons given for this support included that they felt they had a share of the responsibility for the issue and that they wanted to help their employees. Furthermore, 66 per cent of micro employers (those with fewer than five employees) felt that a level of 3 per cent was about right or too little. This support rose to 74 per cent among employers with 50 or more employees.[53]

Impact on other schemes

1.113 Personal accounts are intended to complement, and not replace, existing pension provision from employers. If an employer already offers a suitable alternative scheme, they will be able to seek exemption from the personal accounts scheme and automatically enrol their employees into their existing scheme instead.

[50] Marketing Sciences Ltd internet and telephone research with over 1,000 people, *Views on the Turner Report*, 2005. The sample for this survey was not nationally representative as it included disproportionate numbers of people whose employers contribute to their pension.

[51] IFF research, forthcoming, *Pensions and savings:* 12 focus groups with people aged 18–65.

[52] Research by Ipsos MORI for DWP (Hall S, Pettigrew N and Harvey P, forthcoming in 2006, *Public attitudes to personal accounts: Report of a qualitative study*).

[53] Research by BMRB for DWP (Bolling K, Grant C and Fitzpatrick A, forthcoming in 2006, *Employer attitudes to personal accounts: Report of a quantitative survey*).

1.114 We will consult with employers and the pensions industry to develop detailed proposals on the scheme features that would enable an employer to seek exemption. It is important to ensure that such schemes are at least as favourable to employees as personal accounts. For example, we would want to ensure that:

- for defined contribution schemes, the contribution levels into the scheme are at least equal to the minimum contribution levels for personal accounts;
- for defined benefit schemes, the total benefits accrued by members are at least equal to those that are estimated to accrue from minimum contributions into personal accounts; and
- automatic enrolment procedures are in place to allow employees in employer schemes the same opportunity to overcome inertia and save that personal accounts will offer.

1.115 We will also need to take account of other factors such as the level of charges and waiting periods. We are planning to consult on detailed proposals for how this would work later in the year.

1.116 Personal accounts will provide a foundation for private pension saving which will complement existing occupational and private schemes. Some stakeholders have expressed the concern that firms may 'level down' their existing provision to the minimum requirements of the personal account scheme – in particular by reducing their employer contribution level to 3 per cent.

1.117 Employers offering pensions with contributions above 3 per cent already have a high proportion of their employees in these schemes. The average contribution for firms contributing above 3 per cent is currently 8.8 per cent. If employers were to level down to cover the cost of paying a 3 per cent contribution for those employees newly enrolled into a pension, average contributions to existing scheme members would have to fall from 8.8 per cent to 8.2 per cent.

1.118 Evidence indicates that the extent of levelling down is likely to be limited. Our research indicates that employers who contribute more than 3 per cent view their pension scheme as an important recruitment and retention tool which they want to keep.[54] Preliminary findings from a quantitative survey indicate that, of those employers contributing 3 per cent or more and who report that the introduction of personal accounts would mean an increase in total pension contributions, only just over 1 per cent said they would level down, and the vast majority of these reported they would level down to a level above 3 per cent. Only 2 per cent of all employers, where the introdution of personal accounts would mean an increase in total pension contributions, reported that they might close their scheme.[55]

[54] Research by BMRB for DWP (Marshal H and Thomas A, forthcoming in 2006, *Employer attitudes to personal accounts: Report of a qualitative study*).

[55] Research by BMRB for DWP (Bolling K, Grant C and Fitzpatrick A, forthcoming in 2006, *Employer attitudes to personal accounts: Report of a quantitative survey*).

The impact of a national minimum contribution on employers

1.119 In 2004, £36 billion was contributed to funded pension schemes[56] by employers. Based on a rate of participation of around two-thirds in personal accounts, we estimate that additional employer contributions would be worth around £2.6 billion. The exact amount will depend on factors such as employee opt-out rates and earnings levels.

1.120 Firms will face an average increase in their labour costs of 0.6 per cent. This increase is lower than the 3 per cent minimum employer contribution because:

- the 3 per cent contribution is on a band of earnings only and an employee will never get more than 2.5 per cent of their full earnings;
- many employees are already receiving 3 per cent or more, so there is no additional cost for this group;
- not all employees newly eligible for the contribution will take it up; and
- neither employers nor employees pay tax or National Insurance contributions on the employer contribution.

1.121 Figure 1.xii shows the likely amount that an employer will have to pay for a full-time employee. For example, for an employee earning around £23,000 a year, the effect of the requirement to contribute would be equivalent to adding 26p to the hourly wage.[57]

Figure 1.xii Likely employer contributions

Annual earnings (£)	Employer contribution in a year (£)	As a percentage of all earnings (%)	Increase in hourly wage (£)
10,504	164	1.6	0.08
23,000	539	2.3	0.26
30,000	749	2.5	0.36
35,000	855	2.4	0.41

Source: DWP

Notes: Annual earnings of £10,504 is equivalent to being paid at the National Minimum Wage of £5.05 per hour for 40 hours per week, 52 weeks a year including paid holidays.
Annual earnings of £23,000 is the median annual earnings of all people in full-time employment (ASHE 2004).
Results for the increase in the hourly wage are based on someone working 40 hours per week, 52 weeks a year including paid holidays.
Contributions are estimated using the 2006/07 Primary Threshold of £5,035 and the 2006/07 Upper Earnings Limit of £33,540.

[56] ONS, *Pension trends 2005*.

[57] If the employee worked 40 hours 52 weeks a year, including paid holidays.

1.122 There are around 1.2 million employers in the private sector.[58] A minimum employer contribution of 3 per cent on a band of earnings coupled with automatic enrolment of employees would affect three types of employers – those that currently:

- offer no provision or who provide access to a pension but do not contribute (around 980,000 employers);
- offer some pension contributions but less than 3 per cent (around 8,000 employers); and
- offer a contribution of 3 per cent or more (around 170,000 employers), who would face higher participation rates due to automatic enrolment.

1.123 Figure 1.xiii illustrates different types of employer provision broken down by firm size (number of employees). It shows that the majority of firms have fewer than 50 employees, and that these firms are less likely to offer any pension provision.

Figure 1.xiii Employers currently offering a contribution to a pension scheme by firm size

	Number of employers currently offering . . .			
Number of employees in the firm	No provision and/or no contributions	Some contributions but less than 3%	Contributions of 3% or more	Total
1–4	650,000	7,000	110,000	770,000
5–49	310,000	0	53,000	370,000
50–249	19,000	870	5,500	26,000
250+	4,100	34	1,800	6,000
Total	980,000	7,900	170,000	1,200,000

Source: Employers Pension Provision Survey 2005 and Small and Medium-sized Enterprise Statistics 2004

Notes: Figures may not add to total due to rounding.
Figures rounded to 2 significant figures.

[58] Source: Small Business Service.

1.124 Figure 1.xiv illustrates the effects of personal accounts by firm size. It shows that proportionately more employees will be eligible for automatic enrolment in firms with fewer than 50 employees. The minimum contribution as a percentage of labour costs is also higher for these firms.

Figure 1.xiv The effects of personal accounts by firm size

Firm size (number of employees)	1–4	5–49	50–249	250+
Number of private sector employees (million)	2.2	4.6	2.6	9.1
Number of employees eligible for automatic enrolment (million)	1.4	3.3	1.7	4.4
Personal account participation rates (%)	70	70	65	60
Number of personal account members (million)	0.9	2.2	1.0	2.6
Capped average earnings per participant (£)	15,500	18,300	19,300	18,300
Average cost per employee (£)	140	190	170	110
Costs of minimum employer contribution (£ million)	300	900	400	1,000
Minimum employer contribution as percentage of labour costs (%)	0.9	0.9	0.7	0.5

Sources: DWP modelling using Employers' Pension Provision Survey 2005, Family Resources Survey 2004/05, Annual Survey of Hours and Earnings 2004 and Small- and Medium-sized Enterprise Statistics 2004
Notes: Figures may not sum due to rounding.
Participation rates and costs are based on our central estimate of opt-out at around one third. We estimate that the range of opt-out rates will be between 20% and 50%.
Number of employees who are eligible includes some who we expect may be automatically enrolled into their employer's scheme rather than a personal account. We estimate that around 10 million employees will be automatically enrolled into a personal account. The costs of the minimum employer contribution include the cost of those newly participating in their employers' schemes.
Employers are only mandated to make contributions on earnings between the Primary Threshold and Upper Earnings Limit, and therefore earnings have been capped at £33,540 and actual contributions will be made on earnings above £5,035.

1.125 We will design personal accounts to minimise the burden on employers. Employers will need to undertake a range of tasks which will vary depending on existing payroll systems and the type, and level, of pension provision already offered. There will be some set-up costs and some ongoing tasks. Precise costs will be subject to further detailed design work. At this stage early estimates suggest total set-up costs to all employers could be around £230 million, and total ongoing annual costs around £90 million – about £10 per new scheme member.

Long-term impact

1.126 Employers may manage this additional cost in a number of ways. They can adjust prices, offer lower wage increases or absorb the cost through lower profits.[59] Our research with employers suggests that the majority will use these mechanisms.[60]

1.127 Economic theory suggests that the main mechanism for employers will be to pass on the costs through lower wage increases. In the case of personal accounts, a flexible wage response will be facilitated by the fact that participation is voluntary and that individuals will have full ownership over their pension fund.

Employees on the National Minimum Wage

1.128 For employers with staff on the National Minimum Wage, the scope for adjustment through lower wage rises will be limited. However, of those who would be automatically enrolled, we estimate only 2 per cent are on the National Minimum Wage. The Low Pay Commission takes into account relevant costs faced by employers when making recommendations about the appropriate level of the National Minimum Wage. Therefore, in the future, they will consider any impact of a national minimum employer contribution.

Support for employers

1.129 We have developed a package of measures to help employers manage the transitional impacts of minimum contributions. The key elements of our proposals are that:

- the level of the national minimum employer contribution will be set out in primary legislation, so that employers can have confidence in the stability of this level over time;
- the minimum employer contribution will be phased in over three years (as will the employee contribution); and
- employers will be given due notice of the rate and timing of the introduction of the scheme.

1.130 The priority is to design the scheme and the transition phase so that burdens on employers are minimised. We will consult on transitional support for the smallest businesses, and on whether a longer phasing period is needed.

59 Research by BMRB for DWP (Marshal H and Thomas A, forthcoming in 2006, *Employer attitudes to personal accounts: Report of a qualitative study*).

60 Research by BMRB for DWP (Bolling K, Grant C and Fitzpatrick A, forthcoming in 2006, *Employer attitudes to personal accounts: Report of a quantitative survey*).

Choosing to contribute more into a personal account

1.131 The minimum levels of contribution set out above are intended to promote a minimum level of saving. Some employers and employees will wish to supplement this by making additional contributions, and we see this as a key component of personal accounts. By supplying scheme members with information and education as their savings grow, the scheme will enable people to take a view on whether they should be saving more.

1.132 However, we know that, even with good-quality information, all too often member contributions tend to remain at the minimum contribution level. People have good intentions to increase their pension contributions but never get round to it. One possible way to encourage people to consider increasing the amounts they are contributing to their pension is set out in Box 1l.

Box 1l: Encouraging people to contribute more to their pension

The Save More Tomorrow (SMarT™) scheme, pioneered in the US using behavioural economics concepts, has successfully increased savings rates in US employer-based retirement programmes. US research studies encouraged employees who were already saving for their pension through the workplace to save more by pre-committing to increase their contributions with each pay rise. Employees were given the choice to leave the plan at any time, but the majority of people who joined stayed in. Findings included:

- 78 per cent of employees who were offered SMarT™ in the first case study joined.
- Of these, approximately 80 per cent remained in the scheme for four saving increments.
- Savings contributions increased until employees reached the maximum allowed contribution (typically within four years).

By giving employees the choice to automatically increase their saving rate by 3 per cent at each future pay rise, the average savings rates, in one US research study, increased from 3.5 per cent to 13.6 per cent in just over three years.[61]

[61] Benatzi S and Thaler R, 2003, 'Save more tomorrow: Using behavioural economics to increase employee saving'. *Journal of Political Economy*.

Box 1l: Encouraging people to contribute more to their pension *(continued)*

The encouraging results in the US have prompted the Department for Work and Pensions to work with pension providers to facilitate two case studies with employers who contribute to pensions in their workplace to evaluate the effectiveness of this technique in the UK. PIP (Pension Increase Pledge) is the working title of this initiative. The study will examine if employees who are already enrolled in a workplace pension can be encouraged to save more by agreeing to have their contributions automatically increased annually.

The results of this research[62] will provide us with an insight into ways in which we can increase pension savings in the workplace. This technique may be one way of encouraging people to contribute more and, if effective, we will consider how it can be promoted more widely.

Information and choice

1.133 We endorse the Pensions Commission's view that it is vital that communication with members of the new scheme is designed to enable them, as best as possible, to make informed decisions about their saving.[63]

1.134 In the period before implementation, we will be pursuing three distinct strands of work to meet this objective: developing the information and communications strategy to support the introduction of personal accounts; continuing our work on improving public understanding of pensions; and working with the FSA and others on the broader financial capability strategy.

1.135 While the exact nature of the communications and information package to support personal accounts will depend on the final model for delivery, the introduction of a new national personal accounts scheme will require both a high-level awareness-raising campaign and the provision of specific information and support to employers, individuals and the voluntary sector.

[62] Independent researchers have been commissioned to undertake the evaluation and it is hoped to publish initial findings towards the end of 2006.

[63] Pensions Commission, 2005, *New pension settlement for the twenty-first century*: *The second report of the Pensions Commission*.

1.136 Individual members are likely to need more specific information to help them make decisions at key trigger points, including:

- joining – whether this scheme is right for their current circumstances, and the impact of opting out;
- choice of investment – the balance of risk and return and the possible impact of choosing a particular method of funding or a particular investment portfolio;
- continuing membership – assessing the growth of the pension fund and whether to increase the contribution;
- retirement – the impact of different decisions regarding annuitisation before drawing a pension; and
- choice of branded provider – which provider to choose to administer their pension (dependent on scheme design).

1.137 In developing the information and communications strategy for personal accounts, and our work to improve general public understanding of pensions, we will look for lessons we can learn from other countries. In Sweden, for instance, annual state pension forecasts are issued in a clearly branded, coloured envelope since introducing pension reforms. Research conducted in 2005 showed very encouraging results for this with recall levels of 90 per cent, 52 per cent reading the forecast, 18 per cent comparing it with the previous year's statement and 68 per cent describing it as trustworthy.[64]

1.138 New Zealand provides another example. The Retirement Commission is an independent agency whose mission is to assist current and future generations to have an adequate amount of income in retirement through education, information and promotion. Since 1996, they have been running a programme designed to ensure that people in New Zealand understand retirement income policies and, in particular, are aware of the benefits of supplementing their superannuation (the state pension) with private savings.

[64] Presentation by Arne Paulsson, Informed Choice UK EU Presidency Event 9/11/05.

1.139 We have been working to improve public understanding of pensions through the Informed Choice programme since 2002. We will build on the achievements of this programme alongside our work on personal accounts. We will:

- continue to issue pension forecasts while exploring ways to improve their impact and effect on savings behaviour;
- look at the best way to provide people on low to medium incomes with web-based retirement planning services to give them the information, education and support they need in the context of today's pension system and during the transition to any changes; and
- consider how to increase public awareness of the pension tracing service, the free service we offer to help people trace unclaimed or 'lost' occupational and personal pensions.

Next steps

1.140 This chapter has set out our proposals to ensure that low-cost, good-value, private saving is accessible for all. Putting the detail of these proposals together will inevitably take time – in particular, setting up the necessary legal and administrative framework. We intend that people will be able to start contributing to the personal accounts scheme in 2012.

1.141 We will publish a document later this year setting out the approach we intend to take on the operation of personal accounts. This will include:

- the administration of personal accounts;
- the structure and type of investments;
- the process of taking a pension;
- the exemption process for qualifying workplace schemes;
- linking the contributions band to earnings growth;
- transitional issues on implementing the new scheme; and
- further detail on the information supporting personal accounts, with a detailed update on progress achieved in the Informed Choice programme and timing of future activity.

Chapter 2: Strengthening existing provision

Chapter 2: Strengthening existing provision

Summary

People are not saving enough for their retirement. The introduction of a new scheme of personal accounts, automatic enrolment and minimum employer contributions will tackle at source some of the key barriers to saving, overcoming inertia, reducing costs and simplifying the savings decision.

But our response must also recognise the important role already played by many employers in providing high-quality pension schemes with valuable employer contributions and high-quality support and advice for their staff. We must continue to support this existing provision.

We will:

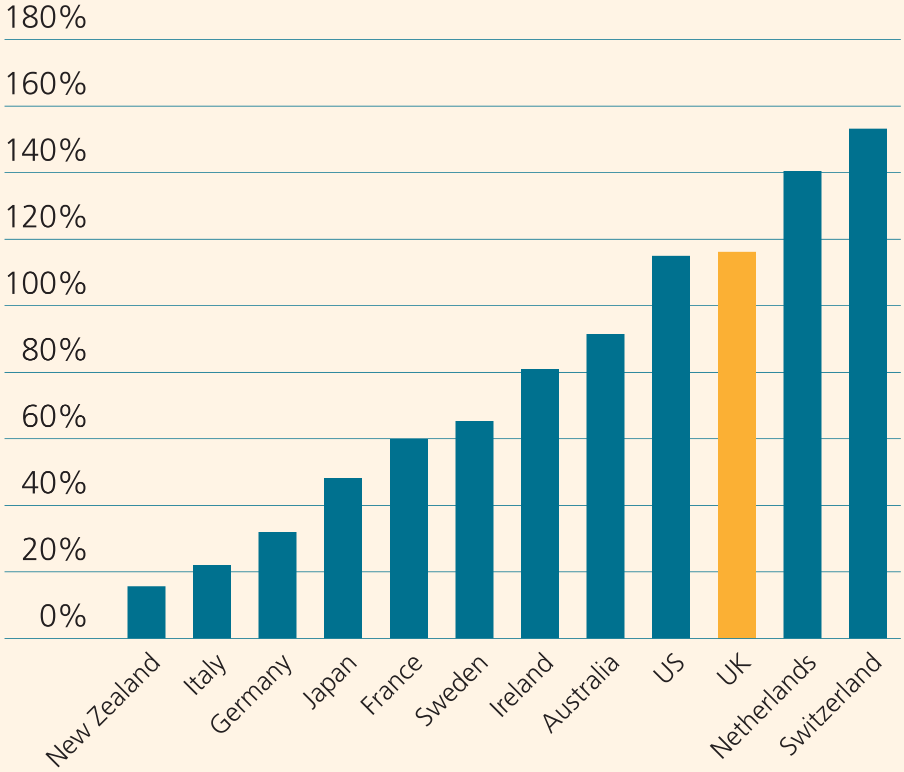
- reduce administrative complexity by **abolishing contracting out for defined contribution pension schemes**. This will also remove a key source of confusion for individuals;
- set in place a **rolling deregulatory review** of pension regulations;
- allow occupational schemes to **convert Guaranteed Minimum Pension rights into scheme benefits**, offering the actuarial equivalent in exchange;
- pilot a **Pensions Law Rewrite Project**, to establish whether there would be value for business in a substantive rewrite of pensions law; and
- bring forward proposals in the autumn for a review of those organisations established through the Pensions Act 2004 to ensure they are configured in the most effective way to achieve our long-term objectives.
- extend the Financial Assistance Scheme to ensure people within 15 years of their scheme's normal pension age in May 2004 may qualify for help.

These measures will help meet the five tests for pension reform. They will make the system **simpler** for employers and providers by reducing regulatory burdens, and for individuals through clarifying the choices they face. They will make the system more affordable and sustainable.

Context for reform

2.1 The introduction of a new pension saving scheme of personal accounts will provide access to a high-quality savings vehicle for those without good existing workplace provision. Many people already have access to such provision through existing occupational arrangements. The UK has a very successful history in occupational pension provision – employers have traditionally treated the provision of good-quality pension schemes as a serious priority in remuneration packages for their employees. Figure 2.i shows, as a percentage of GDP, the total pension assets under management in the UK compared with other countries.

Figure 2.i Total assets for pension funds and life insurance investments as a percentage of GDP, 2004



Source: OECD, Global Pension and Insurance Statistics (2005)

Note: This includes assets in pension funds, life insurance companies and social security reserve funds.

2.2 Personal accounts are intended to provide a new architecture for private pension saving for those not currently covered by alternatives provided through the workplace. Chapter 1 describes how employers already offering schemes of a certain standard will be able to opt out of the requirement to provide access to personal accounts.

2.3 Against this background, it is therefore crucial that we continue to support the existing occupational pensions framework. Employees saving in workplace schemes can benefit not only from contributions from their employer but frequently from low charges and good supporting information. It is an effective environment for saving. We will continue to support work-based pension provision and protect scheme members with a regulatory regime that encourages employers to continue to play a prominent role in pension provision.

2.4 We must also ensure that individuals are well placed to be able to take the decisions that are right for them about pension saving. This will in part be delivered through the measures described in Chapter 1, such as the introduction of automatic enrolment and the ongoing provision of financial and pension-related information. But it must also involve ensuring that there is no unnecessary legal or regulatory complexity for individuals surrounding private pension provision.

Summary of proposals

2.5 To strengthen the system further, we now propose:

- to revise the arrangements for contracting out of the State Second Pension into an occupational or personal pension scheme by abolishing contracting out into defined contribution (DC) pension schemes;
- to investigate further ways to lighten the regulatory burden on business through a rolling deregulatory review of the rules governing pensions, which will feed into the Department for Work and Pension's (DWP's) simplification plan, to be published later this year;
- to allow schemes to convert Guaranteed Minimum Pension rights into scheme benefits, offering the actuarial equivalent value in exchange;
- to pilot a Pensions Law Rewrite Project, to establish whether deregulatory gains could be made from a substantive rewrite of pensions legislation; and
- to bring forward proposals in the autumn for a review of those organisations established through the Pensions Act 2004 to ensure they are configured in the most effective way to achieve our long-term objectives.
- to extend the Financial Assistance Scheme to ensure people within 15 years of their scheme's normal pension age in May 2004 may qualify for help.

Contracting out

2.6 Since 1978, the state pension system has included a mandatory, earnings-related second tier for employees. The system allows individuals a choice, however, on how this earnings-related provision is made: they must either be members of the state second-tier provision (State Earnings-Related Pension Scheme (SERPS)/State Second Pension) or be contracted out into a private pension. Where people choose to contract out of the state scheme, part of their National Insurance contributions (NICs) is rebated and invested to build up a funded pension. Box 2a describes contracting out in more detail.

Box 2a: What is contracting out, and how does it work?

Contracting out was introduced for defined benefit (DB) schemes in 1978, when SERPS was created, and has evolved over time to include DC schemes. It provides a private sector alternative to the State Second Pension, allowing people to invest privately now to replace benefits that would otherwise be provided by the State at some point in the future.

In the current contracting out system, employees forego all or part of their State Second Pension entitlement and in return pay lower-rate NICs and/or receive an annual payment into their pension scheme. Where the contracting out arrangement is an occupational scheme, the employer also pays reduced-rate NICs. These reductions and payments are known collectively as the contracted-out rebate.

For DB schemes, the rebate is currently[1] a reduction in NIC levels of 5.1 per cent (3.5 per cent for employers and 1.6 per cent for employees) on earnings between the Lower Earnings Limit and the Upper Earnings Limit. The rebates for contracted-out DC schemes are two-tier. For DC occupational schemes, flat-rate rebates are made through reduced-rate NICs (1 per cent for employers and 1.6 per cent for employees) and, at the end of the relevant tax year, an age-related 'top-up' is paid direct to the occupational scheme. For those contracted out through a personal or stakeholder pension, full-rate NICs are payable but a higher age-related rebate payment is made direct to their pension fund at the end of the relevant tax year. Age-related rebates are currently capped at 10.5 per cent.

The State therefore saves the need to pay for additional State Pension out of tax/NICs in the future and in return receives lower NIC income now.

DB schemes that contract out must meet an overall scheme quality test, known as the Reference Scheme Test. There are no specific rules about the use of the rebate in DB arrangements.

[1] A review of the rebate rates is required by legislation at least every five years. New rates will be introduced from April 2007. These are set out in the Regulatory Impact Assessment that accompanies this paper.

Box 2a: What is contracting out, and how does it work? *(continued)*

The sponsoring employer of a contracted-out DC occupational scheme must pay amounts equivalent to the rebate into the scheme within a set period. These are known as minimum payments. There is no requirement for the employer to contribute more than the minimum payment. The contracted-out DC benefits from both occupational and personal pension schemes are subject to certain restrictions.

A brief history of contracting out

1978	Contracting out introduced for DB schemes.
1988	Contracting out extended to money-purchase schemes and a 2 per cent incentive added to the rebate for individuals in DC schemes from 1988 to 1993.
1993	1 per cent age addition paid to people aged 30 and over in a DC personal pension scheme from 1993 to 1997.
1997	Age-related rebates introduced for individuals in money-purchase schemes, making the rebate actuarially neutral.

Complexity for individuals

2.7 Since contracting out was introduced in 1978, the pattern of private pension provision has evolved. At that time, most private sector occupational schemes were DB schemes. An estimated 24 per cent of employees belonged to a private sector contracted-out DB occupational scheme. But this had fallen to 11 per cent by 2004, largely as a result of the closure of DB schemes to new members and, in some cases, to all future accruals.

2.8 As a result, the number of individuals contracted out in private sector DB occupational schemes fell from around 5 million in 1989/90 to under 3 million in 2003/04.

2.9 An increasing proportion of private pension schemes now operate on a DC basis. Under the current DC arrangements, with an actuarially neutral rebate, it has become increasingly difficult to judge (particularly for personal pensions) whether or not an individual would be better off in the State Second Pension scheme or contracted out. There is an inevitable tension in substituting DC for DB provision because it is not comparing like with like. Contracting out on a DC basis involves investment in equities and bonds and, as with all investments, there is no guaranteed outcome.[2]

[2] The age-related rebate is capped and it is generally accepted that the majority of those affected by the cap would be better off contracted in.

2.10 Current trends would suggest that an increasing number of people with DC pensions are contracting back into the State Second Pension. There is also evidence that a growing number of providers have contracted policy holders back into the state scheme, unless the policy holder opts not to do so. Between 2001/02 and 2003/04 around 700,000 people in DC schemes contracted back into the State Second Pension.[3]

2.11 The evidence that complexity is a key factor in putting people off any sort of long-term savings decisions is compelling. Elsewhere in this paper we have made clear the priority we place on tackling undersaving and encouraging personal responsibility by clarifying the key decisions people need to take in relation to their financial planning for retirement.

2.12 We want people to be clear on what they can expect from the State. In this context, we have decided that the current contracting out arrangements do not fit with the newly clarified environment in which we are asking people to take their savings decisions. People will not therefore be able to use personal accounts as a vehicle into which to contract out.

Regulatory complexity for pension schemes

2.13 In addition to difficult decisions about the benefits of contracting out into DC schemes, many commentators have pointed to the associated administrative complexity and costs. These arise because of particular conditions that apply to contracted-out rights. Requirements relating to investment, the purchase of a unisex annuity and the provision of a survivor benefit require contracted-out rights to be tracked separately from other rights and treated differently at the point of annuitisation.

2.14 Administrative complexity also arises from rights built up in DB schemes. Part of the reason for the current complexity is that, with each past reform, members have built up a series of different rights under different rules.

2.15 Against this background, any proposals for the reform of contracting out must also address the past rights that individuals have built up if we are to avoid complicating matters still further. Later in this chapter, we introduce proposals to tackle one element of this problem – Guaranteed Minimum Pension rights.

Proposals for reform to contracting out

2.16 The complexity and regulatory burdens associated with contracting out undermine saving. The Pensions Commission suggested that, if contracting out did not exist, it would not be invented now. We accept this view and, therefore, have been considering how to reform contracting out as part of a coherent pensions reform package.

[3] DWP, 2006, *Second Tier Pension Provision 1978/79–2003/04*.

2.17 However, we also recognise, as did the Pensions Commission, that the nature of DB provision does not allow for sudden reforms. Consequently, any changes to DB contracting out will need to take place over the longer term to reflect changes to the State Second Pension, and as part of the evaluation of the overall pensions reform package.

Contracting out for DC schemes

2.18 The Government agrees with the Pensions Commission that the decisions around contracting out into DC schemes have become too complicated and that the system is poorly understood. We now propose to abolish contracting out into DC pension schemes, both occupational and personal/stakeholder.

2.19 Abolishing contracting out into DC schemes will:

- offer greater clarity for individuals, removing the difficult judgement to be made about whether they would be better off contracted in or contracted out;
- enable individuals to make informed decisions about their additional pension saving options by building on a clear foundation from the State;
- avoid the complex decisions for individuals and advisers that could arise from the introduction of a new scheme of personal accounts, if people were able to contract out; and
- reduce costs for providers by removing the associated regulatory complexity.

2.20 We described earlier the conditions that currently apply to contracted-out DC rights. The abolition of contracting out for DC schemes raises important questions about the treatment of rights already accrued in the past and whether any or all of those conditions should continue to apply. We intend to consult on the possibility of reforming or removing the restrictions on investment and the type of annuity that may be purchased with savings built up through contracting out. We will examine options in this area with a view to increasing simplicity for scheme members and reducing the regulatory burden.

2.21 The DC contracted-out rebate will end at the same time as the basic State Pension is uprated in line with earnings, which we describe in detail in Chapter 3.

Contracting out for DB schemes

2.22 In a DB scheme, the pension is calculated by reference to the individual's earnings, and employer and employee contributions are set at a level to fund the scheme benefits. Decisions on funding levels and contribution rates are taken on a long-term basis. Decisions on contracting out and joining the pension scheme are therefore usually more clear cut. The Pensions Commission recognised that the abolition of contracting out for DB schemes would be more likely to spur scheme closure and reduce national saving than to stimulate more saving. This is because it could require a major restructuring of scheme benefits and a revision of scheme rules.

2.23 The Pensions Commission concluded that, for DB schemes, rather than abolishing contracting out, it should be phased out by 2030 when the State Second Pension becomes flat rate, making the flat-rate element of the State Second Pension 100 per cent contracted in. However, we do not intend, at this stage, to bring forward additional proposals to abolish DB contracting out in the longer term. Instead, the long-term future of contracting out for DB schemes will be subject to ongoing review as part of the evaluation of the overall reform package.

2.24 We believe that abolishing contracting out for DC schemes and retaining it for DB schemes on the current basis strikes the best balance between the need to simplify the system, where possible, for individuals and schemes, and a desire not to disturb existing DB provision.

The impact of reforms to contracting out

2.25 As a result of the abolition of contracting out into DC pension schemes, those people who had previously been contracted out into such schemes will start to build up new rights to the State Second Pension. At the same time, they will no longer receive contracted-out rebates into their pension schemes. There will be no impact on their take-home pay.

2.26 Given the actuarial assumptions currently used to calculate the level of the rebate, people should generally be no better or worse off in retirement as a result of the abolition of contracting out for DC pensions.

2.27 An additional impact of this decision will be on the insurance industry and other firms managing contracted-out pension funds. We recognise the need to manage this impact carefully and will take this fully into account when considering how we approach the implementation of this decision. We welcome views on this issue.

Dealing with past rights – Guaranteed Minimum Pension conversion

2.28 Abolition of contracting out for DC schemes will simplify private savings decisions for individuals and reduce complexity for employers offering DC pension provision. There is also, however, an ongoing issue of complexity within DB schemes as a result of the fact that, with each past reform, members have built up a series of different rights under different rules. The most complex of these rules concerns the Guaranteed Minimum Pensions built up on an individual basis by members of DB schemes.

2.29 From 1978 to 1997, if a DB occupational pension scheme wanted to contract out of the additional State Pension, the employer had to agree that the scheme would pay at least a statutory minimum level of benefits – the Guaranteed Minimum Pension. While Guaranteed Minimum Pensions ceased to accrue in 1997, past rights still exist. This is a continuing source of complexity, particularly on wind-up and over transfers. Since 1997, however, contracted-out DB schemes have been required to meet an overall test of scheme quality, the Reference Scheme Test, which is considerably more flexible.

2.30 Against this background, any proposals for the reform of contracting out must also address the past rights that individuals have built up, if we are to avoid complicating matters still further.

2.31 The Government proposes to allow schemes to convert Guaranteed Minimum Pension rights into scheme benefits, offering the actuarial equivalent value in exchange. This would allow for easier (and therefore cheaper) administration in the scheme and also make it easier for the member to move their rights into other pension products, if they wish to do so.

2.32 We estimate that this measure would save schemes around £8 million to £15 million a year, assuming that 25 to 50 per cent of schemes choose to make the change. There would be a one-off cost to implement the change, of between £12 million and £24 million, to make IT software changes and pay associated legal, actuarial and administrative fees.

2.33 The Government intends to bring forward legislation to enable this change as soon as a suitable opportunity arises.

2.34 One further proposal for possible administrative simplifications relating to contracting out has been that we should allow employers to buy their staff back retrospectively into the State Second Pension. We have considered this approach, but, for a number of reasons outlined in Box 2b, we have decided not to take this proposal forward.

Box 2b: Buy-back into the State Second Pension

It has been suggested that as part of the pension reform package the Government should allow contracted-out pension schemes to 'buy back' their members' rights in the State Second Pension. The potential benefits to schemes of such a buy-back are that it would enable them to simplify their administration – for example, closed DB schemes might be able to stop operating contracting out altogether – and to match their assets more closely to their liabilities. However, it would not in itself reduce the pension fund deficits facing certain DB schemes: deficits would only be reduced if scheme sponsors financed the buy-backs, and this would consume cash that sponsors might use to reduce their deficits in other ways. It would also produce a short-term cash inflow to government (though this would be offset over the longer term by increased payments of the State Second Pension).

The Government is sympathetic to the aims of the buy-back proposal. It is envisaged that forthcoming legislation will allow schemes to convert certain contracted-out rights (Guaranteed Minimum Pension rights) into scheme benefits. Accordingly, we undertook a preliminary investigation of both the legal and the financial feasibility of creating a facility for more broad-based buy-backs. This investigation suggested that buy-backs would be feasible in principle, but very complex in practice. In addition, unless significant changes were made to SERPS/State Second Pension, it would not be possible to guarantee that individuals would receive at retirement as much SERPS/State Second Pension as they had given up in the pension scheme. Accordingly, the Government does not propose to include a provision for buy-backs in its pension reform.

Further reducing the regulatory burden

A continuing programme of simplification

2.35 The Government recognises the importance of security and confidence as prerequisites to private pension saving. The Pensions Act 2004 set out a new approach. The Act created the Pension Protection Fund (PPF), a major new institution that radically transformed the nature of protection offered to members of DB pension schemes. Over 10 million members of final salary pension schemes now benefit from the security of knowing they will receive a meaningful occupational pension even if their company becomes insolvent and the pension scheme is underfunded.

2.36 The Act also established The Pensions Regulator (TPR), which now assists in protecting members' benefits while enabling companies to get on with running good schemes. It operates a risk-based approach to regulation in line with the recommendations of the Hampton Review.[4] It promotes effective governance for all work-based pension schemes and works with trustees, employers and professional advisers to put things right where necessary.

2.37 Since the 2004 Act, the Government has been pursuing a range of simplifying measures. These have included:

- changes to section 67 of the Pensions Act 1995 to make it easier for schemes to amend scheme rules, by allowing changes that affect accrued rights, provided that the overall value of benefits is not changed (depending on take-up, potential ongoing savings of £3.5 million a year);

- key legislation in the Finance Act 2004 to replace the complex pensions tax rules with one simple and flexible regime. The legislation was implemented in April 2006;

- aligning some contracting out rules with tax rules (savings in the region of £9 million a year); and

- making it easier for employers who run several small schemes to bulk-transfer members with protected rights into a single scheme (expected to save schemes £10 million over the next three years).

2.38 In addition, TPR and the PPF are considering how they might contribute to the simplification process. TPR, for example, has already been working on reducing the burden of the scheme return, with a more streamlined version available from the beginning of May 2006. It is also reviewing its information and data requirements in the widest sense and looking at where it can use information already gathered by other organisations – government or commercial – rather than requiring schemes to submit it. The PPF is looking at the requirements governing the provision of information to its Board with a view to identifying and eliminating duplication wherever possible.

2.39 In the light of regulatory experience, TPR is also considering whether there are parts of the legislative framework which have proved to be unnecessary or less effective in practice than anticipated, and which could be removed – for example, some types of notifiable event – and will make recommendations to DWP. TPR will continue to review its effectiveness in fulfilling its statutory objectives, particularly in the context of proportionate and risk-based regulation.

[4] Hampton Philip, March 2005, *Reducing administrative burdens: effective inspection and enforcement*. This report can be accessed at www.hm-treasury.gov.uk/hampton

2.40 TPR's aim is to focus on those areas where concerns are greatest, and to concentrate on delivering better and more effective risk-based regulation relevant to its environment and stakeholders. TPR will therefore apply a light touch to enforcing legislation that does not contribute significantly to the achievement of its objectives and will draw DWP's attention to legislative requirements that appear to be ineffective or disproportionate.

Deregulatory review

2.41 The proposals contained earlier in this chapter to abolish contracting out on a DC basis will considerably simplify the position for DC occupational schemes. Enabling the conversion of Guaranteed Minimum Pension rights within DB schemes will help that part of the pensions sector. Alongside the introduction of the new scheme of personal accounts, we also propose to review the current requirement on most employers to designate a stakeholder pension provider. Clearly, the future of stakeholder pensions is an important issue and one that we will consider carefully with key stakeholders in the industry and with employers.

2.42 In addition, we are now launching a rolling deregulatory review of pensions regulation, which will feed into DWP's simplification plan, to be published later this year. It may be possible to remove, merge or simplify many of the layers of legal requirements introduced in and since the 1995 Pensions Act. This could include re-examining the provisions on matters such as:

- mandatory indexation of pensions in payment;
- member-nominated trustees;
- administrative and internal control requirements;
- restrictions on changes to accrued rights (section 67);
- payments to employers where surplus funds exist;
- deemed buy-back; and
- internal dispute resolution.

2.43 Reforms in some of these areas (for example, further reform of the requirement to apply price indexation to pensions in payment) could have the scope to make a significant difference to the costs of running an occupational pension scheme.

2.44 We will establish a group of external stakeholders to help us review the current position, first to identify particular areas where quick wins may be possible (including changes that could be achieved by secondary legislation or administrative action), and then, more comprehensively, to maintain momentum by mapping out a programme of simplification measures.

2.45 We would welcome proposals for priority areas – in the first instance, during the consultation period following the publication of this paper.

Pensions Law Rewrite Project

2.46 The Government has also been considering the possibility of launching a Pensions Law Rewrite Project, drawing on the experience of the successful recent Tax Law Rewrite Project, which has been progressively rewriting the body of tax law with a view to making it simpler and easier to understand. Such a project would involve a mixed team of public and private sector lawyers and other professionals taking a hard look at the complexity of pensions law to see whether it could be written more clearly, thus removing some of the burden of compliance without changing the substance of the regulatory policy.

2.47 This would be a very major undertaking and consequently the Government proposes to run a pilot which would focus on one or more sets of regulations which have an impact on business, to test whether the approach is likely to produce worthwhile dividends in terms of simplicity and, ultimately, savings for schemes and employers.

The institutional landscape for pensions

The existing landscape

2.48 The pensions landscape has changed markedly as a result of the introduction of the Pensions Act 2004 and the creation of two new independent statutory bodies, The Pensions Regulator and the Pension Protection Fund.

2.49 These bodies – working together – have transformed the security of occupational pension saving for members of DB schemes. The Act also established the Financial Assistance Scheme to provide help to many of those who had lost the most in the past. The scheme came into operation on 1 September 2005, providing help to qualifying members within three years of their scheme pension age on 14 May 2004. The Financial Assistance Scheme (FAS) will help groups close to retirement who lost out before the PPF was established. Following the Prime Minister’s announcement to expedite the review of the FAS planned for CSR07, the Government has decided to extend the FAS so that it will assist eligible people who were within fifteen years of their scheme pension age on or before 14 May 2004. This should ensure that up to a further 30,000 people who lost significant amounts when their pension schemes were wound up, will benefit from the new arrangements. Under this extension, scheme benefits will be tapered so that the Government will pay the full 80 per cent to those within seven years of scheme pension age, 65 per cent to those within eight to eleven years of scheme pension age and 50 per cent to the remainder.

2.50 The establishment of these new pensions bodies has added to the existing pensions landscape. In addition to the government departments with various responsibilities for pensions policy, there are several government-sponsored bodies charged with functions partly or wholly related to pensions policy, and beyond that a number of outside organisations whose roles include pensions to a lesser or greater extent. A number of these are described in Box 2c.

Box 2c: The existing institutional landscape

The Pension Protection Fund – a statutory fund established under the provisions of the Pensions Act 2004 to pay compensation to members of eligible DB pension schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover PPF levels of compensation.

The Pensions Regulator – a regulatory body for work-based pension schemes, created under the Pensions Act 2004, which takes a risk-focused approach to regulation.

The Financial Assistance Scheme – administered by DWP and managed by a national Financial Assistance Scheme Operational Unit, the scheme offers help to people who have lost out on their pension because their scheme was underfunded, and the employer is insolvent or no longer exists.

The Pensions Advisory Service – an independent non-profit organisation which provides information and guidance on the whole spectrum of pensions, covering state, occupational, personal and stakeholder schemes.

The Pensions Ombudsman – an independent and impartial adjudicator who investigates and decides complaints and disputes concerning occupational pension schemes and Personal Retirement Savings Accounts.

Maintaining the consensus

2.51 The Pensions Commission recommended the creation of a government advisory body. The Commission envisaged that such a body would provide a detailed analysis of key trends in demographics and pension provision. The overall intention was to provide an independent and trusted voice that would spell out ‘the unavoidable trade-offs’.

2.52 The Government recognises the value of the Commission's recommendation. The Commission itself has been hugely successful in driving forward the debate on pension reform and in particular in helping convince the public of the need for change. We therefore propose to periodically commission reviews drawing on a range of independent expert advice in the light of emerging evidence on demographic change.

Supporting the strategy for an ageing society

2.53 Chapter 4 sets out plans to ensure a cross-government strategic approach towards an ageing society. Part of that work has implications for the institutional landscape that need to be considered:

- The Social Exclusion Unit promised a review to consider the establishment of an office for ageing and older people.

- The Government committed in *Opportunity Age*[5] to explore the scope for an observatory on ageing that would improve the evidence base available to policy makers.

2.54 Further work remains to be done in both of these areas – the review promised by the Social Exclusion Unit will not be complete until later this year and options exist regarding how any institutional changes would take effect. An observatory on ageing, for example, could fit within an existing institution, or form part of any office for ageing and older people.

Pensions institutions

2.55 The pension reforms, particularly the new scheme of personal accounts, and the work on an ageing society, will have significant implications for the pensions institutional landscape. This makes it appropriate and in line with the principles of good governance and better regulation to review those organisations established through the Pensions Act 2004 and how they fit with the reform proposals. The aim is to ensure they are configured in the most effective way to achieve our long-term objectives. We will be bringing forward plans for this review in the autumn, once we have developed further detail on the scheme of personal accounts.

[5] DWP, 2005, *Opportunity Age: Meeting the challenges of ageing in the 21st century* (Cm 6466i) DWP.

2.56 This chapter has outlined a range of measures to help strengthen the existing occupational pensions sector, and to help clarify further the decisions individuals need to take with regard to their saving. Coupled with the measures outlined in Chapter 1 – introducing mandatory automatic enrolment, a minimum level of employer contributions and a new scheme of personal accounts – these measures will help support a private pensions sector delivering good outcomes for individuals in retirement.

2.57 But for these measures to be successful, it is essential that individuals receive the right incentives from the State Pension as a foundation on which to build savings. The following chapter introduces a radical reform to the state pension system to ensure that it continues to perform this vital function.

Chapter 3: Providing a foundation for private saving

Chapter 3: Providing a foundation for private saving

Summary

Chapters 1 and 2 outlined our proposals to tackle at source behavioural barriers to saving and to strengthen existing private pension provision. These include proposals for a new, low-cost pension saving scheme of personal accounts. But the current state pension system is highly complex, making it difficult for individuals to be confident about exactly what they can expect from the State, and many people – particularly women – will not get full pensions despite working or making other contributions to society for significant periods.

The state pension system seeks to achieve two objectives – to tackle pensioner poverty, and to provide a foundation for retirement incomes for all. The Government's reforms since 1997 have done both while maintaining long-term affordability. The objective of the reforms in this paper is to build long-term confidence in this approach.

As the number of pensioners increases, the generosity of the state pension system for those on average earnings is falling relative to the wealth of the rest of society. The reforms set out in this chapter will create a system that, over the long term and in the face of demographic change, provides a decent minimum for the poorest and a foundation for all upon which to plan for their retirement.

This chapter outlines proposals to:

- ensure that the basic State Pension can act as a foundation for further provision, by linking its value to rises in average earnings;
- raise the State Pension age from its level in 2024 of 65 for both men and women, in line with the growth in average life expectancy;
- reform the State Second Pension so that it becomes a simple, flat-rate weekly top-up to the basic State Pension; and
- ensure that, before implementing the earnings link of the basic State Pension, means-tested provision continues to be focused on those with small savings, by taking steps from 2008 to target the Pension Credit on this group.

We can now also announce an intention to continue to uprate the Guarantee Credit in line with earnings over the long term.

The current system is based on outdated assumptions: its rules are rooted in an era in which most men were expected to work and pay contributions from 16 to State Pension age; and in which women were expected to rely on their husbands for support. Today's society is not like that. More and more people benefit from further and higher education while the trends of rising numbers of unmarried partnerships and growing female participation in the labour market are expected to continue.

Summary *(continued)*

Many people's working lives are interrupted by caring and other activities. The introduction of Home Responsibilities Protection (HRP) in 1978 went a long way towards improving the situation for women. Women's pension entitlements are, on average, catching up with men's. But there remains a critical cohort of women over the age of about 45 now who did not fully benefit from HRP. They have significantly poorer contribution records – despite the fact that most of them will have made important and valuable contributions to society.

Many people are therefore left uncertain about whether they will get a full basic State Pension, and find it difficult to work out what additional State Pension they will get and whether their income will be means-tested. This chapter outlines how we will respond to these challenges. We will:

- reduce the number of qualifying years needed for a full basic State Pension from 44 for men and 39 for women to 30 for all those reaching State Pension age from 2010;
- convert HRP into a positive weekly credit, aligning the rules for when it is available between the basic State Pension and the State Second Pension;
- establish a new Carer's Credit for those undertaking care for the sick and severely disabled for 20 hours or more a week;
- abolish the minimum contribution conditions in the basic State Pension and the Labour Market Attachment Test in the State Second Pension, to ensure that every year of contributions or credits count; and
- further simplify and modernise the state pension system by abolishing outmoded elements such as adult dependency increases and National Insurance autocredits.

Taken together, the reforms outlined in this chapter contribute to meeting the key tests we have set for pension reform. They will promote **personal responsibility**, by ensuring that the state pension system operates effectively as a foundation on which people can build for their incomes in retirement. And they will aid **simplicity and fairness**, by ensuring that fewer people retire on less than a full basic State Pension.

The reforms are **sustainable**, as they deliver a pension that maintains its value relative to national wealth. And, through increases in the State Pension age and the withdrawal from direct provision by the government of earnings-related pensions, we will ensure that the system remains **affordable** for the long term.

Context of reform

The demographic challenge

3.1 The overall balance within the current state pension system is under threat from the demographic challenges described in detail in Annex D. While the current system is affordable now, if unreformed it will remain so into the future only by becoming less generous for the average earner over time.

3.2 If spending on pensioner benefits were to remain constant per pensioner as a proportion of national income, spending would have to rise by around £80 billion per year (in 2006/07 prices), or over 2 per cent of GDP above its forecast level in 2050. If all current indexation policies were to be continued indefinitely, we would see a rise in spending on pensioner benefits of nearly 1 per cent of GDP (£30 billion in 2050) but this would mask a fall in the proportion of national income spent per pensioner of around a quarter.

3.3 The challenge, in the face of a growing number of pensioners, is to sustain the broad balance of the current system, including, crucially, its successes against pensioner poverty, while keeping it affordable and flexible into the future. Since 1997 we have focused money on the poorest pensioners, helping to lift 2 million pensioners out of absolute poverty and 1 million out of relative poverty. Pensioner incomes are higher on average than in any previous generation, while poverty among pensioners is historically low.

3.4 Our first task was to tackle poverty for today's pensioners. Our next priority is to provide a foundation for those who have contributed which will act as a building block for private saving for tomorrow's pensioners. Incentives to save in the current system remain strong. Recent research has shown that incentives for many on low incomes have improved as a direct result of the introduction of Pension Credit.[1] Problems with incentives could, however, develop if a pensions system evolved where a significant majority of pensioners were entitled to Pension Credit in the long term. That has never been the intention of this Government. But further unfounded speculation on this point could undermine the incentives of people who want to save today. Our reforms make it clear that this speculated further spread of entitlement to Pension Credit will not happen.

[1] Sefton J, van de Ven J and Weale M, 2005, *The effects of means testing pensions on savings and retirement,* NIESR (National Institute of Economic and Social Research).

Providing a firm foundation for private saving

3.5 The state pension system must make clear the 'deal' between the State and the citizen. The state system must establish the right environment for people to take responsibility for their security in retirement, by allowing them to plan and make decisions today and in the future that they can understand and that they are confident will not be unravelled by future governments. The state system must provide a foundation on which people can be confident of building through the new pension saving scheme of low-cost, portable personal accounts. People should be clear about what the State will do, and what they must do for themselves.

3.6 The Government cannot, in the face of an ageing population, hope to provide both a foundation for private savings and a good-quality alternative to occupational provision.

3.7 We therefore propose to reform the structure of the state pension system in order to shift it to a simpler, flat-rate system that can provide a foundation for individual saving.

Unequal entitlements in the state pension system

3.8 The state pension system recognises unpaid social contributions through HRP, Carer's Allowance and more recently through the introduction of the State Second Pension, which is more generous to carers and low earners. The introduction of the Minimum Income Guarantee in 1999, and its successor the Pension Credit in 2003, have helped lift nearly 1 million women out of relative poverty. Over 2.1 million, or two-thirds, of those who have benefited from Pension Credit are women.

3.9 But the Government is committed to reducing remaining inequality in outcomes, particularly for women and carers. The Department for Work and Pensions' publication *Women and pensions: The evidence* considers in detail the disadvantages women have faced in building pension provision.

3.10 The *Family Resources Survey* shows that there are around 3.6 million carers below State Pension age caring for adults in the UK. Most of these carers are building rights to the basic State Pension either because they are making sufficient National Insurance contributions or because they receive a benefit which attracts a credit towards their basic State Pension. However, around 390,000 carers are not accruing basic State Pension rights. 120,000 of them are caring for 20 hours or more a week, and this group of carers appears to face more difficulties in the labour market than those caring for fewer than 20 hours a week and than the overall population.

3.11 The average entitlements of women both to the basic State Pension and to additional State Pension (the State Earnings-Related Pension Scheme (SERPS) and State Second Pension) are still some way below those of men. Women's State Pension records are improving, largely as a result of HRP and increased labour market participation. However, only around 30 per cent of women reaching State Pension age recently are entitled to a full basic State Pension and by 2010 this will still be only around 50 per cent of newly retired women. This is compared with around 90 per cent of men in 2010. By 2025 around 80 per cent of women are projected to retire with a full basic State Pension, but the Government believes that action must be taken to improve state pension outcomes for women much earlier.

3.12 Reform must address these issues. But it must do so in a way that recognises the vital principle that with rights come responsibilities. The system must continue to offer 'something for something'. Everyone who contributes, whether through paid or social contributions, should expect to know what they will get from the State in retirement so that they can better plan their retirement and the savings they need to make. Through our reforms, those who contribute can have confidence that the state will provide a solid foundation.

Summary of proposals

3.13 In order to provide a simpler, flat-rate system that will be a foundation for individual saving, we will:

- link the basic State Pension to rises in average earnings. Our objective, subject to affordability and the fiscal position, is to do this in 2012 but in any event at the latest by the end of the next Parliament. We will make a statement on the precise date at the beginning of the next Parliament;

- raise the State Pension age in 2024 from 65 for both men and women in line with the growth in average life expectancy. The State Pension age will be increased by one year over a two-year period from 2024, and then again in 2034 and in 2044. This will signal the need for a behavioural change towards working longer as we live longer;

- reform the State Second Pension so that it becomes a simple, flat-rate weekly top-up to the basic State Pension. Accruals will start gradually to become flat rate at the same time as we start to uprate the basic State Pension by earnings. We estimate that the State Second Pension will become completely flat rate around 2030 or shortly afterwards; and

- ensure that, before implementing the earnings link of the basic State Pension, means-tested provision continues to be focused on those with small savings, by taking steps from 2008 to target the Pension Credit on this group.

3.14 Taken together, these reforms will produce an affordable, sustainable and fair system, in which each generation will spend a similar proportion of their lives contributing to and receiving pensions.

3.15 Under the new system, anyone meeting the simpler entitlement conditions will receive a full basic State Pension worth about 20 per cent of median earnings. Years spent working or caring will boost this amount through the reformed State Second Pension, so that someone working or caring for 40 years can expect to retire on around 30 per cent of median earnings – or around £135 in today's earnings terms – before any private saving.

3.16 Everyone should have the opportunity to build a decent State Pension entitlement on the basis of their own actions and in their own right. We will modernise the contributory principle so that it reflects the social and economic realities of the 21st century. In order to achieve this, we will:

- reduce the number of qualifying years needed for a full basic State Pension to 30, from 44 for men and 39 for women;
- convert HRP into a positive weekly credit for the basic State Pension, and align the rules for when the credit is available between the basic State Pension and the State Second Pension so that those caring for children aged under 12 are eligible;
- align credits for foster carers across the basic State Pension and the State Second Pension;
- move from a system of annual credits in the State Second Pension to weekly credits, enabling people to combine credited and paid contributions in order to accrue a year of entitlement to the State Second Pension;
- establish a new Carer's Credit in the basic State Pension and the State Second Pension for those undertaking care for the sick and severely disabled for 20 hours or more a week; and
- abolish the minimum contribution conditions in the basic State Pension and the Labour Market Attachment Test in the State Second Pension, to ensure that every year of contributions or credits counts.

3.17 These measures (which will apply to people reaching State Pension age on or after 6 April 2010) will help ensure that a far wider range of unpaid social contributions are recognised for the purpose of building entitlement to state pensions, resulting in a considerable and immediate increase in the number of women retiring on a full basic State Pension – around 70 per cent of those reaching State Pension age in 2010 instead of around 50 per cent without reform. In 2020, around 90 per cent of women and over 90 per cent of men reaching State Pension age are projected to be entitled to a full basic State Pension under our reforms.

3.18 As a result of the general improvement in entitlement, we will also be able to abolish a number of the complex and often outmoded provisions that currently exist in the state pension system. We will:

- abolish adult dependency increases which, as we recently announced in *A new deal for welfare: Empowering people to work*, we do not intend to carry forward into the Employment and Support Allowance; and

- abolish National Insurance 'autocredits' awarded to those between 60 and 65, in line with equalisation of women's State Pension age.

Earnings-linking the basic State Pension

3.19 Since 1980, the level of the basic State Pension has been formally linked to inflation through the Retail Price Index (RPI).[2] Since 1999, the value of the basic State Pension has risen faster than this through a series of higher than inflation increases. But there has for years been a debate about whether the basic State Pension should be linked to earnings, as it was briefly in the 1970s.

3.20 There are a number of reasons to think that an earnings link represents an appropriate response to long-term demographic change. We have outlined how our reforms since 1997 have led to pensioner incomes being at their highest-ever level. Having significantly reduced pensioner poverty, we are now able to create a long-term foundation for saving by restoring the earnings link. We can make clear for the long term the deal between the State and the individual, to allow people to plan with confidence for their retirement.

3.21 People's expectations for their incomes in retirement are largely based on their earnings and standard of living during working age. If the state system is to serve as a foundation for their retirement planning, it must retain its level relative to these expectations. This will help to address the problem of undersaving by enabling people to predict with confidence what they are likely to receive from the State when they retire, and therefore what they will need to save in addition to meet their expectations.

[2] Regular uprating was introduced in 1973. Legislation allowed discretion to increase the basic State Pension in line with prices or earnings. From 1975 until 1980, legislation required the basic State Pension to be uprated by the better of earnings or prices inflation. Since 1980, the legislation has required the basic State Pension to be uprated in line with prices. However, in 2003 the Government undertook to uprate the basic State Pension by a minimum of 2.5 per cent.

3.22 It is also important to ensure that targeted benefits are just that – directed at those in society who need them most. At present, Pension Credit achieves this. The Government has successively raised the Guarantee Credit by earnings and has already committed to do so to 2008 in order to continue to tackle pensioner poverty. We intend to continue this uprating strategy over the long term. But if Pension Credit alone continues to rise with earnings and the level of contributory benefits drifts away from the means-tested safety net, it could mean that more and more people fall subject to means-testing in retirement. This could affect people's incentives to work and save, and dilute the sense of personal responsibility for saving that we want to instil.

3.23 The Government believes that people must have the opportunity to build a basic State Pension entitlement that can give them confidence in the value of making additional provision. This will also help to encourage people to save through automatic enrolment in the scheme of personal accounts. And we are clear that we cannot allow our progress against pensioner poverty to falter. Taken together, we believe that both the Guarantee Credit and the basic State Pension must retain their value relative to the average earnings of society.

3.24 During the next Parliament, therefore, we will re-link the uprating of the basic State Pension to average earnings. Our objective, subject to affordability and the fiscal position, is to do this in 2012 but in any event at the latest by the end of the next Parliament. We will make a statement on the precise date at the beginning of the next Parliament.

3.25 But this is a major undertaking. On its own, linking the basic State Pension to rises in earnings from 2012 would lead to an increase in spending on pensioners of £46 billion or 1.4 per cent of GDP by 2050, in addition to the costs of increasing coverage to state pensions. We have made clear that the Government's economic policies since 1997 have had specific benefits for pensioners and future pensioners. To risk the stability of the economy for the sake of linking the basic State Pension to earnings growth would be counter-productive. This element of the reform package is therefore inextricably linked to two others.

3.26 First, raising the State Pension age in line with increases in life expectancy will help to bring about a behavioural change so that people begin to work longer as they live longer. It will slow the growth in the number of pensioners, while ensuring that pensioners continue to be able to enjoy a roughly constant proportion of their adult lives in retirement. Maximising the impact of this increase, through the measures described in Chapter 4 to help people work for longer, will further help to stabilise the support ratio, ensuring that these reforms remain affordable.

3.27 Secondly, we intend to accelerate the withdrawal from direct provision of earnings-related pensions to provide a simple, flat-rate foundation that rewards working and caring, building on which will be the responsibility of individuals. Reforms to the State Second Pension will speed up the move to make it a flat-rate top-up to the basic State Pension and will reduce expected expenditure on the State Second Pension in the longer term, further helping to fund linking the basic State Pension to earnings. Reforms to the State Pension age and the State Second Pension are described later in this chapter.

Raising the State Pension age

3.28 State Pension age in the UK has varied in the past. The first support for pensioners, introduced from 1909, was available only at 70. From 1926 to 1940 State Pension age was 65 for all. And only since 1940 has it been on the current basis. Not long after the current state pension scheme was introduced in 1948, the question of State Pension age was investigated in 1953–54[3] by the Phillips' Committee which concluded that State Pension age did "not represent the limit of working life".

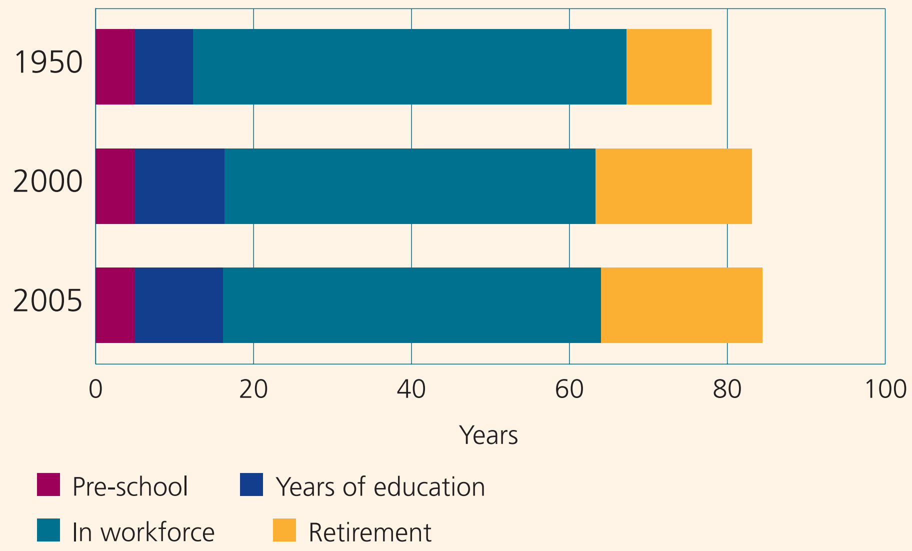
3.29 Life expectancy has improved considerably since State retirement pensions were first introduced, and these improvements are projected to continue. Over the last two decades, the healthy life expectancy of men and women aged 65 has risen by more than two years. Despite this, men retire on average three years earlier than they did when the present State Pension ages were set and women two years earlier.

Consequences of changing demographic and retirement patterns

3.30 Rising life expectancy is to be welcomed. However, there are other consequences we must face up to. If people are spending more years in retirement, they must work longer, increase savings or the State must find resources to pay the State Pension to more people for longer. The changes in the length of time an average man spends in different periods of his life are illustrated in Figure 3.i.

[3] *Report of the Committee on the Economic and Financial Problems of the Provision for Old Age*, December 1954, paragraph 308.

Figure 3.i Average years spent in each life stage for men retiring in 1950, 2000 and 2005



Sources: Pre-school years are based on the age that compulsory education starts; average years of education for the 1950 retiree are based on the minimum school-leaving age at the time; average years of education for 2005 retirees are based on Banks and Smith (2006); Retirement in the UK using Family Expenditure Survey data; average age at retirement and life expectancy are based on Pensions Commission analysis

3.31 Some of these issues could be addressed by increasing the levels of employment among older workers. While the average retirement age for women, 62, is above their current State Pension age, men on average retire at 64, one year before they become eligible for their State Pension. By contrast, five decades ago when life expectancy was lower, men on average retired at 67 and women at 64. This means that those who retired in 1950, who constituted about 40 per cent of their generation, survived to a retirement which then accounted for 17 per cent of their adult life. If the retirement age remains at the current level, those who will retire in 2050 would constitute about 90 per cent of their generation and could look forward to spending on average 35 per cent of their adult life in retirement.

3.32 However, rising life expectancy is a long-term trend and we need to raise the State Pension age in order to address the fact that although we are living longer, on average we are not working proportionately longer. The rise in State Pension age will need to go hand in hand with cultural and behavioural change around retirement, and a corresponding rise in average retirement age. Measures already brought forward by the Government, together with those proposed in *A new deal for welfare: Empowering people to work* published earlier this year, will help us to meet our aspiration of 1 million more older workers. This is a part of the wider goal of an employment rate equivalent to 80 per cent of the working-age population. Chapter 4 of this paper contains a range of further policy proposals designed to deliver still more progress towards this objective, and outlines the positive overall impact on pensions if we were to meet this aspiration by 2030.

3.33 In order to maintain stability in retirement incomes, people need to take greater personal responsibility for their working and saving decisions. To help them do this, the Government will provide a foundation by linking the basic State Pension with earnings. But in doing this it is imperative that we don't pay for progressively longer retirements.

3.34 We therefore support the Pensions Commission's recommendation that the State Pension age should rise to 68 by the middle of the century. We propose to introduce legislation to raise the State Pension age in stages:

- the first increase, from 65 to 66, to be phased in over two years, starting in April 2024;
- the second increase, from 66 to 67, again phased in over two years, from April 2034; and
- the third increase, from 67 to 68, also to be phased in over two years, from April 2044.

3.35 By 2050, these reforms to State Pension age alone will reduce the costs of our proposed reforms to the state pension system by around £30 billion. By doing this we will continue to tackle pensioner poverty, be able to sustain the generosity per pensioner of the State Pension, and sustain the balance between work and retirement.

Findings from the National Pensions Debate: rise in State Pension age

Participants at the National Pensions Day were asked to consider a gradual increase in State Pension age as part of a package of measures for reforming state pensions. Following their deliberations, the majority (56 per cent) agreed with a gradual rise in State Pension age, though just under a third (32 per cent) disagreed. More people over State Pension age agreed with the proposed gradual rise in State Pension age than any other age group. 46 per cent of young people (aged between 16 and 24 years) disagreed with a gradual rise in State Pension age, while 42 per cent agreed.

What will raising State Pension age mean in practice?

3.36 On current projections, the increase in State Pension age will mean that men reaching State Pension age in the future will, on average, spend about the same number of years of their adult life in receipt of the State Pension as now, as shown in Figure 3.ii. For women, there is a slight reduction compared with the position as it is projected to be in 2020 (when the increase in female State Pension age to 65 will be fully phased in). However, there is no significant reduction in the actual number of years, which remains greater than for men.

Figure 3.ii Number of years spent post-State Pension age following transition to new State Pension ages

Years	2006 Current State Pension age	2020 State Pension age at 65	2026 State Pension age at 66	2036 State Pension age at 67	2046 State Pension age at 68	2055 State Pension age at 68
Men	20.1	21.6	21.1	21.1	21.0	21.8
Women	28.3	24.5	24.0	23.8	23.6	24.4

Source: Government Actuary's Department's 2004-based principal projection; median cohort figures for the UK

Note: State Pension age for women is currently 60.

3.37 Figure 3.iii shows that the proportion of adult life spent in receipt of the State Pension will remain about the same. By 2055, assuming life expectancy continues to increase in line with projections, for both men and women the number of years after State Pension age will be broadly the same as that of those reaching 65 in 2020 – indeed for men, it would have grown slightly.

Figure 3.iii Percentage of adult life spent post-State Pension age following transition to new State Pension ages

Percentage	2006 Current State Pension age	2020 State Pension age at 65	2026 State Pension age at 66	2036 State Pension age at 67	2046 State Pension age at 68	2055 State Pension age at 68
Men	30.0	31.4	30.6	30.1	29.6	30.4
Women	40.3	34.3	33.3	32.7	32.1	32.8

Source: Government Actuary's Department's 2004-based principal projection; median cohort figures for the UK

Note: State Pension age for women is currently 60.

3.38 Figure 3.iv shows that raising State Pension age to 68 would not, on average, reduce the numbers of people who survive to the new State Pension ages.

Figure 3.iv Percentage of people projected to survive to State Pension age following transition to new State Pension ages, compared with earlier generations

Percentage	Generation born in 1941 (1946 for women) reaching State Pension age in 2006	Generation born in 1955 reaching State Pension age of 65 in 2020	Generation born in 1960 reaching State Pension age of 66 in 2026	Generation born in 1969 reaching State Pension age of 67 in 2036	Generation born in 1978 reaching State Pension age of 68 in 2046	Generation born in 1987 reaching State Pension age of 68 in 2055
Men	76	82	82	83	84	86
Women	89	88	88	89	89	91

Sources: Figures for the generation born in 1941 are based on the Government Actuary's Department's England and Wales life tables; the subsequent figures are based on the Government Actuary's Department's UK life tables

Note: State Pension age for women is currently 60.

3.39 As discussed in Chapter 2, we propose that the Government will periodically commission reviews, drawing on a range of independent expert advice.

3.40 These reviews could, for example:

- provide advice to the Government on whether the timetable for increasing State Pension age – as set out in legislation – remains appropriate;
- gather evidence on future life expectancy and the consequences for public expenditure;
- provide detailed analysis of disparities in life expectancy between different social classes and the relative effects on different social groups of increases to the State Pension age; and
- monitor participation rates and levels of contributions to the personal savings scheme as well as the labour market for older workers (including average retirement ages).

3.41 While there is growing public acceptance of the evidence that life expectancy overall is increasing, there is nonetheless concern that the additional years will not necessarily be healthy years. To date, the evidence would suggest that increased life expectancy is also resulting in people staying healthier for longer. As the Pensions Commission has noted, this is an area where evidence is incomplete. Another task of these reviews could be to keep this evidence under review.

3.42 We note the Pensions Commission's suggestion that the age at which people become entitled to the Guarantee Credit in Pension Credit could remain at 65, in order to protect those with the lowest life expectancies. We think this is an issue that must be considered nearer the relevant time in the light of the available evidence about inequalities in life expectancy and trends in working among older people. More detail about demographic trends in relation to different social groups is contained in Annex D.

Reforms to the State Second Pension

3.43 On top of the basic State Pension, many people are accruing a second tier of state pension, through the State Second Pension, which replaced SERPS in 2002.

3.44 The State Second Pension has given many people, particularly women and carers, access to an additional pension for the first time. Currently those bringing up children under the age of six, certain carers and people with a long-term disability are all credited into the State Second Pension at a flat rate of around £1.20 a week at retirement for every year worked or credited, with those earning above the Lower Earnings Threshold (£12,500 a year) accruing some earnings-related provision on top.

3.45 The State Second Pension has also helped those on low incomes by treating anyone earning over the Lower Earnings Limit (£4,368 a year) but earning below £12,500 as if they earned at this higher level. In addition, the rate at which the pension accrues at £12,500 has been doubled under the State Second Pension, making the scheme far more redistributive than SERPS (1978–2002).

3.46 But while the Government will this year spend £19 billion on the State Second Pension, or its contracted-out equivalents through the rebates, this aspect of the system is poorly understood. Few people are aware of it at all, and even fewer of how their entitlement to it builds. Many people are building entitlement to the State Second Pension without even being aware that they are doing so.

3.47 The beginning of this chapter made clear that, in the face of an ageing population and the need for the state system to provide a foundation for people's savings, the State should move away from the direct provision of pensions related to individuals' earnings and concentrate on flat-rate provision in the future. The introduction of the new personal accounts scheme will mean that for the first time everyone will have access to a genuinely low-cost private savings vehicle. We do not want the State Second Pension to duplicate this, which is why we are able to reinforce and speed up its change in focus to a flat-rate top-up benefit for years spent working, caring or parenting.

3.48 Accruals will start to become flat rate more quickly at the same time as we start to uprate the basic State Pension by earnings. We estimate that the State Second Pension will become completely flat rate in around 2030, or shortly afterwards.

3.49 Some people have argued that providing a flat-rate State Pension should entail a move to a single-tier State Pension, perhaps at the level of the Guarantee Credit – often referred to as the Citizens' Pension. However, we believe that we can achieve a better outcome through our reforms. We will create a simple, flat-rate system which gets most people over the level of the Guarantee Credit, but we will be able to do this more quickly and at less cost.

Box 3a: Why not a Citizens' Pension?

The Pensions Commission considered the case for an Enhanced State Pension, similar in design to the Citizens' Pension proposed by the National Association of Pension Funds.

Although models for a Citizens' Pension vary in detail, the underlying proposition is a flat-rate pension set at the rate of the Guarantee Credit and uprated in line with earnings. It would be paid to new and existing pensioners. Both the Savings Credit and the State Second Pension (and contracting out) would be withdrawn as soon as the Citizens' Pension was in place.

The Government recognises the attractive simplicity that could in theory be achieved through a Citizens' Pension. We have thoroughly examined the Pensions Commission's response to the proposition and tested alternative approaches to achieving a single flat-rate pension.

Like the Commission, we have concluded that the complexity and expense of gradual transitional approaches to a Citizens' Pension are too great – the prize of simplicity would be lost.

The alternative, 'big bang', implementation where the new system immediately replaces the old is more plausible than gradual transition methods. However, the Government again agrees with the Pensions Commission's findings that a modified two-tier system provides the most practical and safe approach.

The costs of introducing a Citizens' Pension overnight are immediate and substantial. If an Enhanced State Pension were introduced in 2010, the Pensions Commission estimates that it would cost an additional £14 billion in the first year. This would increase to £25 billion by 2015 and would peak at £60 billion (2.2 per cent of GDP) around 2040, before falling back to £39 billion (1.2 per cent of GDP) by 2050. This is clearly unaffordable and would put the stability of public finances and the viability of pension reform at risk. It is implicit in these costs that the preserved rights that workers have built to SERPS and the State Second Pension (and contracting out equivalents) are paid on top of the Citizens' Pension.

Box 3a: Why not a Citizens' Pension? *(continued)*

Moreover, many poorer pensioners would see little change in their circumstances and, unless transitional protection was applied, could lose income because of the withdrawal of the Savings Credit.

The Pensions Commission therefore examined a more complicated but less expensive model which reduced costs, and tackled the regressive distributional effects of the model above.

Their revised model introduced an 'offset' arrangement whereby pensioners would be paid the better of what they had built up under the previous system or the new pension. In practice this means that any accrued State Second Pension rights would be offset against the Citizens' Pension – so that people would get either what they had built up under the old arrangements or the new pension set at the level of the Guarantee Credit, whichever was greater.

The Pensions Commission considered that this would be too difficult to implement because of the complexity of applying the offset to the many different types of rights people have built up under the current system. People would not have a clear idea of what the State would provide.

Furthermore this offset method would still result in a considerable immediate increase in expenditure. Costs using the offset arrangements would be an additional £10 billion in 2010, and £8 billion in 2015. Costs would peak at 0.9 per cent of GDP around 2040, falling back to 0.3 per cent GDP by 2050.

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

The Pensions Commission concluded, as does the Government, that – starting from where we are now – a two-tier system is preferable to a single-tier pension. A two-tier system has greater flexibility, there is public attachment to the basic State Pension and a two-tier system avoids the transitional complexity of one tier and the risks associated with an immediate cessation of contracting out.

3.50 We therefore plan to accelerate the way in which accruals in the State Second Pension are becoming flat rate. This benefit will be protected against rises in average earnings during accrual, and then against inflation once in payment. Combined with a basic State Pension linked to earnings, this will produce a total State Pension that is uprated partly by earnings and partly by prices in payment, as recommended by the Pensions Commission. Under the new benefit, each year of work, parenting or caring will effectively top up the State Pension by at least £1.20 a week at retirement in average earnings terms.

3.51 This proposal is in line with the recommendation of the Pensions Commission to move to a flat-rate State Second Pension by 2030 – though we extend coverage of the State Second Pension from 2010 to bring in more people with lower earnings and more carers through our coverage reforms outlined later in the chapter.

3.52 Together with our measures to increase coverage in the basic State Pension, outlined later in this chapter, this will mean that, after 40 years of work or credits, a low earner can expect to build up an additional top-up of around £60 a week. Coupled with their basic State Pension entitlement, this will give a total State Pension at retirement of around £135 a week in today's earnings terms.

Entitlement for the self-employed

3.53 The Pensions Commission recommended that the Government investigate the possibility of extending coverage of State Second Pension to the self-employed on a voluntary basis. The Commission's suggested mechanism for achieving this was through the introduction of age-related National Insurance contributions.

3.54 The Government accepts that any consideration of the self-employed becoming entitled to the State Second Pension would need to include age-related contributions. Setting a standard rate in a voluntary system could mean that the young are overcharged (they are more likely to get a better return in a private pension) and older workers undercharged.[4] Given that the young would be unlikely to join the scheme because it would not be worthwhile, other National Insurance payers would have to subsidise older workers entering at what would effectively be a cheap rate. (Because State Second Pension is compulsory for employees throughout a working life a standard rate can be charged without the need for age-related contributions.) However, age-related contributions are probably too expensive for most older low paid workers to consider.

[4] The State Second Pension is a defined benefit – each year of contributions buys a set amount of weekly pension (though a younger person will have to wait longer to receive the money). But in private pensions, a younger worker's investment has the benefit of many years of investment growth and interest.

3.55 We share the Pensions Commission's own concerns that

"… the complexity of age-specific contribution rates and the higher level required later in life, might make voluntary membership of State Second Pension unattractive for many self-employed."

3.56 The Government is unable to reconcile these issues and is reluctant to commit taxpayers' money to setting up a speculative scheme where enrolment may be low. Nor does the Government wish to introduce a scheme exclusively for self-employed people with only low profits. Profits from self-employment can fluctuate year on year, which would result in people being included and then excluded. Such a scheme would have arbitrary cut-off points and would have to have numerous exclusions and exceptions (for instance, someone in part-time self-employment who had other earnings or a large occupational pension).

3.57 A further factor when considering scheme development is that the average duration of self-employment is around eight years. For many earners, who move from employment to self-employment and back again, it is unlikely that a period out of the State Second Pension would have a significant impact on their retirement income.

3.58 The introduction of personal accounts, described in Chapter 1, will bring in new arrangements to enable the self-employed to build a second pension. On balance, the Government believes that the State Second Pension should not be extended to the self-employed.

Pension Credit

Guarantee Credit

3.59 Pension Credit is made up of two elements. The first, the Guarantee Credit, ensures that no one aged 60 or over need live on an income below £114.05 a week (£174.05 for couples). Pension Credit is the successor benefit to the Minimum Income Guarantee (MIG), both of which have risen in line with average earnings growth since 1999. The Guarantee Credit is payable to people aged 60 or over, rising to 65 or over with the equalisation of State Pension age for men and women between 2010 and 2020.

3.60 The Government has committed to uprating the Guarantee Credit in line with earnings until 2008. We can now announce an intention to continue this uprating strategy over the long term. This will ensure that the gains we have made against pensioner poverty are secure into the future. As now, the Guarantee Credit will provide a guaranteed minimum level of income in retirement for those who have been unable to provide adequately for their own retirement. It will also provide a higher income for people with severe disabilities and other specific groups.

Savings Credit

3.61 The second element to Pension Credit is the Savings Credit, available to people aged 65 and over. This ensures that those low and moderate earners who have modest savings for retirement over the level of the basic State Pension benefit from their savings. The operation of the Savings Credit is described in more detail in Box 3b.

Box 3b: The Savings Credit

The Savings Credit rewards people aged 65 and over (or who have a partner of that age) who have made some additional provision for their retirement, for example through a second pension or capital assets. It applies to all those with modest incomes over and above the value of the full basic State Pension which for 2006/07 is £84.25 for a single person and £134.75 for a couple.

The Savings Credit accrues at the rate of 60p for every pound of qualifying income above the threshold, up to a maximum of £17.88 for a single person and £23.58 for a couple. People with income above their guarantee level (which is the standard Guarantee Credit of £114.05 a week for single people or £174.05 a week for couples plus any additional amounts payable for severe disability, caring responsibilities, and/or housing costs) will have their Savings Credit reduced by 40p for every pound of income above that level. This means that pensioners with income up to £159 a week (£233 a week for couples) can qualify. Some, including severely disabled people and carers, will be able to qualify if their incomes are higher than this.

Box 3b: The Savings Credit *(continued)*

The maximum Savings Credit award is set at 60 per cent of the difference between the basic State Pension and the Guarantee Credit. The gap between these two has been widening as one increases with average earnings and the other increases by less. Because it draws momentum from both, the maximum Savings Credit grows faster than either of these uprating factors in isolation, which means it grows faster even than the Guarantee Credit, and therefore faster than earnings.

If current uprating policies were pursued indefinitely, an increasing proportion of the pensioner population would be entitled to the Savings Credit. It has never been the Government's intention that a significant majority of the pensioner population would, in the long term, be eligible for Pension Credit. Our reforms confirm this.

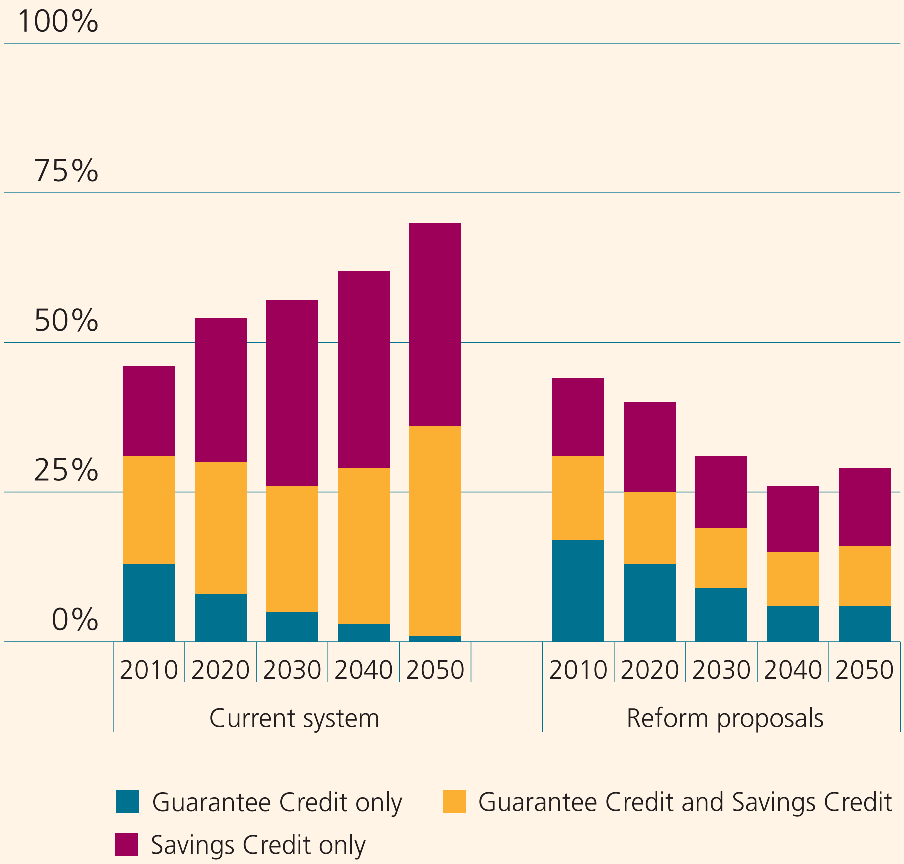
3.62 To ensure that, before implementing the earnings link of the basic State Pension, means-tested provision continues to be focused on those with small savings, we will take steps from 2008 to target the Pension Credit on this group.

3.63 We think this is reasonable because the State Second Pension has, since 2002, provided generous provision for low-paid employees. Those who earn between the National Insurance contribution Lower Earnings Limit and £12,500 a year (and those credited in) accrue a pension at a flat rate as though they were earning £12,500 a year and at twice the old SERPS accrual rate. This means low-paid employees get a more than fair return on their contributions. This must, over time, influence the design of the Savings Credit.

3.64 The Savings Credit will continue to reward people who make provision for their retirement. However, as State Second Pension matures, more and more people will have built up State Second Pension entitlement. We agree with the Pensions Commission's assessment that the starting point for calculation of the Savings Credit should be raised as this happens. From 2008 we will uprate the lower threshold of the Savings Credit by earnings. From 2015 the maximum Savings Credit will be frozen in real terms.

3.65 The impact of this, alongside our reforms to the structure and coverage of the other aspects of the State Pension and the introduction of a low-cost scheme of personal accounts, will be a considerable reduction in the numbers of people whose entitlements will be means-tested in the future. Under current uprating policies projected forward, around 70 per cent of pensioner households will be entitled to some Pension Credit by 2050. Under our reforms, that figure will be reduced to around a third. This will further help to clarify people's savings decisions and retirement planning. Figure 3.v shows how entitlement to Pension Credit is projected to develop into the future under current policy and after the reforms to the state pension system.

Figure 3.v Proportion of pensioners eligible for Pension Credit over time



Source: DWP projections, using micro-simulation modelling

Notes: The estimates indicate that over time the reform proposals will reduce the proportion of pensioners eligible for Pension Credit, although the size of the reduction is sensitive to the modelling assumptions and projected changes in the distribution of pensioner incomes.
The estimates shown here are the mid-points of projections taken from two separate micro-simulation models. Modelling of reform proposals does not include any increase in private saving from the introduction of personal accounts, which would further reduce the numbers eligible for Pension Credit.
Projections under current policies are consistent with the long-term expenditure projections for Pension Credit.
Projections under reform will depend on the policy detail. This chart illustrated outcomes based on a 2012 start date for earnings uprating of the basic State Pension and setting the saving credit in earnings terms from 2008 and then real terms from 2015. As paragraph 37 of the summary sets out, our objective, subject to affordability and the fiscal position is to uprate basic State Pension by earnings from 2012 but in any event at the latest by the end of the Parliament. We will make a statement on the precise date at the beginning of the next Parliament.

Tax-benefit integration

3.66 Since 1997 the Government has reformed Britain's tax and benefit systems to achieve three overarching objectives: to ensure adequate financial incentives to work and save; to reduce child poverty and increase financial support for all families; and to tackle poverty among the current generation of pensioners and support people in providing for their retirement.

3.67 In the past the tax and benefit systems failed to address the challenges of poverty and incentives to work and save for retirement. The Government has brought forward a series of reforms designed to bring the tax and benefit systems closer together. Taken together, the Government's policies to modernise the tax and benefit systems constitute the most fundamental reform of those systems since the 1940s. For pensioners this has meant, alongside the introduction of the Pension Credit, additional resources to raise the age-related personal allowances in Income Tax, designed to lift more pensioners out of Income Tax and ensure that most taxpaying pensioners benefit. In 1999, and again in 2003, additional resources were used to give step increases in the level of these allowances, and exceptionally between 2001 and 2005 the age-related Income Tax allowances were indexed in line with the rise in average earnings.

3.68 In the light of the proposed reforms to the state pension system set out in this paper, the Government will continue to consider the potential gains from greater tax and benefit integration in terms of improving financial incentives to work and save and providing greater simplicity for pensioners.

A new contributory principle – the proposals in detail

3.69 The pension system of the 1950s and 1960s sought to provide some protection of pension entitlements for women by allowing wives to draw on the contribution records of their husbands.

3.70 Reforms since the 1970s have had a dramatic and very positive impact on the pension entitlements of women and carers. The introduction of HRP in 1978 meant that the vital contribution made to society by those caring for children was recognised for the purposes of building entitlement to a pension. Since that time, years spent caring for children under 16 have counted for the purposes of building entitlement to the basic State Pension, but usually only for complete years.

3.71 The introduction in 2002 of the State Second Pension as a successor to SERPS meant, for the first time, that some caring responsibilities were reflected not only in basic State Pension entitlement but also in access to a second pension. Each year 1.9 million carers, mostly women,[5] are now credited in to the State Second Pension as if they were earning £12,500 per year. Those earning above £12,500 will continue to accrue some earnings-related provision until around 2030.

3.72 There remains, however, a generation of women aged over 45 who can expect to reach State Pension age with significantly lower amounts of basic State Pension than men. The immediate issue is tackling the inequality for this generation of women who may have missed out on the full impact of HRP but also may have not returned to or kept in touch with the labour market in the way younger women have.

3.73 There is a widespread consensus about the need to act to counter the inequalities that currently exist between men and women in state pension entitlement. In a recent survey almost four out of five people thought that carers of sick or disabled relatives should get the same amount of state pension as someone who had worked all their life.[6] Many approaches to achieving better state pensions for women have been suggested. The Pensions Commission proposed a residence test.

3.74 We agree with the Pensions Commission that a two-tier system is still the best way forward but that the basic State Pension as a near universal underpin is the right foundation on which to build and on which to encourage private saving.

3.75 We do not agree that the solution to inequality lies in moving all or part of the entitlement rules onto a residency basis. The reasons for this view are outlined in more detail in Box 3c. But the key reason is a belief that the contributory principle promotes personal responsibility and positively rewards people's contributions to society.

[5] Source: Lifetime Labour Market Database (a 1 per cent sample of NIRS 2 data). Data relate to 2003/04 and include all those in the UK, and those accruing the contracted-out equivalent.

[6] *BMRB Omnibus survey,* February 2006.

Box 3c: Why not a residence test?

Our core objection to a residence test is one of principle. *A new deal for welfare: Empowering people to work* reaffirmed our view that our system of welfare should be based on the recognition that with rights come responsibilities.

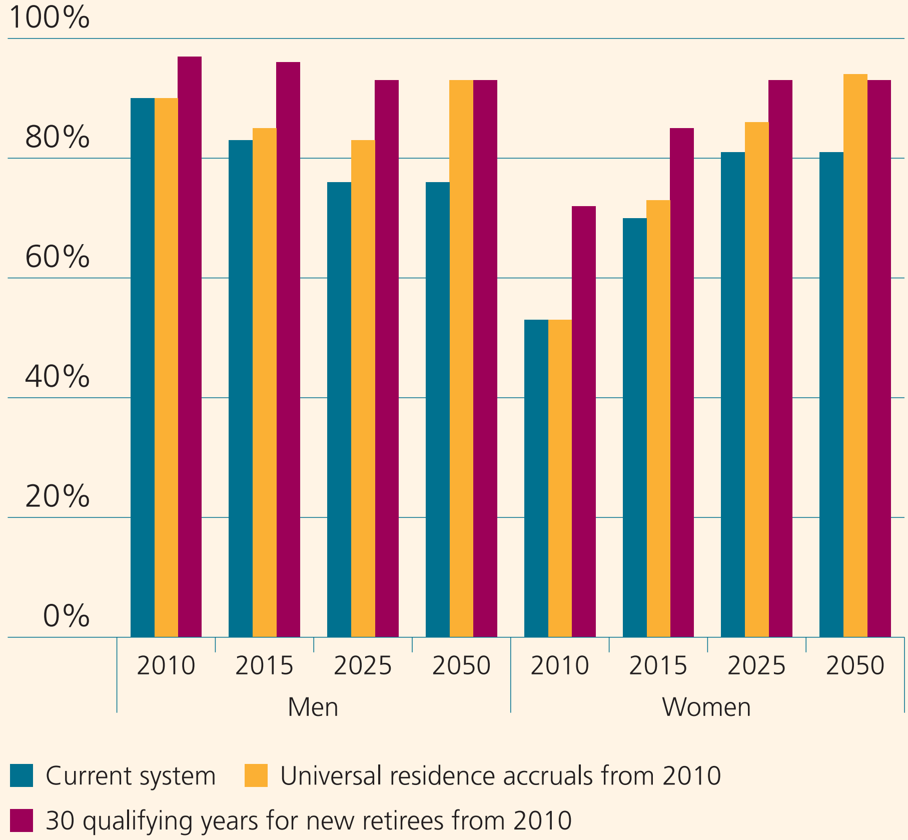
The Government believes it is right for people to receive state pensions in return for making economic or social contributions during their working lives. We do not think it is fair to recognise people for State Pension purposes purely on the basis of residence while others are contributing to society through working and caring.

But there are also more practical and operational concerns with a residence test. These are set out below.

- There is **no established system for recording residence retrospectively outside those under the existing tax and benefit systems**, and these systems do not cover all members of the population. A residence test could only be introduced for new accruals. As part of the EU, the UK also has significant movement of people in and out of the country, for example to work abroad, and is subject to reciprocal social security agreements both with other European Economic Area countries and through bilateral agreements.
- Under the sort of residence test proposed by the Pensions Commission, the impact of the changes takes many years to make a difference. We believe our reforms to the contributory system have **more radical and immediate effects** than a move to a residence test for future accruals, as shown in Figure 3.vi.
- A long residency test would have the best chance of excluding or minimising the entitlement of those with little connection to the UK. But too long a test would not significantly improve outcomes, leaving many people without a full basic State Pension. A short test may improve outcomes but would carry a greater **risk of fraud or abuse**. Some people could spend a relatively modest number of years in the UK yet accrue a substantial proportion of a UK pension which would then be exportable, and payable, for the rest of their life.
- Introducing a residence test for future accruals would mean running both residence-based and contributory entitlements to the basic State Pension in parallel for the next 45 years (if using the Pensions Commission proposal) and running an ongoing contributory system for State Second Pension beyond that. This **would make the system more complicated**, and make it more difficult for people to predict with confidence what their entitlement would be in the future, and thus become a disincentive to save.
- Residency is **not necessarily any more effective** at increasing coverage to state pensions than our reforms are. Depending on the design of the residence-based pension, both could mean that around 95 per cent of people receive full basic State Pension entitlement in the long term. However, a residence-based scheme for new accruals would take longer to reach this level.

Box 3c: Why not a residence test? *(continued)*

Figure 3.vi Percentage of people reaching State Pension age with full basic State Pension under different schemes



Source: Based on projections from Government Actuary's Department's Retirement Pension Model, GB. Estimates for residence accruals are necessarily an approximation only.

The Pensions Commission also proposed an immediate and retrospective universal basic State Pension based on residency to the over-75s. Our analysis suggests that there would be few real gainers among the low- to moderate-income brackets, with higher basic State Pension entitlement largely just displacing Pension Credit entitlement. Yet there would be high costs.

3.76 This section sets out a number of reforms to elements of the contributory principle in order to ensure that a greater range of social contributions is recognised for the purposes of building rights to state pension entitlement.

Reducing qualifying years for a full basic State Pension

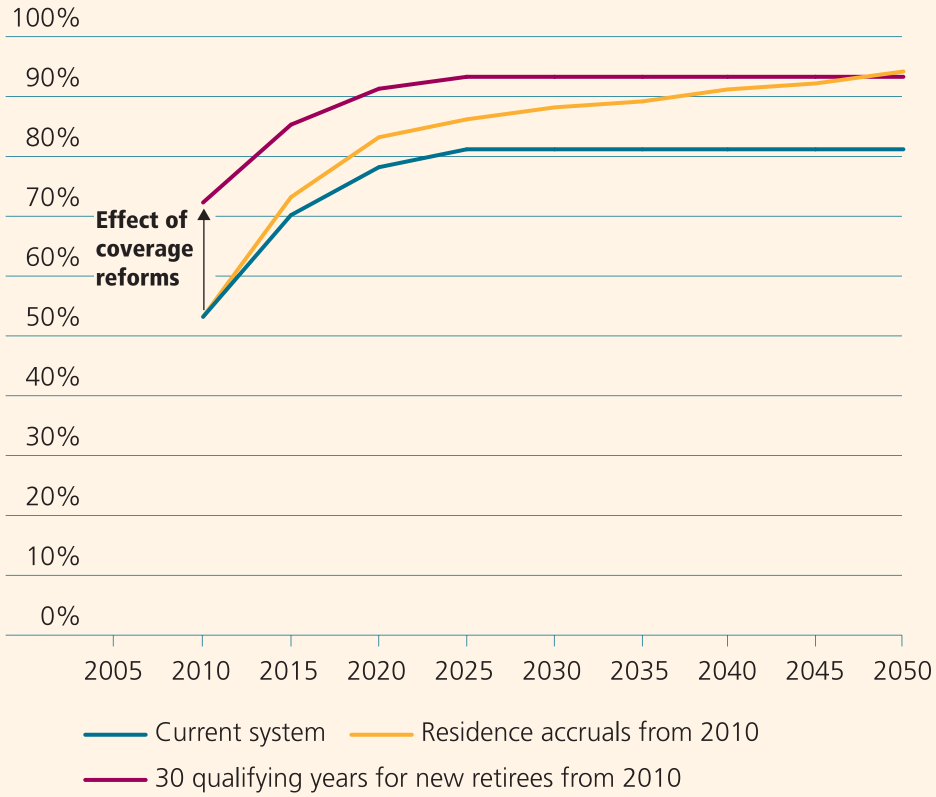
3.77 The Government proposes that the number of qualifying years required to achieve a full basic State Pension be reduced from 44 for men and 39 for women to 30 years on an equal basis. This reform offers the appropriate balance between the need for modernisation of the conditions for entitlement to the basic State Pension with the objective of retaining the contributory basis of the system. Figure 3.vi shows the impact on pension outcomes for those reaching State Pension age after April 2010.

Why 30 qualifying years?

3.78 We want to maintain the link between the basic State Pension and contributions to society. However, the current number of qualifying years excludes some people who have contributed during their working lives from the right to a state pension. Today's society is one where both men and women combine work and caring, and undertake higher or further education. Reducing the qualifying years required for a full basic State Pension gives these people the opportunity to build rights to a full basic State Pension, while not diluting the contributory basis of the system.

3.79 Under the current system, women aged 45 or over today are projected to have state pension entitlements which are, on average, projected to lag significantly behind those of men for around the next 20 years. Under our reforms this critical group will receive better state pension outcomes in their own right. A residence-based approach for new accruals would not help this group build up a much better basic State Pension. Outcomes under our proposals mean that over 90 per cent of women reaching State Pension age will get a full basic State Pension by 2025, but under the model proposed by the Pensions Commission the same outcomes would not be achieved much before 2050. Up to an extra 270,000 women will be getting a full basic State Pension by 2020 under our proposals – possibly in the region of 200,000 more than under a residence-based scheme. Figure 3.vii shows the proportion of women reaching State Pension age with full basic State Pension under our reforms and under a residence-based system.

Figure 3.vii Percentage of women reaching State Pension age with full basic State Pension under different schemes



Source: Based on projections from the Government Actuary's Department's retirement Pension Model, GB. Estimates for residence accruals are necessarily an approximation only.

Notes: Under residence accruals, 44 years are required for a full basic State Pension. Women's entitlement is based on their own and their husband's contributions.

Converting HRP into a positive credit

3.80 HRP was introduced in 1978 to assist people who have caring responsibilities, and are either not in paid employment or have low earnings, to build entitlement to basic State Pension. It also helps protect entitlement to certain bereavement benefits for the carer's spouse or civil partner.

3.81 However, it is not widely understood, can be inflexible and it is difficult to determine whether the HRP recipient will qualify for a full basic State Pension until they reach State Pension age. In particular, for reasons explained in Annex B, women have lost out because only full years can be recognised for state pension purposes, and therefore periods shorter than this where caring has been undertaken do not count towards their basic State Pension.

3.82 We therefore plan to replace the system of HRP with new weekly National Insurance credits for care of children (where there will remain a link with Child Benefit) until the youngest child turns age 12. These changes will make it easier for recipients to understand their entitlement and make informed choices about working and saving for retirement.

3.83 The credits will be aligned to allow those caring for children up to the age of 12 to receive both basic State Pension and State Second Pension. Currently entitlements to State Second Pension are only given to those caring for children up to the age of 6, whereas in basic State Pension they are given to those caring for children up to the age of 16. Moving to age 12 could be perceived as making entitlements for parents less generous from 2010 as we are removing the opportunity to gain credits for four years of a child's upbringing. However, our reduction in the required number of qualifying years to 30 for a full basic State Pension means that we are reducing the number required for women by nine years.

3.84 Aligning credits for care of children up to the age of 12 should mean around an additional 780,000 women and 30,000 men will be accruing State Second Pension entitlements. Moving to age 12 is also consistent with Working Age initiatives to encourage lone parents to take steps into the labour market as their children reach secondary school age.[7]

3.85 Foster carers have only been able to protect their basic State Pension entitlement by applying for HRP since 2003. We propose to bring them into State Second Pension, again by application, from 2010 through the new crediting arrangements.

3.86 We plan to introduce transitional arrangements to ensure that any period of childcare undertaken before the reforms are implemented which would qualify for HRP under the existing rules of the scheme will be preserved, but converted into the new, more generous credits.

Combining contributions with credits to get a qualifying year for State Second Pension[8]

3.87 Currently a person can build up entitlement to State Second Pension through the award of credits with certain benefits.[9] However, these benefits must normally be awarded over a complete tax year in order to get State Second Pension. It is not possible to be eligible for State Second Pension through a combination of credits from benefits or with contributions from earnings in any single tax year.

[7] The employment rate for lone parents (LP) with a youngest child aged 0–5 is 39.1 per cent, and for those with a youngest child aged 0–11 it is 50.1 per cent. For LPs with a youngest child aged 12 and over it is 71.1 per cent. The 12 and over category includes those with a youngest child aged 16–18 as long as that child is in full-time education. Source: *Labour Force Survey*, spring 2005.

[8] Currently either earnings equivalent to 52 weeks of the Lower Earnings Limit or credits are required to obtain a year of State Second Pension accrual.

[9] Child Benefit in respect of a child under age 6, HRP while looking after a sick or disabled person, Incapacity Benefit or Severe Disability Allowance (subject to the labour market attachment test), Carer's Allowance (or an underlying entitlement to it); or a tax year in which they have reckonable earnings equivalent to 52 weeks at the Lower Earnings Limit.

3.88 We propose to move from the current system of annual credits in the State Second Pension to weekly credits. This will provide more flexibility, enabling people to combine credits and paid contributions during a tax year to build up a year of State Second Pension. It ensures that we are recognising social contributions and earnings equally for the purposes of state pension entitlement and consistently in both tiers of the State Pension.

A new credit for carers

3.89 The introduction of Carer's Allowance has helped recipients build up entitlement to the basic State Pension since 1976.[10] Recipients have also been able to get State Second Pension from 2002. Around 440,000[11] people, caring for 35 hours a week or more, are receiving Carer's Allowance.

3.90 Carer's Allowance is awarded to those who:

- do not earn above a set limit (£84); and
- provide regular and substantial care, that is for 35 hours or more; and
- care for one severely disabled person receiving the middle or highest rate of Disability Living Allowance care component, Attendance Allowance, or the equivalent rates of Constant Attendance Allowance.

3.91 While Carer's Allowance and HRP[12] provide comprehensive cover, they only do this for people who are effectively full-time carers – those who would have most difficulty engaging in the labour market. Those caring for less than 35 hours or for more than one disabled person are not recognised and we know that some caring responsibilities can compromise an individual's ability to work and build up a state pension.

3.92 *Women and pensions: The evidence* reported that employment rates of carers looking after someone for more than 20 hours a week are significantly lower across all age groups.[13] Additionally, those caring for more than 20 hours a week are more likely to suffer disadvantages from caring in terms of their health or other aspects of their life.[14]

[10] The predecessor to Carer's Allowance, Invalid Care Allowance, was first payable in 1976.

[11] 440,000 people were receiving Carer's Allowance at November 2005.

[12] Those caring for 35 hours or more not entitled to Carer's Allowance may apply for HRP, and Income Support recipients who are caring are automatically awarded HRP. (See Annex B for more detail.)

[13] *Family Resources Survey*.

[14] Maher and Green, 2002, analysing General Household Survey 2000.

3.93 The Government now proposes that people who undertake care for the severely disabled for 20 hours or more a week should become entitled to credits for both basic State Pension and State Second Pension. We estimate that around 70,000 people a year could gain a credit for basic State Pension from this proposal, and over half of these will be women. The new credit for those caring for 20 hours or more should mean around 110,000 more women and 50,000 more men will be accruing entitlements to State Second Pension.

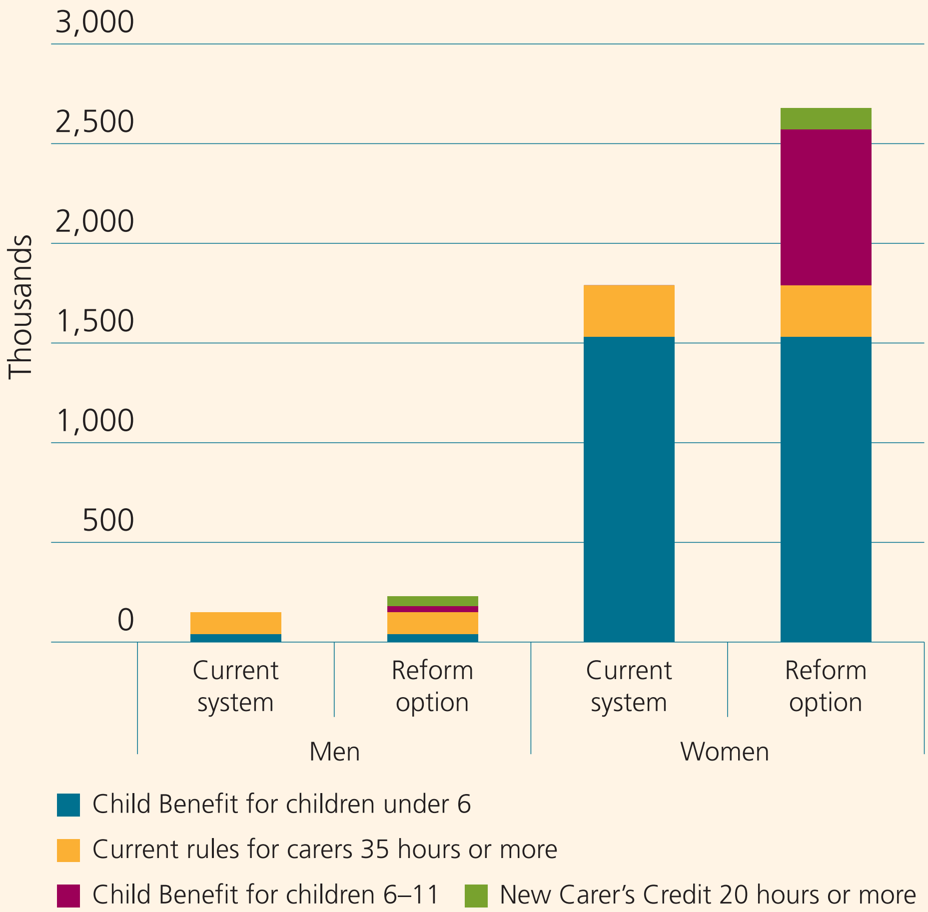
3.94 A system of certification will be required to claim the new credits. We will consult with key stakeholders on the most effective way to implement the new arrangements for those reaching State Pension age from 2010. We propose that the new crediting arrangements for carers, including the replacement of HRP with a weekly credit and the introduction of a new carer's credit, will apply to bereavement benefits.

Findings from the National Pensions Debate: extending coverage

Proposals to increase entitlement for carers accords well with the public's view of the principles on which an additional State Pension should be based. At the National Pensions Day, participants were asked to give their views on what should count towards the State Second Pension. The majority believed that paid work, voluntary work, caring for children, caring for the sick, elderly or disabled and time spent long-term sick or disabled and unable to work, should count towards the State Second Pension. Of these, people agreed most strongly that paid work and caring for the sick, elderly or disabled should count.

3.95 The more generous crediting arrangements will mean up to 1 million more individuals (around 90 per cent of which are women) will be accruing State Second Pension credits in a given week – which should feed through to higher State Second Pension entitlements in retirement. Figure 3.viii shows the numbers accruing State Second Pension before and after changes to coverage.

Figure 3.viii Numbers credited into State Second Pension before and after changes to coverage



Source: Family Resources Survey average 2003–2005

Note: Lower Earnings Limit is assumed to be £82 per week in 2004/05, £79 per week in 2003/04 and £77 per week in 2002/03 cash terms.
The Family Resource Survey asks respondents about their activity in a given week. Fifty-two weeks of State Second Pension accrual are needed for one qualifying year of State Second Pension. The survey is therefore likely to overestimate the number accruing a year's worth of accrual, as some weeks of accrual may be missed during the year.

Ensuring that every year counts

3.96 Currently, to build up any entitlement to basic State Pension a person must satisfy two National Insurance conditions of entitlement. The first is satisfied through having earnings over the Lower Earnings Limit or by paying Class 2 or Class 3 contributions to make one qualifying year. The second is that they must then have at least 25 per cent of the number of qualifying years required for full basic State Pension – generally the equivalent of a further nine (for women) or ten (for men) qualifying years. This entitlement condition is known as the '25 per cent *de minimis* rule'.

3.97 These rules mean that small numbers of people have no entitlement to basic State Pension despite having up to nine years of contributions or credits. The two conditions of entitlement are more likely to affect some ethnic minority women who may feel or face cultural barriers to participating in paid work. Those women in this position usually contribute to society in other ways, such as through childcare or care of severely disabled people.

3.98 The Government proposes that the two conditions of entitlement are abolished. Up to 100,000 people a year reaching State Pension age could benefit from this.[15] These reforms underpin the other changes we are making to broaden the coverage of state pensions and in the context of the overall reform package – which includes more obvious recognition of caring responsibilities – they will have a far greater positive effect.

3.99 In State Second Pension there is no *de minimis* rule equivalent to that in the basic State Pension. There is however a 'labour-market attachment test'. The test applies to long-term Incapacity Benefit recipients in respect of entitlement to additional State Pension.

3.100 The test requires that a long-term sick or disabled person must have paid, or be treated as having paid, Class 1 National Insurance contributions for at least one-tenth of their working life since 1978 (when additional State Pension through SERPS was first introduced). For example, a person reaching State Pension age in 2005/06 would have a working life of 27 years since 1978 and would have needed to have worked and paid Class 1 National Insurance contributions for three years (one-tenth of 27 years rounded to the nearest whole year) in order to receive entitlement to State Second Pension.

3.101 We propose to remove this complex procedure from 2010.

Abolishing the adult dependency increase

3.102 The state pension system includes provision for a man or woman's state pension to be increased if another adult is financially 'dependent' on him or her. These increases are known as adult dependency increases (ADIs) and have their origins in the immediate post-war period where single breadwinner households were the norm. We propose that ADIs will no longer be awarded from 2010. Annex B sets out in detail our proposals for abolishing ADIs.

Autocredits

3.103 Since April 1983, National Insurance credits – known as 'autocredits' – have been available to men aged 60 to 64. They were introduced in 1983 as a response to high unemployment alongside the ending of the requirement that men aged 60 or over had to register as unemployed to qualify for Supplementary Benefit.

[15] This figure includes overseas cases, some of which benefit from reciprocal agreements.

3.104 In 1993, it was proposed that autocredits should become available to women, on the same basis as currently applies to men, as female State Pension age was increased from 60 to 65 between 2010 and 2020.

3.105 In developing our proposals for reform of the state pension system, we have reconsidered the rationale for these credits. Our conclusions are that:

- they are out of step with other measures the Government is taking to encourage people to extend their working lives to their full capacity; and
- under our proposals to widen access to the basic State Pension they will become largely redundant.

3.106 We therefore propose that they should be phased out in line with the increase in women's State Pension age between 2010 and 2020.

Impact on Working Age benefits

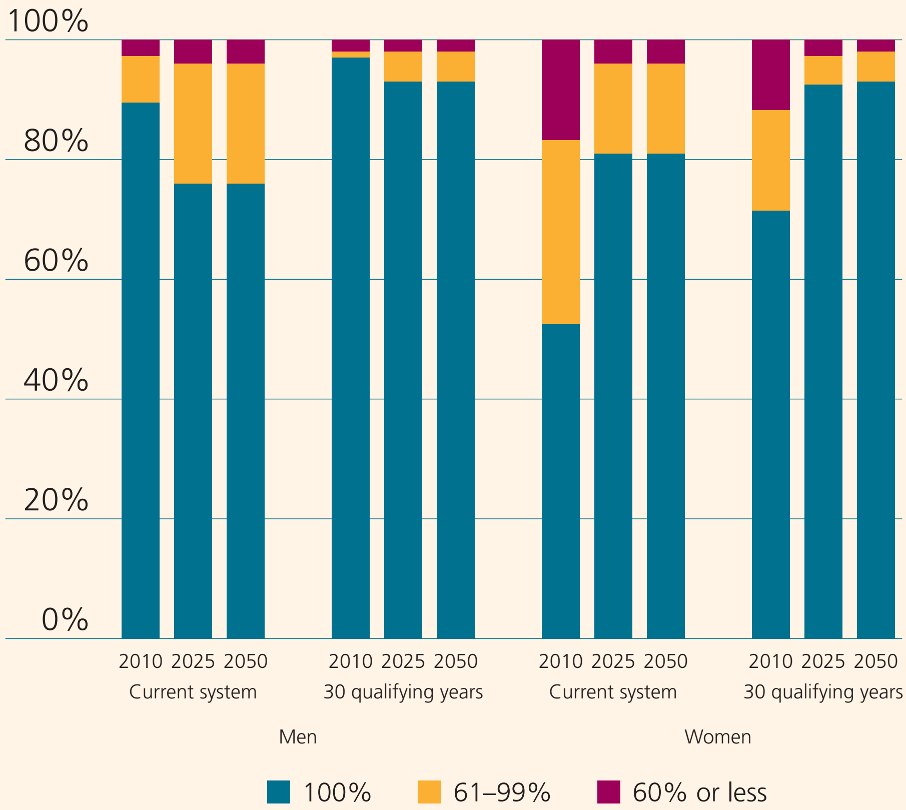
3.107 This paper sets out the reforms we are proposing for pensions. People of working age have different needs and responsibilities. Any changes to their current arrangements will form part of our long-term aim to simplify the benefit systems for people of working age announced in the consultation document *A new deal for welfare: Empowering people to work*, published in January.

3.108 We do, however, seek views on the crediting arrangements for the State Second Pension following the proposals in *Empowering people to work* to replace incapacity benefits with Employment and Support Allowance (ESA) from 2008. These arrangements could be as now, with entitlement to credits beginning after 52 weeks of claiming ESA, after the 13 week assessment phase, or credits could be restricted to those entitled to the Support component only.

Outcomes

3.109 Today around 30 per cent of women and 85 per cent of men reaching State Pension age are entitled to a full basic State Pension. By 2010 only around 50 per cent of women reaching State Pension age are expected to be entitled to a full basic State Pension compared with around 90 per cent of men. Introducing our reforms for those reaching State Pension age from 2010 will mean around 70 per cent of women reaching State Pension age in 2010 will have a full basic State Pension entitlement. By 2025 over 90 per cent of women and men reaching State Pension age are expected to get full basic State Pension entitlements compared with around 80 per cent if we do nothing. Figure 3.ix shows the impact of our reforms to the basic State Pension entitlements for new retirees in 2010, 2025 and 2050.

Figure 3.ix Percentage of people reaching State Pension age with different proportions of the full rate of basic State Pension



Source: Projections from Government Actuary's Department's Retirement Pension Model, GB

3.110 Importantly, these reforms taken together will see more people, especially women, building up entitlement in their own right, on the basis of their own actions. This will allow us to sweep away some of the complex and often outmoded rules that exist within the state pension system.

3.111 This chapter has set out how we will reform the structure of the state pension system and increase coverage of the state pension to address inequalities in order to provide a foundation to private savings. The next chapter goes on to look at working longer as an integral part of our reforms to meet the pensions challenge.

Chapter 4: Extending working life in an ageing society

Chapter 4: Extending working life in an ageing society

Summary

We are living longer – something that we should celebrate, but which also raises challenges for individuals and for society in how we support an ageing population. As a key part of our response to these challenges, we must enable and encourage people to work longer. Higher employment will sustain national wealth, while longer working provides a greater opportunity for people to build provision for their retirement through private saving.

Significant progress towards increasing the number of older workers has already been made. Employment rates for older workers have increased steadily since 1997, and over 1 million people are now working after State Pension age. But more needs to be done to change the culture and behaviour surrounding retirement.

We will, therefore, bring forward further measures to address the key barriers which prevent people staying in work for longer, and encourage more people to work up to and beyond State Pension age:

- enabling greater flexibility to allow people to choose a phased approach to retirement;
- providing improved communications and information in support of longer working; and
- working in partnership with employers to encourage them to retain older workers, and to offer them greater flexibility around retirement.

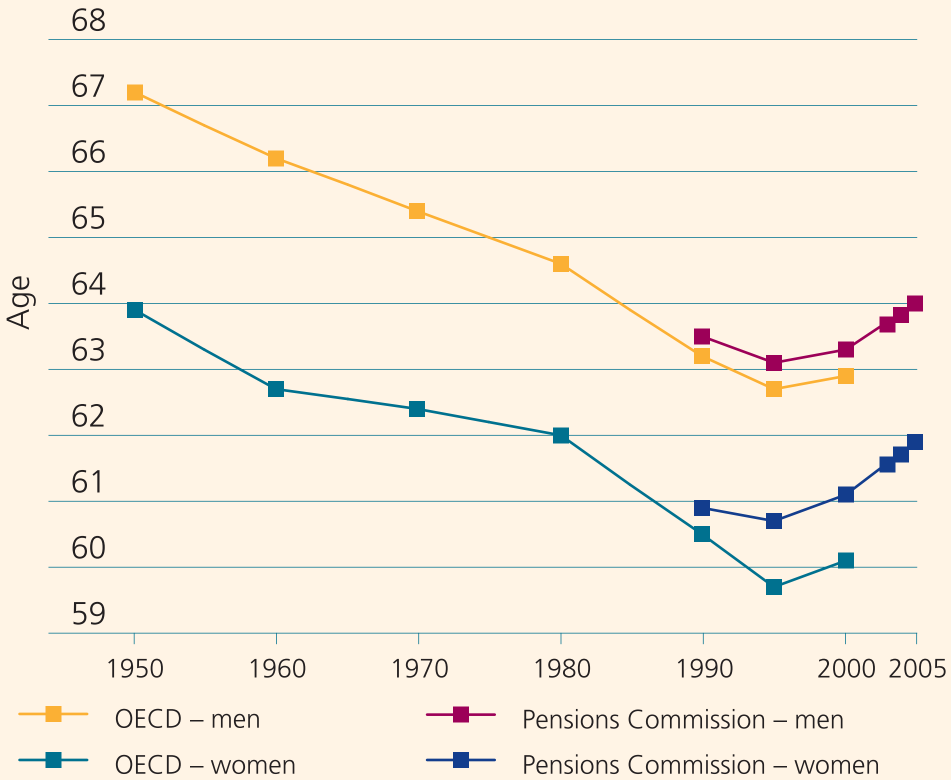
We also recognise that an ageing society raises wider challenges than simply those related to pensions and older workers. This chapter also develops further our strategy for an ageing society.

These elements of our policy will aid the **sustainability and affordability** of the pensions system, by contributing to our aspiration for an employment rate equivalent to 80 per cent of the working-age population. And through facilitating and encouraging longer working, they will help people to take **personal responsibility** for their security in retirement.

Context for reform

4.1 Despite improvements in longevity, average retirement ages have been falling – a trend that has only recently begun to reverse (see Figure 4.i). The average percentage of an adult male's life spent in retirement has increased from 17 per cent in 1950 to 31 per cent in 2005 (see Figure 4.vii).

Figure 4.i Trends in mean age of retirement



Sources: Blöndal and Scarpetta (1999), The Retirement Decision in OECD Countries, OECD Economics Department, Working Papers No.202,
World Economic Forum (2004), Living Happily Ever After: The Economic Implications of Ageing Societies,
Pensions Commission estimates

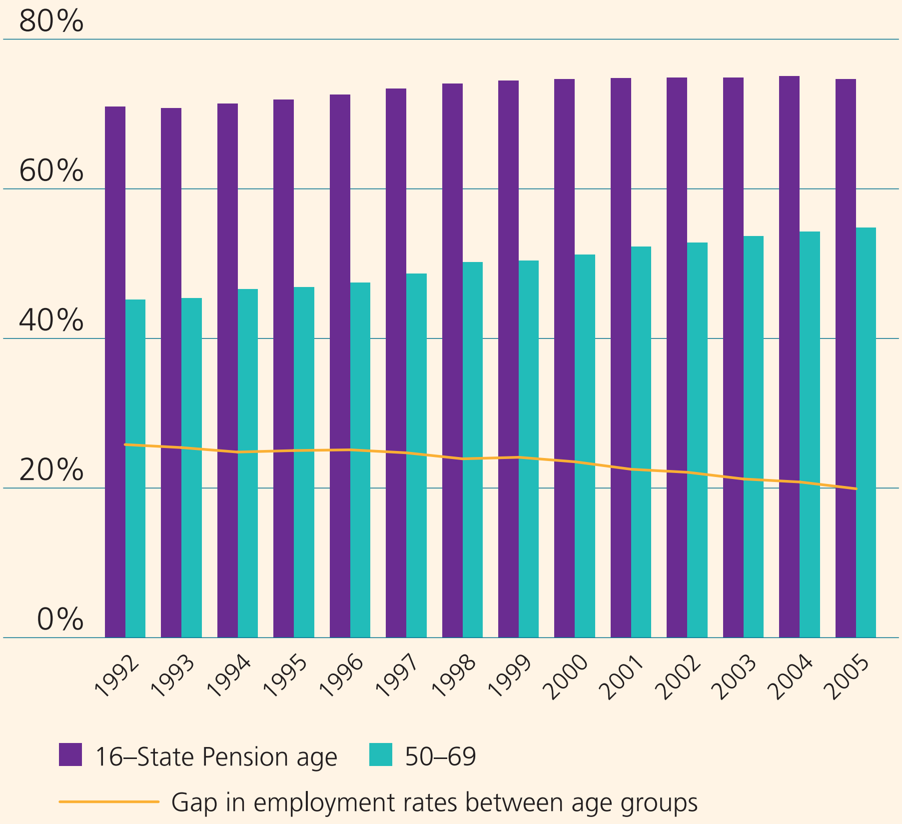
Addressing the pensions challenge through employment

4.2 Working for longer not only provides a direct means by which people can supplement their income in later life, but also a way of building up greater state and private pension entitlement for the future – thus helping them to maintain their standard of living in retirement.

4.3 Longer employment is the logical response to an ageing population: the more people who are in work and contributing to the growth of the economy, the more funds there will be available to support those people who are in retirement.

4.4 Recent years have seen a significant increase in the employment rate of 50 to 69-year-olds, which has risen by 6.1 percentage points from 48.7 per cent in 1997 to 54.8 per cent in 2005. However, the employment rate for people aged 50 to the current State Pension age (70.7 per cent) is still lower than for the overall working population (75 per cent), and considerably lower than for the 25–49 age group (over 80 per cent). More needs to be done to reduce the gap.

Figure 4.ii Difference in employment rates between people of working age and people aged between 50 and 69



Source: Labour Force Survey, GB, autumn quarters

Achieving an 80 per cent employment rate

4.5 In January 2006, *A new deal for welfare: Empowering people to work*[1] described the Government's long-term aspiration of an employment rate equivalent to 80 per cent of the working-age population. Realising this aim represents a substantial, yet

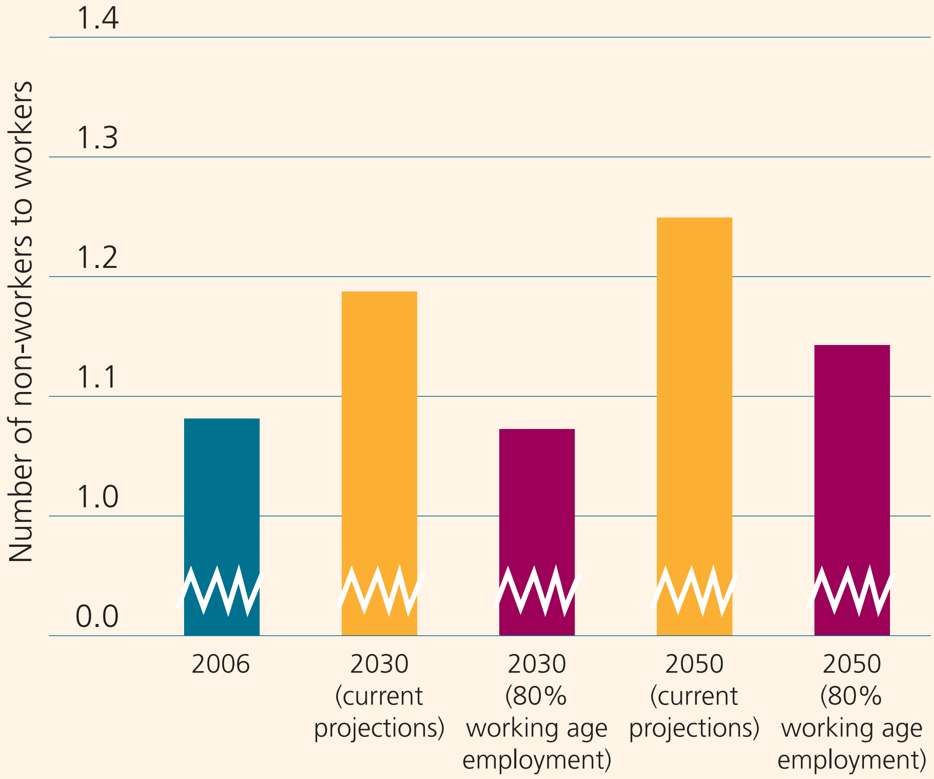
[1] DWP, 2006, *A new deal for welfare: Empowering people to work* (Cm 6730), DWP.

achievable, challenge. It would break all UK employment records. To move towards it, the Government aims to:

- reduce by 1 million the number of people on incapacity benefits;
- help 300,000 more lone parents into work; and
- increase the number of older workers by 1 million.

4.6 Improving employment for these groups will increase opportunity and decrease poverty, and will support an ageing population in the longer term. Figure 4.iii shows how the economic dependency ratio would differ from current projections in 2030 and 2050 if we were to meet our 80 per cent employment aspiration by 2030.

Figure 4.iii Impact of higher employment on the UK economic dependency ratio



Source: DWP estimates, based on Government Actuary's Department's 2004-based principal projection and HM Treasury projections of employment published in the 2005 Long-Term Public Finance Report

4.7 Reaching 80 per cent would lead to a significant increase in GDP, perhaps by as much as 2.7 percentage points by 2050.[2] Higher GDP would make total government expenditure more affordable and would increase the income available to support pensioners through the state pension system.

4.8 In addition, the reduction in the number of people receiving incapacity benefits and the additional lone parents and older people in work would reduce expenditure on benefits, while increased employment would also result in increased pension contributions, leading to reduced spending on Pension Credit, though with some increase in State Second Pension spending. Taken together, the reduction in benefit and pension spending could be up to 0.5 per cent of GDP in 2030.

4.9 Increasing the number of older workers by 1 million is a long-term aim and will need to take account of a number of factors. It will require a continued concerted effort to change the culture and behaviour surrounding retirement.

Current Government approach

4.10 Significant progress has already been made. In addition to the steady increases in employment rates for older workers since 1997, over 1 million people are now working after State Pension age.

4.11 The employment programme to help older workers, New Deal 50 plus, has supported over 150,000 entries into work since its launch in April 2000, and back-to-work help is now available to people claiming Pension Credit (from age 60). Our Age Positive campaign has influenced employers by promoting the business case for age-diverse workforces, and every year sees increasing interest from employers in adopting non-ageist employment practices.

4.12 We have taken action to ensure that those already choosing to work for longer are given the opportunity to do so. In October this year, new legislation will come into force, which, for the first time, will give people the right to challenge age discrimination in the workforce. We will also be introducing a default retirement age of 65, below which employers will not be able to force people to retire on the grounds of age (unless it can be objectively justified).

4.13 The default retirement age will be carefully monitored and after five years, in 2011, we will undertake a formal, evidence-based review. The default retirement age will be abolished if this review concludes that it is no longer appropriate. Of course, employers can operate without a retirement age and many are already realising the benefits of doing so.

[2] This based on a comparison between HM Treasury's *Long-Term Public Finance Report* and reaching employment equivalent to 80 per cent of the working-age population, assuming that the additional workers have weekly productivity that is half that of the remainder of the working population.

4.14 The Commission for Equality and Human Rights, due to be established by late 2007, will provide guidance to employers and individuals on good practice relating to age in employment and support implementation of the age discrimination legislation. Our Be Ready promotional campaign, launched in May last year and delivered in partnership with business groups and trade unions, has already begun to influence employment practice and raise awareness of the forthcoming legislation.

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

4.16 In the medium term, structural changes are also planned, including raising the earliest age from which a (non-state) pension can be taken from 50 to 55 by 2010. Equalisation of State Pension age, due to take place between 2010 and 2020, will see women's State Pension age rise gradually to 65 in line with that of men.

Helping older workers

4.17 The Government's recent publication, *A new deal for welfare: Empowering people to work*, proposed a series of measures to boost support for older people returning to work, and to improve the information available about options for work and retirement. These measures are now moving towards implementation:

- Aligning our additional employment support for long-term unemployed older people with that of younger age groups by requiring people aged 50 to 59 to take up the additional jobseeking support available through New Deal 25 plus. Phased national roll-out will commence from April 2007.

- Requiring unemployed older people to participate in New Deal 50 plus activities after six months claiming benefits, including attending work-focused interviews and developing action plans. We are planning towards piloting this measure.

- Improving back-to-work support for Jobseeker's Allowance claimants and their dependent partners who are over 50. This is already required for couples claiming Jobseeker's Allowance who were born after 1957, and keeps both partners in contact with the work-focused help and support available through Jobcentre Plus. This will happen from April 2007.

- Piloting face-to-face guidance sessions tailored to help people approaching or over 50 and in work to understand the options available to them for work, training and retirement, and to support them in planning for later life. The pilots are due to begin in 2007.

- Working with employers to promote the extension of flexible working opportunities to older workers. Research found that, for 50 to 69-year-olds, many of those who were retired would have liked to have worked for longer if there had been part-time or flexible work options available.[3] Our Be Ready campaign will begin this activity this year, and beyond that we will seek other vehicles for promoting this agenda.

- Increasing the involvement of the information, advice and guidance services in promoting the New Deal 50 plus In Work Training Grant and supporting those people over 50 interested in taking it up.

Enabling longer working

Overcoming barriers to longer working

4.18 The first step towards extending working life is to overcome the barriers that we know prevent or discourage people from working for longer. Poor health and disability status are the most significant factors pushing people in their 50s and 60s out of work and reducing the likelihood that they will return. Promoting healthy workplaces and securing good management of occupational health is therefore crucial to increasing healthy outcomes throughout life and helping older people work to a later age if they wish to do so.

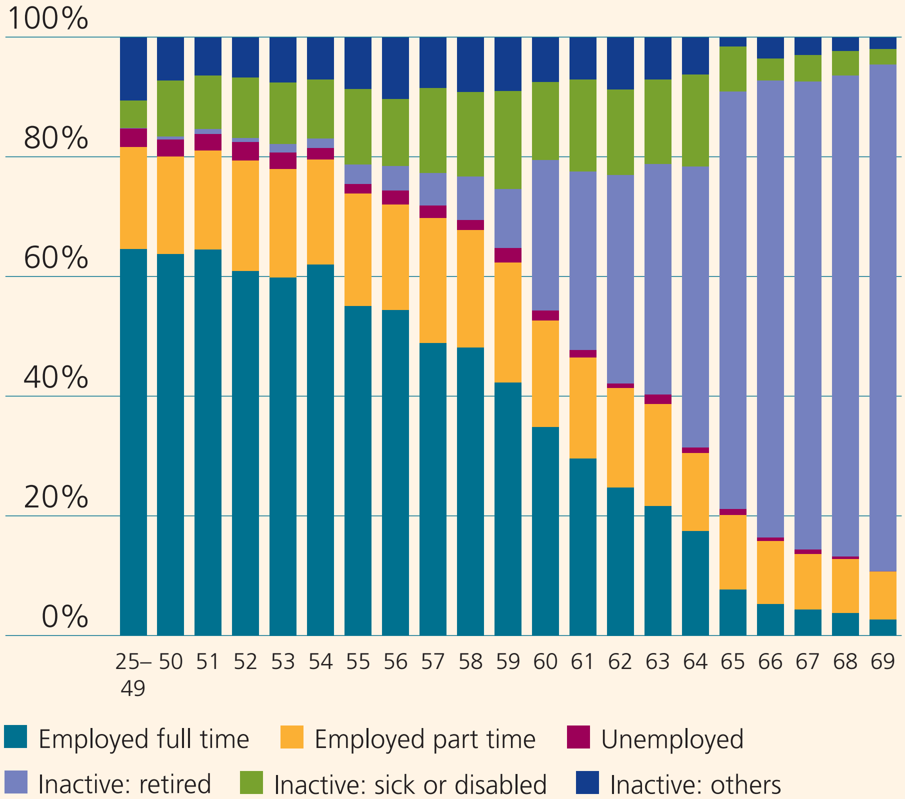
4.19 In October 2005, the Government launched a strategy for the health and well-being of working-age people, *Health, work and well-being – Caring for our future*.[4] The new National Director for Occupational Health will lead this ambitious programme of work.

4.20 We also recognise that working patterns and the barriers to longer working are not the same for everyone aged 50 or over. While there are common features that affect older workers of all ages, when we look at employment patterns by age we see some specific factors at work for different age groups.

[3] *Do employers need older workers?* Briefing Paper 5, October 2005, Centre for Research into the Older Workforce at the University of Surrey.

[4] DWP, DH and HSE, 2005, *Health, work and well-being – Caring for our future*.

Figure 4.iv Economic activity by age



Source: Labour Force Survey, Autumn 2005, GB

Note: The 'Inactive: others' category includes those who are economically inactive because they are looking after family/home, or are inactive for other reasons.

50–59: Of those people over 50 but under the State Pension age, we know that more are economically inactive due to ill-health than are out of work due to retirement or unemployment. We also know that half of those people claiming Incapacity Benefit are over 50. Early intervention is critical to ensure that people do not become dependent on benefits and move into early retirement. We set out proposals in this area in *A new deal for welfare: Empowering people to work*.

60–65: The most common time for change from employment to economic inactivity (especially to retirement) is between age 60 and 65, as shown in Figure 4.iv. Around 45 per cent of men and 67 per cent of women in the 60–64 age group are economically inactive. We know that those who work up to State Pension age are most likely to be working beyond State Pension age. Supporting this group in work for longer will be key to sustaining work up to State Pension age and beyond, particularly as women's State Pension age equalises. Therefore if we are to achieve our aspiration of 1 million additional older workers, we need to address some of the barriers faced by this group.

State Pension age and over: Over 1 million people over State Pension age are working today, many in part-time work. The employment rate for those over State Pension age has increased from 7.9 per cent in autumn 2000 to 10.2 per cent in autumn 2005. The average age of retirement for women is currently about 62, which is above women's State Pension age. However, further growth is vital for the future, which may involve people working increasingly flexibly in a way that suits their personal circumstances after State Pension age.

4.21 In Chapter 3, we discuss proposals for raising State Pension age from 2024 onwards, in order to ensure a more generous State Pension in the face of rising average life expectancy. Individuals under the age of 47 (on 5 April 2006) will have to wait longer to receive their State Pension, and for some this will mean working for longer than they might have originally planned.

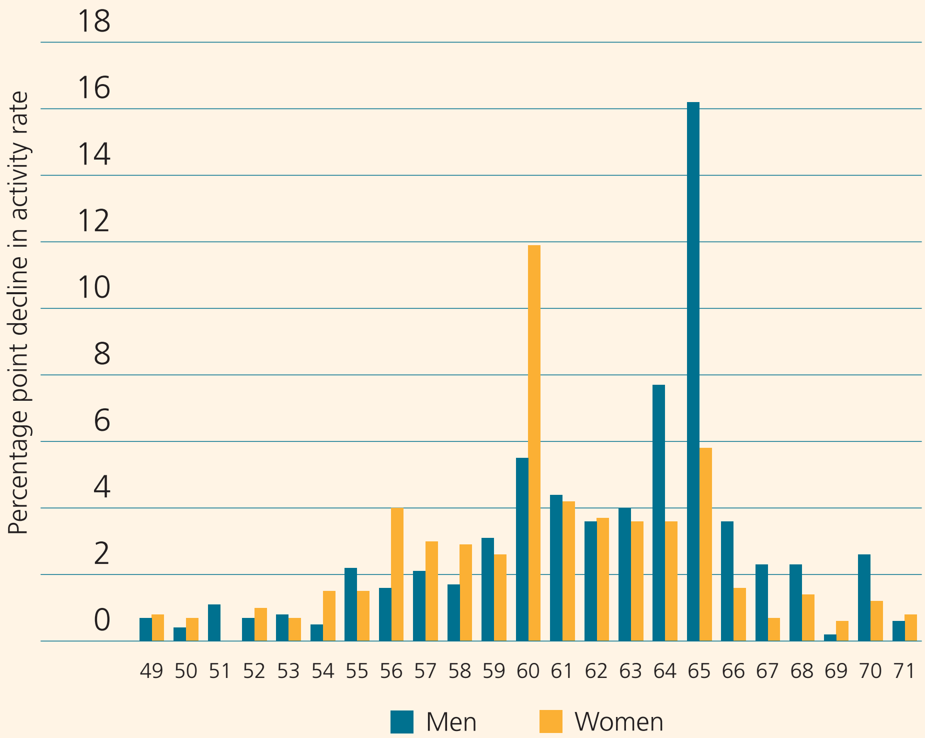
Figure 4.v Future eligibility for State Pension

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

Note: Women's State Pension age is already due to gradually increase to 65 between 2010 and 2020.

4.22 Figure 4.vi shows that the current State Pension age is important in determining when people retire; there are quite sharp increases in the move to inactivity at 65 for men and 60 for women. However, the current average age at which people leave the labour market is 64 for men and 62 for women, which shows that, although State Pension age has an influence upon when people retire, it is not perhaps as powerful in deciding when people leave the labour market as some might think.

Figure 4.vi Average annual decline in activity rates of single-year cohorts, average over 2001–05



Source: Labour Force Survey, GB

Notes: Calculated from Labour Force Survey four quarter averages.
Figures are calculated by averaging the difference in activity rates, since the previous year, over the period 2001–05 for each single-year cohort. For example, the activity rate of the 55 age group is compared with the activity rate of the 54 age group the previous year for each year 2001–05, and the differences are then averaged over the period. The results show a marginal rise in activity for women aged 51, but this has not been included in the Figure.

4.23 The rise in State Pension age will therefore need to go hand in hand with behavioural change around retirement, changes to the benefit system, as set out in *A new deal for welfare: Empowering people to work*, and a corresponding rise in average retirement age.

4.24 In 1950, the average male retired at age 67 and could expect to live for another 10.2 years, thus spending 17 per cent of his life in retirement. Today the average retirement age for men is 64, and life expectancy at that age is another 20.9 years, meaning that 31 per cent of life is spent in retirement. If we were to achieve an average retirement age of 65 for men by 2020, rising life expectancy could still mean that the same proportion (31 per cent) of life would be spent in retirement as now – see Figure 4.vii.

Figure 4.vii Percentage of adult male life spent in retirement

Due to rising life expectancy, the average man who worked to age 64 in 2005 will spend the same percentage of their life in work and in retirement as a man who might retire at age 68 in 2050. In 1950 the average man retired at age 67 and had a much lower percentage of adult life spent in retirement.

	1950	2005	2020	2050
Age of retirement	67	64	65	68
Life expectancy at age of retirement (years)	10.2	20.9	21.6	21.4
Percentage of adult life (18+) spent in retirement	17.2	31.3	31.4	30.0

Sources: Government Actuary's Department's UK life tables; Pensions Commission for historic retirement data

Looking ahead: a long-term approach

4.25 Our future efforts need to respond to the different experiences and circumstances of the age groups outlined above and address the factors that lead to early economic inactivity. In considering what more needs to be done, we have not focused solely on low-income groups, but have considered what will encourage people of all incomes to continue working, as this will be of maximum benefit to the economy and to the long-term future of our pensions system. And people of all incomes may benefit from the higher replacement rates gained by longer working.

4.26 To achieve the rise in average retirement ages and increased employment rates in the long term, we propose a two-pronged approach that (a) effectively supports people who are sick, disabled or unemployed in returning to work, with greater focus on those in their late 50s and over 60s as State Pension age is equalised; and (b) supports people in work for longer (potentially for a year or two more).

4.27 The measures outlined in *A new deal for welfare: Empowering people to work* will provide greater support to older people returning to work. We now also need to provide measures that will encourage and enable people to remain in work for longer. This means:

- enabling greater flexibility to allow people to manage caring responsibilities and health issues alongside work, and to choose a phased approach to retirement;
- informing people about their options and choices, addressing age discrimination and tackling the culture of early retirement, through improved communications, especially to individuals; and
- working in partnership with employers to encourage them to retain older workers and offer them greater flexibility around retirement.

Flexible working and phased retirement

4.28 Increasing choice and flexibility around retirement will enable people to continue working who might otherwise leave the workforce, due to other demands on their time and energies or their inability to cope with full-time working in their current job. Flexible working consistently features in research and reports as a key element to any strategy to encourage and help older people to stay in work. It enables people to manage health conditions, balance caring responsibilities, and achieve a smooth transition into an active retirement by allowing the pursuit of other activities alongside working.

4.29 Recently published DWP research[5] with people aged 50–69 highlighted that the attitudes of individuals and employers affected the ability to extend working life. Where health problems and caring responsibilities had been taken into account by their employer, some people were able to remain in work. However, others felt that they were a burden and so did not want to ask for their needs to be accommodated. Respondents felt that government had a role in supporting flexible working practices. Other research found that, among 50 to 69-year-olds, half of those in work wanted to carry on working and many of those who were retired would have liked to have worked for longer if there had been part-time or flexible work options available.[6]

4.30 We introduced the right to request flexible working for parents with young children in 2003 and this has proved successful at helping parents to combine work with caring for their families, with 90 per cent of requests agreed. We are extending this right to include carers of adults from April 2007. As the peak of caring responsibility falls between the ages of 45 and 65, this new right will be of significant benefit to older workers, who will have greater opportunity to balance caring with working. The Government has committed to a full, evidence-based review in 2011 of the default retirement age being introduced in October this year. As part of this review, we will consider the working patterns of older people.

4.31 We have already announced in *A new deal for welfare: Empowering people to work* that we will work with employers through Age Positive to promote best practice and encourage more opportunities for flexible working and retirement. However, there are also ways in which the pensions and benefits systems can support flexible retirement and make flexible working more affordable for people on low incomes. Doing so would mirror the opportunities available to better-off people, who can take advantage of the flexibility in occupational pension schemes that supports part-time work leading up to retirement.

[5] Irving et al, 2005, *Factors affecting the labour market participation of older workers: Qualitative research*, DWP Research Report 281.

[6] *Do employers need older workers?,* Briefing Paper 5, October 2005, Centre for Research into the Older Workforce at the University of Surrey.

4.32 The Pensions Commission has suggested that State Pension deferral could be beneficial to people on lower incomes who want to continue to work, by allowing them to draw part of their pension while deferring the rest. We are keen to see how the changes introduced last year to make State Pension deferral more generous will increase the numbers of people working and deferring, and will be undertaking research on this in due course.

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

Supporting informed decision making

4.34 We already have well-developed communications campaigns in place, focused on raising awareness of age diversity in the workplace and promoting the interests of older workers, but these are aimed at employers. Age Positive has been running since 2000 to promote the business benefits of an age-diverse workforce. The campaign includes employer case studies and guidance on a dedicated website, as well as events, awards initiatives, research and generating media coverage in the leading national, regional and trade press.

4.35 Announced in the 2004 Budget, the Government's Be Ready campaign was launched in May 2005, in partnership with employer lobby groups and trade unions, and is in the process of targeting promotional material at all 1.4 million employers in Great Britain. It aims to promote good practice relating to age in employment, and to encourage employers to move towards age diversity in advance of the implementation of age discrimination legislation in October 2006.

4.36 In *A new deal for welfare: Empowering people to work*, we announced that we will conduct pilots of face-to-face guidance with people approaching or over 50, to help individuals to understand their options in relation to work, training and retirement, and to plan constructively for later life. We hope to learn from these pilots about the type of information and support people need, and to use this to improve government communications to this group, as well as developing best practice for others who provide help to the over-50s.

4.37 However, we know that a considerable shift in opinion is needed to change behaviour towards later retirement, and so more effort will be needed over the next decade. Research tells us that many people are not aware of the benefits of working longer and the links between work and their retirement income. For example:

- People do not realise by how much life expectancy has increased. They underestimate the age to which they can expect to live and anticipate becoming sick and dying in a similar timescale to that of the previous generation. They also have low awareness of the general demographic structure of the UK and the economic and social impacts this will have in the future.[7]

- There is still a commonly held attitude among employees that older people remaining in work prevents younger people from getting jobs.[8]

- Individuals have unrealistic aspirations for early retirement, which are unlikely to be realised without sensible planning and significant saving.[9]

- Only around a third of people who had retired voluntarily before State Pension age had considered the financial implications of doing so.[10]

- People tend to have fixed ideas about the nature of work, viewing it as ‘full time’ and ‘fixed or permanent’ and rarely considering that work could be part time or flexible and could fit around other interests and commitments.[11]

4.38 The findings from the National Pensions Debate suggest that when people are given more information to counteract some of these misconceptions, their understanding of the importance of working longer grows and they are more prepared to accept that retirement should happen later than they might have previously assumed. At the start of National Pensions Day, 42 per cent of the participants agreed that people would have to work longer to solve the pensions issues in the UK; at the end of the day, this figure had risen to 57 per cent.

4.39 Better information is vital to raise awareness and assist decision making in planning for later life. The Government will actively pursue a long-term strategic approach to communication with its audiences, integrating all relevant elements of communications for future pensioners, including State Pension deferral, equalisation of State Pension age and extending working life, to ensure the delivery of joined-up and relevant communications to customers.

[7] Mayhew V, 2002, *Pensions 2002, Public attitudes to pensions and planning for retirement*, DWP; Robinson P, 2005, *Working later: Raising the effective age of retirement*, IPPR.

[8] Irving et al, 2005, *Factors affecting the labour market participation of older workers: Qualitative research*, DWP; Gosling and Lewis, 2005, *Trust no-one? Public attitudes to raising the age of retirement*, IPPR.

[9] Mayhew V, 2002, *Pensions 2002: Public attitudes to pensions and planning for retirement*, DWP.

[10] Humphrey et al, 2003, *Factors affecting the labour market participation of older workers*, DWP.

[11] Irving et al, 2005, *Factors affecting the labour market participation of older workers: Qualitative research*, DWP.

4.40 There are a number of specific steps we will take to ensure that messages are communicated consistently to the over-50s, to help them understand the options available to them. We will:

- include information on the opportunities and support available to extend working life and provide signposting in Pension Service leaflets to people approaching State Pension age and planning for retirement;
- offer information about the opportunities and support available on extending working life and provide signposting to more detailed sources of information and guidance in pension forecasts that are issued to people over 50;
- increase public awareness of State Pension deferral by more prominently publicising its availability in the State Pension application process, in State Pension forecasts and in any other relevant materials; and
- provide general awareness training for all Pension Service front-line staff and more in-depth training for staff most likely to deal directly with customers who are approaching State Pension age.

Working with employers

4.41 We cannot deliver increased employment rates and higher average retirement ages without the support of employers. Much good practice already exists, and many employers operate employment policies that actively support older workers and offer flexibility around retirement. Our research[12] shows that around two-thirds of employers have equal opportunities policies and performance appraisal systems which can help guard against discrimination.

4.42 However, there are still many that operate policies and practices that are potentially discriminatory – indeed, one-fifth of employers say that some jobs in their establishment are more suitable for some age groups than others, with a tendency to favour workers between 25 and 49 years of age. Building on our current employer engagement programmes, we will work in partnership with employers to better support longer working.

[12] Metcalf with Meadows, 2006, *Survey of employers' policies, practices and preferences relating to age*, DWP Research Report 325.

The public sector as an employer

4.43 The Pensions Commission recommended that public sector employers should be exemplars in defining and encouraging best practice for older workers in the areas of recruitment, retention, retirement, occupational health and education and training. In the fourth quarter of 2005, the public sector accounted for one in five workers in the UK, and therefore its employment practices will have a big impact on the workforce in general. The Government can play a vital role in leading the way and we propose to begin by introducing change across government departments.

4.44 Government departments are committed to improving working practices to support older workers and to using their influence across other areas of the public sector to ensure non-discriminatory practices. We will identify the best practice that already exists and consider ways to encourage more good practice across the public sector.

4.45 The Department for Work and Pensions has already taken the decision to operate without a compulsory retirement age for its staff. This decision is based on the evidence of successfully operating with a retirement age of 65 with a right for employees to request working longer, for the past two years, even in the light of significant reductions in staff numbers to improve efficiency during this period.

4.46 We want the public sector to become an exemplar of health and well-being at work. The Ministerial Task Force for Health, Safety and Productivity, which was set up to drive improvements in sickness absence management in the public sector, will support the *Health, work and well-being* strategy by ensuring that the public sector responds and leads by example.

4.47 The measures outlined here and in *A new deal for welfare: Empowering people to work* will take time to have an effect on employment rates and average retirement ages, especially where we are seeking to effect a culture change. We will monitor progress carefully and work with employers and partners to understand how employment practices and retirement behaviour are changing. Given the importance of this agenda in securing both higher employment and security in retirement, we will keep it under periodic review to consider in the future whether further government interventions are needed.

The wider context: a strategic approach to an ageing society

4.48 Achieving a culture change with respect to the length of working lives and raising average retirement ages are crucial to forming a response to an ageing society that is fair, affordable and sustainable. But our response to an ageing population stretches far wider than just ensuring financial security in retirement. We need to ensure that quality of life, respect and dignity in older age are also secure.

4.49 In March 2005, the Government published *Opportunity Age*,[13] our strategy for a successful ageing society. The strategy aims to promote a wide culture change, ending the perception of older people as 'dependent', and to ensure that longer life is healthy and fulfilling, with older people playing a full part in society. We set out how all parts of government, central and local, are organising themselves more effectively to deliver a wide range of initiatives – not only to improve financial security and extend working life, but also to combat discrimination, promote active ageing and improve services to promote the well-being and independence of older people.

4.50 We have now taken account of responses to the consultation on *Opportunity Age*[14] and are taking action to:

- establish a set of indicators of well-being and independence, which will enable us to track progress. We will report on a biennial basis starting with a baseline document in summer 2006;
- consider the scope for setting up an Office for Ageing and Older People to promote the ageing agenda, together with an Observatory to improve the co-ordination and dissemination of information about ageing;
- promote active ageing and tackle health inequalities, particularly focusing on the most socially excluded;
- put together a cross-government approach to the needs of older people and an ageing society for the 2007 Comprehensive Spending Review; and
- launch the LinkAge Plus pilots in eight areas, from July 2006, to test the most effective way of delivering holistic services for older people.

This programme of work also builds on the recent Social Exclusion Unit report on excluded older people[15] and the Department of Health's White Paper.[16] In order to drive it, we will develop existing structures, such as the Cabinet Sub-Committee on Ageing and its supporting mechanisms.

[13] DWP, 2005, *Opportunity Age: Meeting the challenges of ageing in the 21st century* (Cm 6466i), DWP.

[14] A summary of responses to the consultation on *Opportunity Age* will shortly be available on the DWP website at www.dwp.gov.uk/opportunity_age/

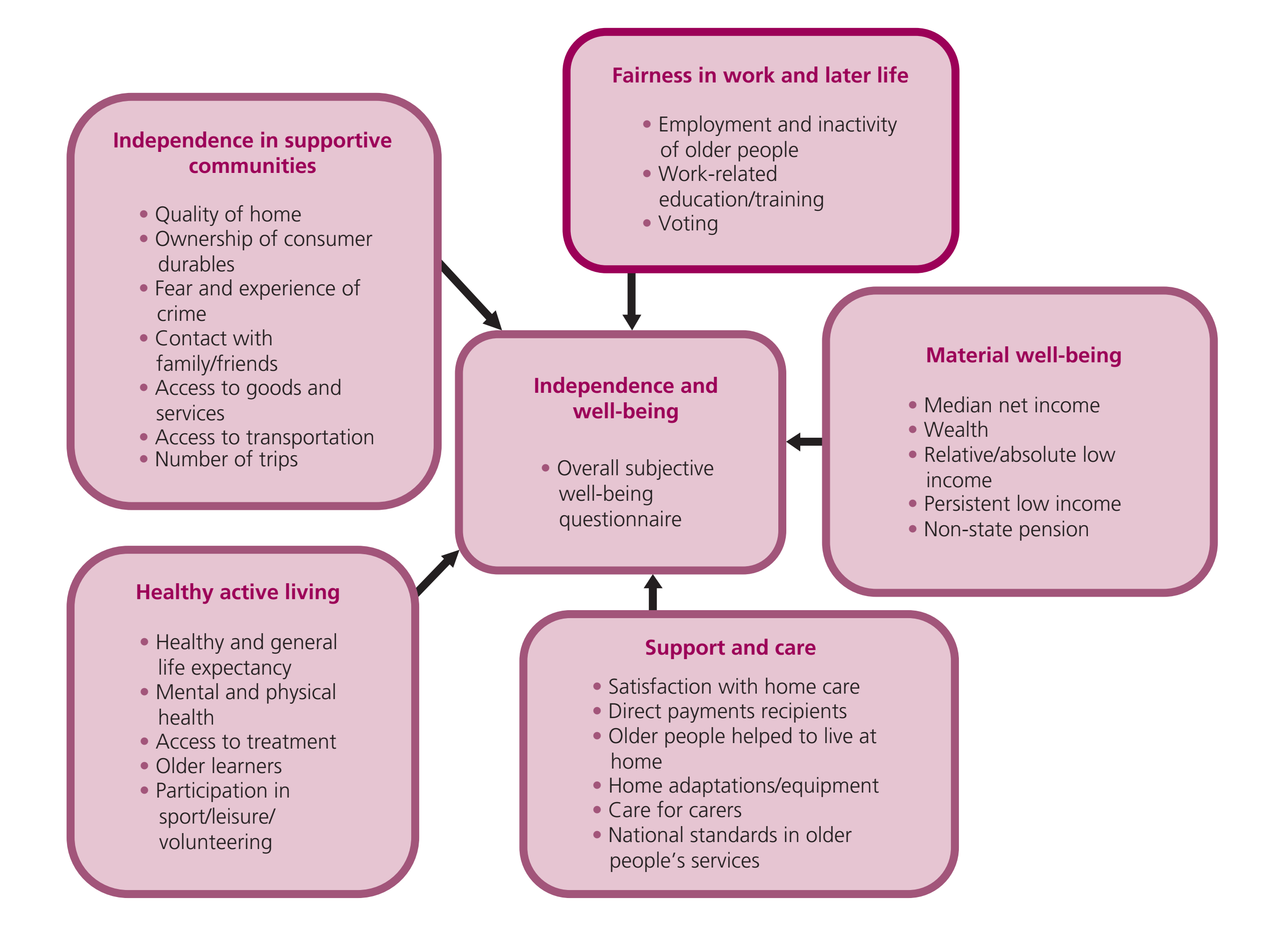
[15] Social Exclusion Unit, 2006, *A sure start to later life: Ending inequalities for older people*, ODPM.

[16] Department of Health, 2006, *Our health, our care, our say: A new direction for community services* (Cm 6737).

Establishing a set of indicators

4.51 In *Opportunity Age*, we committed to develop a set of indicators of older people's well-being and independence so that we could see what effect central and local government strategies on ageing were having on the lives of today's and tomorrow's older people. With the help of stakeholders across and beyond government, we have agreed a baseline set of indicators on which we intend to publish our first report in the summer. Figure 4.viii shows these indicators.[17] We intend to develop additional measures, which we need in order to reach a balanced assessment based on the direct experience of older people, to add to or refine this original set, and to publish progress reports biennially, starting in 2008.

Figure 4.viii Indicators of older people's independence and well-being



[17] Full details of the indicators, with their data sources, will be available shortly on the DWP website at www.dwp.gov.uk/opportunity_age/

Chapter 5: Consultation arrangements

Chapter 5: Consultation arrangements

5.1 An electronic version of this document can be found at www.dwp.gov.uk/pensionsreform.

5.2 The proposals for reform set out in this paper are informed by an extensive programme of Government consultation with key stakeholders and the National Pensions Debate – involving nearly 10,000 members of the public in face-to-face debate and via our website. A list of those consulted is available on the website alongside this paper.

5.3 Our proposals are accompanied by Regulatory Impact Assessments and technical appendices which are also available at the above website address.

5.4 We welcome comments on any aspect of our proposals. Our consultation arrangements are in line with the Cabinet Office's Code of Practice on Consultation. A copy of the Code can be found at www.cabinetoffice.gov.uk/regulation/consultation. The six consultation criteria set out by the Cabinet Office are:

- Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.
- Be clear about what your proposals are, who may be affected, what questions are being asked and the timescale for responses.
- Ensure that your consultation is clear, concise and widely accessible.
- Give feedback regarding the responses received and how the consultation process influenced the policy.
- Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.
- Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

How to respond

5.5 When responding, please state whether you are responding as an individual or representing the views of an organisation. Where possible, please supply evidence in support of your views. If you are responding on behalf of an organisation, please make clear who the organisation represents and – where applicable – how the views of members were established.

5.6 The closing date for receiving comments is **Monday 11 September 2006**. Please ensure that your response reaches us by this date. Your response can be submitted by letter, fax, or email to:

Pensions Reform White Paper Team
Department for Work and Pensions
Level 3, The Adelphi
1–11 John Adam Street
London WC2N 6HT

Telephone: 020 7712 2855
Fax: 020 7962 8591
Email: pensions-white-paper@dwp.gsi.gov.uk

5.7 We will publish a summary of the comments we receive, along with a response from the Government on how we intend to proceed, within three months of the close of this consultation.

Additional copies and alternative formats

5.8 Additional printed copies of this document can be ordered from:

The Stationery Office
PO Box 29
Norwich NR3 1GN

Telephone: 0870 600 5522
Fax: 0870 600 5533
Email: book.orders@tso.co.uk

5.9 The Welsh version of this document can be found at www.dwp.gov.uk/welsh/pensionsreform.

5.10 The Executive summary of this document is available in English, Welsh, Braille, large print, and on audio cassette. These are free of charge and can be ordered by contacting:

Pension Guide
Freepost RLXH-JUEU-GZCH
Northampton NN3 6DF

Telephone: 08457 31 32 33
Textphone users: 0845 604 0210

Confidentiality

5.11 The information you send us may need to be passed to colleagues within the Department for Work and Pensions and published in a summary of responses received in response to this consultation, along with a response from the Government.

5.12 Because of the Freedom of Information Act (2000), all information contained in your response, including personal information, may be subject to publication or disclosure. By providing personal information for the purposes of the public consultation exercise, it is understood that you consent to its disclosure and publication. If this is not the case, you should limit any personal information which is provided, or remove it completely. If you want the information in your response to the consultation to be kept confidential, you should explain why as part of your response, although we cannot guarantee to do this. We cannot guarantee confidentiality even if your IT system claims it automatically. The contact point to discuss this is:

Geoff Ashton
DWP Consultation Co-ordinator
5th Floor East, Trevelyan Square
Leeds LS1 6EB

Telephone: 0113 23 27 107
Email: geoff.ashton@dwp.gsi.gov.uk

5.13 More information about the Freedom of Information Act can be found on the website of the Department for Constitutional Affairs at www.dca.gov.uk/foi/index.htm.

Help with your queries

5.14 Our proposals do not affect your current state pension entitlements. If you have queries about your future state pension entitlements, you should contact The Pension Service on 0845 30 001 68.

5.15 If you have any queries about the proposals set out in this paper, and would like to discuss these before sending us your comments, please contact the Pensions Reform White Paper Team.

5.16 DWP values feedback on how well it consults. If you have any comments on the process of this consultation (as opposed to the issues raised) please contact the DWP Consultation Co-ordinator. In particular, please tell us if you feel that the consultation does not satisfy the criteria set out at paragraph 5.4. Please also make any suggestions as to how the process of consultation could be improved further. Please contact:

Geoff Ashton
DWP Consultation Co-ordinator
5th Floor East, Trevelyan Square
Leeds LS1 6EB

Telephone: 0113 23 27 107
Email: geoff.ashton@dwp.gsi.gov.uk

Annexes

Annex A: Measuring undersaving for retirement

A.1 Chapter 1 describes the barriers to saving that individuals face, and a number of patterns in existing private pension saving. It concludes that a considerable number of people may be saving less for their retirement than they need in order to avoid unexpected or unwelcome drops in their standards of living once they reach retirement. This will mean that as they near retirement they will be faced with a choice between needing to save more or to work longer than they had intended.

A.2 The chapter gives a range for the number of people for whom retirement undersaving might be a problem. This annex describes in more detail the factors that affect this range, and who the people might be who fall within it.

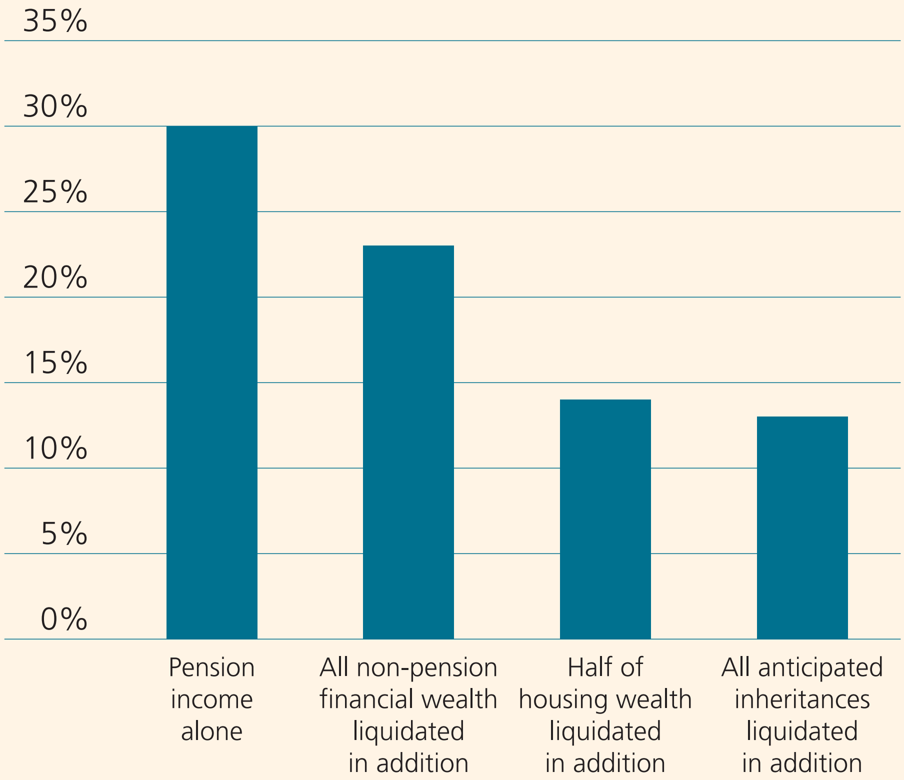
How many people are undersaving?

A.3 Previous estimates of undersaving have been based on individuals' current membership of a pension and their pension saving rate. *Simplicity, security and choice: Working and saving for retirement* (published by the Department for Work and Pensions in 2002) estimated that 3 million people of working age were 'severe' undersavers, who were predicted to have a replacement rate of less than half, and that between 5 and 10 million people with projected replacement rates of half to two-thirds might wish to consider working longer or saving more. The Pensions Commission, using their benchmarks for target replacement rates, suggested that around 12 million were undersaving.

A.4 New data[1] on wealth, current savings and retirement plans means we can improve our estimates for those aged from 50 to State Pension age. This analysis is summarised in Figure A.i.

[1] *The English Longitudinal Study of Ageing 2002*. This is a survey of those aged over 50 which collects detailed information on the health and wealth of individuals and their partners.

Figure A.i Percentage of the UK population aged between 50 and State Pension age who are undersaving



Source: Institute of Fiscal Studies (IFS) – Prepared for Retirement? The Adequacy and Distribution of Retirement Resources in England (October 2005), with DWP adjustments

Notes: The original undersaving estimates were derived from IFS analysis of data from the English Longitudinal Study of Ageing and related to those aged between 50 and State Pension age living in England with at least one earner in the household. However, the above figures have been adjusted to be representative of the UK population aged between 50 and State Pension age.
Figures do not include Pension Credit.

A.5 These estimates are lower than those given by the Pensions Commission, which estimated that 38–43 per cent of people aged 46 to State Pension age were undersaving for retirement. Two major reasons for the differences are:

- The Institute for Fiscal Studies (IFS) figures are based on households, the Pensions Commission's on individuals. This means that an individual with low pension themselves, but whose spouse has enough pension for both, would be counted as an undersaver by the Pensions Commission but not by the IFS.
- The IFS figures had information on pension wealth accrued to date – the Pensions Commission had to assume that people had saved at a constant rate in the past.

A.6 Based on pension income alone, 30 per cent of this age group are undersaving. But evidence[2] shows that many people are saving for retirement outside a pension, or have other assets which could be used to provide retirement income. It is unrealistic to assume that none of these assets will be used, but equally unrealistic to assume that all available assets will be used to produce retirement income. If we define an undersaver as someone who does not have enough wealth to meet their benchmark with assets excluding their main house, and excluding any inheritances they may receive, we see that around 23 per cent of this age group are undersaving.

A.7 For younger age groups we do not yet have data on accrued wealth. If we assume that 23 per cent of this group are also undersaving for retirement, this gives a total of 6.5 million people of working age undersaving. However, data on falls in private pension membership, and the implication of the reduction in employer contributions to pensions, suggest that today's younger cohorts are less likely than previous cohorts to be saving for their retirement. In particular, the proportion of people aged 25–49 who are saving in a non-state pension has fallen by 7 per cent.[3] To reflect this drop, we have adjusted upwards slightly the percentage of undersavers below 50, resulting in an overall estimate of 7 million undersavers across the working-age population. Given that contributions to pension schemes have also fallen, this is likely to be an underestimate of the true position.

A.8 Not all of these pensions undersavers will in fact end up with insufficient retirement income. For younger people in particular, there is time to increase pension contributions, or work longer. But it does show that on current trends a significant proportion of the population, while not necessarily heading for absolute poverty in retirement, may see an unwelcome fall in living standards in retirement.

A.9 We will continue to monitor these figures using the *English Longitudinal Study of Ageing* (ELSA) and the new *Wealth and Assets Survey,*[4] in order to provide the best estimates of the extent of undersaving on an ongoing basis.

Who is undersaving for retirement?

A.10 Figure A.ii divides the over-50s population into fifths by income level. Those most likely to be undersaving are those on middle incomes, but there is a significant amount of undersaving across most income groups. Those in the poorest fifth (roughly equivalent to a single person earning less than £8,000 a year) are at the lowest risk because most of these will reach an 80 per cent replacement rate from their state pension rights.[5]

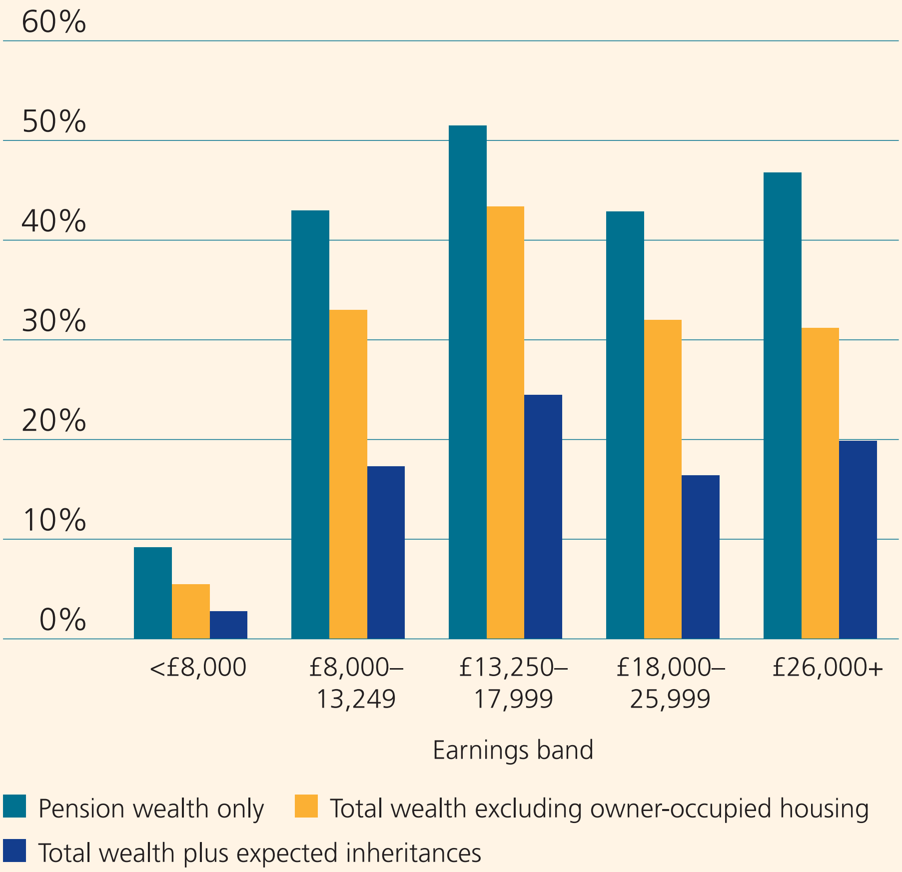
[2] IFS, 2005, *Prepared for retirement?: The adequacy and distribution of retirement resources in England,* IFS.

[3] *Family Resources Survey 2002/03–2004/05*.

[4] The *Wealth and Assets Survey* is a new, cross-government survey that DWP has been developing with ONS and other departments. It will collect data on household wealth and assets, providing a rich data source on people's saving behaviour, and allowing us to understand and track trends in undersaving much more accurately.

[5] IFS analysis of ELSA (to be published 2006).

Figure A.ii Percentage of people aged between 50 and State Pension age at risk of falling below the Pensions Commission benchmark replacement rates



Source: Further analysis of those at risk of inadequate resources in retirement (Emmerson and Tatlow, Institute for Fiscal Studies, forthcoming)

Notes: Percentages refer to percentage of individuals in families with some earned income. Includes those not in paid employment whose partner has employment income. Earnings bands represent equivalised family gross earned income, including any profits from self-employment.
Figures do not include Pension Credit.

A.11 One in four of those undersaving for retirement did not join an offered employer scheme, and one in four had never had a private pension.

A.12 Some characteristics are associated with a greater likelihood of undersaving for retirement. For middle earners, those with qualifications below degree level were more likely to be at risk of undersaving. Low/average levels of numeracy, irrespective of educational level, also increased the risk of undersaving. For middle and high earners, the self-employed were also likely to be more at risk than the employed. Finally, couples were at less risk than individuals.

Annex B: Improving fairness in the state pension system – technical detail

B.1 This chapter explains in more detail our proposals for addressing inequalities and reducing complexity in the state pension system. It specifically gives more detail on:

- Home Responsibilities Protection (HRP) and our plans to replace it with a system of weekly credits for childcare, which will be aligned within the state pension scheme; and
- adult dependency increases (ADIs), and our decision to abolish them, which will reduce some of the complexity within the state pension system.

How does HRP work?

B.2 HRP was introduced on 6 April 1978. It protects the basic State Pension and certain bereavement benefits of men and women who are precluded from regular employment because they care for children or provide care for someone who is sick or disabled.

B.3 HRP protects the basic State Pension position for complete tax years throughout which a person:

- cares for a child under the age of 16 for whom the parent receives child benefit;
- receives Income Support and is not required to be available for employment so that he or she can look after an ill or disabled person at home; or
- regularly looks after someone throughout the tax year for at least 35 hours a week who has been getting Attendance Allowance, Constant Attendance Allowance or the highest or middle rate of the care component of Disability Living Allowance, normally for at least 48 weeks in each tax year; or
- is a registered foster carer (since April 2003).

B.4 In order to qualify for a full 100 per cent basic State Pension, a person must normally have qualifying years for about 90 per cent of the years in their working life. Normally the amount of years needed is 44 for men and 39 for women. Unlike credited National Insurance contributions (NICs), HRP does not treat the recipient as if they have made actual NICs. Instead it operates by reducing the number of years needed to qualify for a basic State Pension. So when calculating a person's entitlement, the number of years for which they were covered by HRP is taken away from the number of qualifying years required for a full basic State Pension. HRP cannot reduce the number of qualifying years to less than half of the maximum or 20, whichever is the lower. (This rises to 22 for men from 2010 and gradually rises to 22 for women from 2020 when State Pension age for men and women is equalised at 65 years.)

B.5 HRP is only available on an annual basis and can only be awarded if a person has been caring for a full tax year. The intention was that HRP should protect a person's pension over substantial periods of time spent caring, not short periods of a few weeks or months.

Why change HRP?

B.6 HRP is clearly working. The significant improvement in the number of women aged 45 or below today who are projected to reach State Pension age with a full basic State Pension is, to a large extent, due to the positive effect that HRP has had on pension outcomes.

B.7 However, it is not widely understood[1] and its eventual effect – whether a woman will need HRP years in order to get a full State Pension, for example – is only apparent at the point when the State Pension is calculated. This lack of transparency does not help people to make informed decisions about planning and saving confidently for their retirement. By replacing HRP with credits, we will enable people to better plan their retirement in conjunction with their savings.

B.8 HRP can also be inflexible and, at times, unfair. An individual cannot build up basic State Pension entitlement through HRP alone, for example. This means that those people who spend a substantial proportion of their working life caring may gain nothing unless they have at least five years of (paid or credited) contributions, one of which must be a paid year. There is also an upper limit on the number of years spent caring which can be protected through HRP: an individual can build up only a maximum of 19 years of HRP over their working life.

B.9 We therefore plan to replace the system of HRP with new weekly National Insurance credits. This will remove the inflexibilities in the current scheme, thereby enabling carers to combine paid work. This more transparent, beneficial and understandable arrangement will provide higher pensions, thus making it easier for recipients to make informed choices about working and to take personal responsibility for saving for retirement.

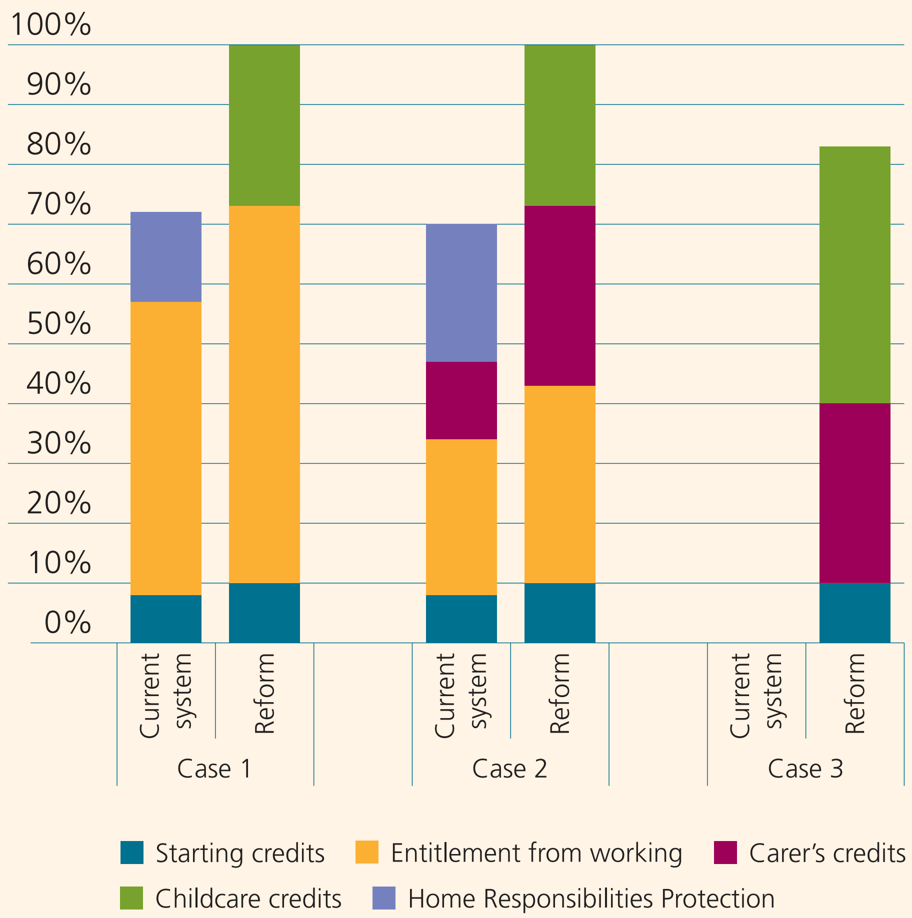
B.10 The crediting arrangements for state pensions for parents with care of children will be aligned. Entitlement of HRP depends on the child being aged under 16 years for basic State Pension and under 6 for credits in State Second Pension. Under the new crediting arrangement it will be 12 for both. This supports labour market incentives and, taken together with the other improvements in coverage, means that people will have greater opportunity to build a full basic pension than under the current scheme. The reduction to 30 qualifying years for full basic State Pension, and other changes to contribution conditions, will compensate the reduced generosity in HRP.

[1] *Women and pensions helpline,* Pensions Advisory Service, March 2005.

Transitional arrangements

B.11 Our intention is that any periods of care undertaken before reforms are implemented, which would qualify for HRP under the existing rules of the scheme, will be preserved, but converted into the new, more generous credits. So six years of HRP for caring for a disabled adult prior to 'A-Day', for example, will be converted into six years of credits for basic State Pension and State Second Pension accrual.

Figure B.i Basic State Pension entitlement for women – three illustrative cases: proportion of full rate of basic State Pension from different sources



Source: DWP calculations

Notes: These calculations are for women reaching State Pension age in 2010.
Entitlement is based on women's own contribution record only.
Cases are illustrative only.

B.12 People below State Pension age who had childcare responsibilities prior to 'A-Day' may have a reasonable expectation that years of HRP/State Second Pension protection that they have built up have been 'banked' for their State Pension – and this may have informed their additional savings decisions. We do not propose to disturb this. Therefore, we intend to retain the existing age limits in respect of childcare undertaken before these reforms are implemented, so theoretically a person could have a number of credits already accrued at the point of change for children up to the age of 16 in the basic State Pension and age 6 in State Second Pension.

B.13 Figure B.i shows the basic State Pension outcomes for three hypothetical individuals, to illustrate the type of career patterns which will result in gains from the coverage reforms.

B.14 Case 1 works after higher education before she has two children, and cares for them until they are age 7. She returns to work until around age 50. Thirty qualifying years and turning HRP into a credit means that her entitlement increases from around 70 per cent of the full rate to 100 per cent.

B.15 Case 2 has three children at age 19, and cares for them until age 40. After this she works for ten years, and then cares for an elderly relative. She gains full rate after the reforms as a result of the reduction in qualifying years, changing HRP into a credit and extending the provision of adult carers credits.

B.16 Case 3 again cares for three children from age 19 until age 40. But she doesn't work at all, so fails the first contribution condition and receives nothing under the current system. Her time spent caring for children and an elderly relative gives her over 80 per cent of the full rate under the reform.

B.17 These improvements will increase protection for carers and provide greater transparency within the system.

Abolishing the ADI

B.18 The state pension scheme includes provision for a man or woman's State Pension to be increased if another adult is financially 'dependent' on him or her – these increases are known as ADIs and have their origins in the immediate post-war period when single breadwinner households were the norm. We propose that ADIs will no longer be awarded from 6 April 2010.

B.19 Originally ADIs of State Pension were available for a range of family members, but since the 1980s, availability has been restricted to the recipient's spouse or a person having care of the recipient's children, with restrictions in the case of women claiming in respect of their husbands. The test of dependency is that the spouse or other person does not have earnings or an occupational or personal pension above the standard rate of Jobseeker's Allowance – currently £57.45 per week – and is not receiving benefit in their own right. The rate of the ADI is set at around 60 per cent of the recipient's entitlement to basic pension – currently £50.50 per week where the recipient is entitled to a full basic State Pension.

B.20 Under the current provisions, in order for a woman to become entitled to an ADI of basic pension in respect of her husband she must also have been entitled to an ADI of long-term Incapacity Benefit immediately before reaching State Pension age. As part of the package of equalisation measures in the 1995 Pensions Act, from 6 April 2010 ADIs are set to become available to women in respect of their husbands and to people in civil partnerships in respect of their civil partners on the same basis as they are currently available to men.

B.21 As female participation in the labour market has increased, the number of ADIs in payment has steadily declined from around 100,000 in 1997 to around 66,000 in November 2005. However, the number of ADIs payable with State Pension is projected to increase from 2010 as female State Pension age rises to 65 between 2010 and 2020 and coverage is extended to men and civil partners from 2010.[2]

B.22 In developing our proposals for reforming the state pension system, we have considered whether the current provisions for ADIs are relevant to, and compatible with, a system for the 21st century. Our conclusion is that the concept of 'dependency' on which the ADI provisions are based has little relevance in today's society in which partnerships of equals are the norm. There is a powerful argument that the expenditure would be better invested in providing improved state pensions, particularly for women.

B.23 We therefore propose that ADIs will no longer be awarded from 6 April 2010. All existing entitlements will be protected up to 2020. This means that any ADI payable in respect of a dependent aged 55 or over will, subject to the current rules, remain in payment up to the point she reaches State Pension age and becomes eligible for a State Pension either in her own right or based on her spouse's contributions. Based on the current caseload, we estimate that around three-quarters of ADIs in payment at 2010 will be in this category. Those for whom ADIs would otherwise have been payable and who are unable to work will, of course, be eligible for the usual range of working-age benefits. In the minority of cases where there is an ADI still in payment in 2020, we will ensure that the individual and his or her spouse receive advice on other possible benefit entitlements. We recently announced in *A new deal for welfare: Empowering people to work* that we do not intend to carry forward ADIs into the Employment and Support Allowance.

[2] Currently, with unequal State Pension age, in order for an ADI to be payable, the wife must normally be more than five years younger than the husband. Once State Pension age is equalised at 65 in 2020, an ADI would potentially be available in any case where the wife is younger than the husband. On average, a wife is around two years younger than her husband.

Annex C: Adequacy in pensions outcomes

C.1 The proposals outlined in this paper are intended to tackle at source the barriers that people face to saving and to clarify the environment in which they make decisions to save and work. The starting point of the analysis in this paper is that adequacy of pension saving is best understood in terms of the levels at which people would need to be saving to avoid unwelcome or unexpected falls in their standards of living as they move into retirement.

C.2 Understanding pension adequacy in this way is different, and represents a move away, from the previously articulated aspiration to reverse the ratio of pension incomes from 60 per cent delivered by the State in 1998, when this target was announced, to 60 per cent from private provision by 2050. We now judge that the time is right to revise this aspiration.

C.3 In the 1998 Comprehensive Spending Review (CSR), the Government adopted a Public Service Agreement (PSA) target to "promote policies consistent with a change in the ratio of spending on pensions by the State to spending on pensions by the private sector from around 60:40 to 50:50 by 2025 and 40:60 in 2050". This target was based on the policy regime set out in the 1998 paper, *A new contract for welfare: Partnership in pensions*, in particular the introduction of State Second Pension and stakeholder pensions. In view of the changes to the policy regime since 1998, of those proposed in this paper, and of technical issues with the target itself, we believe that now is an appropriate time to reconsider its relevance.

C.4 The policy changes that have had the most direct impact on the target since 1998 are the increases in state spending on pensioners as a result of the introduction and promotion of Pension Credit and of above-inflation uprating of the basic State Pension. These have meant that – despite quite rapid increases in average private pensions – the ratio between state and private spending had only fallen from 57:43 in 1996/97 to 56:44 in 2004/05.[1] The policy changes set out in this paper, in particular the broader coverage and more rapid indexation of basic State Pension, will have a similar effect. Perversely, a less generous approach to State Pension reform would help the Government meet the target.

[1] *Pensioners Income Series*, based on the *Family Resources Survey*.

C.5 The target is relevant to the evidence – in particular the progressive scaling back by both employers and employees of their commitment to occupational provision – that private pension saving is not growing fast enough. But a number of technical issues undermine its relevance. It does not include earnings, which make up 6 per cent of the income of single pensioners and 12 per cent of that of pensioner couples. Earnings have grown more rapidly than state support and, had they been included in the target, the share of spending coming from the State would have fallen from 53 per cent in 1996/97 to 51 per cent in 2004/05. The measure we have reflects income but not wealth. It does not, for example, reflect pensions or equity withdrawal taken in the form of a lump sum. The measure is also an average and can be heavily influenced by a relatively small number of people with large private pensions.

C.6 As a result of these deficiencies, the best analysis (for example by the Pensions Commission and the Institute of Fiscal Studies) and almost all of the debate about the future adequacy of pensions have been in terms of undersaving rather than the ratio of state to private pension spending. In our view, the target has failed to play much of a role in any of the important policy debates about pensions in the UK. Therefore, it is proposed to cease monitoring progress against this PSA target from the start of the 2007 CSR period, and to investigate a more appropriate target regime.

Annex D: The extent and impact of demographic and societal change

D.1 The pensions system today is being asked to perform a very different role to when it was first established. When the first state support for pensioners was introduced, soon after the turn of the last century, people reaching 65 (only about 6 per cent of the population at the time) could expect to live for around a further ten years. Today, more people reach 65 (over three-quarters of the generation now retiring), and they can expect to live into their 80s and beyond, with average life expectancy for a 65-year-old today having reached around 20 years. Those reaching 65 by the middle of this century will represent over 90 per cent of their generation and will have a life expectancy of around another 24 years.

D.2 Increased longevity is something we should celebrate. But it raises serious questions for individuals and societies as to how they continue to support themselves and an ageing population in an ever-growing period of retirement.

Demographic trends

D.3 The structure of society today is very different from when the current pension system was designed, and tomorrow's society will look different again.

D.4 It is well documented that people are living longer and that fertility rates are falling, and the rapid pace of advances in medical treatments and the better state of health of the general population is such that the extent of improvements in life expectancy is continually being revised upwards. The 1994-based population projections had forecast that a man aged 65 in 2006 would have a life expectancy of a further 17 years. However, the latest set of projections, made just a decade later, show that the same individual in 2006 can look forward to another 20 years, an upward revision of a fifth.[1] Similar patterns can be seen for the average 65-year-old woman, with life expectancy up to 23 years, compared with 18 for her equivalent 25 years ago.

D.5 Life expectancy at age 65 has risen at a rate of three months a year over the last quarter of a century. And more people now reach 65 than ever before – 83 per cent of those aged 20 in 1961 are still alive and reaching 65 today.

[1] The Government Actuary's Department's (GAD's) 1994 population projections had been based on the assumption that, by 2032, the rate of mortality improvement would reach 0.5 per cent a year at all ages, thereafter halving every 10 years. By contrast, the latest projections assume that mortality improvement will reach 1 per cent a year by 2029, and then remain constant at this rate.

D.6 The improvement of longevity has been well spread both across the constituent countries of the UK and across the different social groups. Between 1980 and 2005, life expectancy at 65 increased from 13 to 20 years in Northern Ireland, from 12 to 19 years in Scotland, and from 13 to 20 years in England and Wales.

D.7 Mortality rates[2] for the generation born between 1936 and 1945 (current retirees) have also improved significantly from those experienced by the generation born between 1906 and 1915. For those with managerial/professional jobs, mortality rates are down to just one-third of those faced by the turn-of-the-century generation; for those in unskilled manual occupations they are down to just three-fifths.

D.8 Meanwhile, UK fertility[3] has remained below replacement level since 1973, and is now around 1.77 children per woman. The 'replacement level' is the number of children required per woman for a population to reproduce itself – for each woman to have, on average, one daughter who survives to childbearing age. Because slightly more boys than girls are born, and because not all babies born will survive to childbearing age, the replacement level is a little higher than two – between 2.05 and 2.1.

D.9 Forecasting mortality and birth rates is difficult. It is speculated that increasing levels of obesity among children may decrease their life expectancies, while new breakthroughs in medicine may lead to significant improvements. Clearly, birth rates depend largely on the choices of tomorrow's parents, which experience has shown can vary significantly between generations. The Government Actuary's Department uses a constant fertility rate and assumes that mortality rates will continue to improve, but at a slower rate than during the past decades, and that migration will remain constant. They estimate that for every individual aged over 65, there were five adults aged 20–64 in 1950, there are under four now, and there will be a little over two by 2050.

D.10 These pure age comparisons tell only part of the story. In 1950, most people left school in their early teens, and men at least would continue working or looking for work until death, incapacity or retirement, which was often later than the State Pension age of 65. Women were likely to leave the labour market on marriage and remain dependent on their husband through working age and retirement. Now, it is common for people to remain in education for many more years, and until recently average retirement ages were falling despite the increases in life expectancy. Women, however, spend much more time in paid work, and since 1997 average retirement ages have been increasing gradually. Alongside this, increasing numbers of people, including parents, choose not to marry, and separation and divorce is more common. The labour market is more fragmented, and jobs for life are rarer. Living standards have risen for all, but, over the past 25 years at least, more for pensioners than for working-age adults.

[2] A mortality rate is the ratio of deaths in relation to the total population in a particular group. These mortality rates are for the age bracket 60 to 69 and are derived from the Office for National Statistics' (ONS's) *Longitudinal Study*.

[3] A fertility rate gives the number of children per woman of childbearing age.

D.11 This has complex implications for pensions policy. It suggests that there is now a greater need for women in particular to build up their own pension rights, but also a much greater ability for them to do so. Pensions may have to last for longer than they did for previous generations – but there is scope for extending working lives, perhaps through flexible working, to supplement pension saving.

D.12 The increase in women's employment and any future increases in the State Pension age will boost this country's economic growth, and also the total income available to UK citizens. But this in itself will not be a sufficient response to pensions challenges. Income sharing within families is very different to the challenges of sharing income across and between generations through the state pension system. The challenge remains to ensure that pensioners and non-pensioners share equitably in the increasing prosperity of the UK.

Life expectancy and health

D.13 While there is growing public acceptance of the evidence that life expectancy overall is increasing, there is nonetheless concern that the additional years will not necessarily be healthy years. Looking back, evidence would suggest that increased life expectancy is also resulting in increased healthy life expectancy, although not at the same rate. As the Pensions Commission has noted, this is an area where evidence is incomplete.

D.14 The ONS has calculated that in the 21 years up to 2002, male life expectancy at age 65 in the UK as a whole increased by 3.1 years, of which 2.1 were 'healthy' years. The number of years free from any form of impairment which limits activity to any significant extent ('disability-free' life expectancy) has also increased by 1.5 years over the same period.

D.15 No official projections of healthy life expectancy or disability-free life expectancy are readily available, and there is no consensus on how future trends will develop. If the trends seen in the past 21 years were to persist, healthy life expectancy would increase at around two-thirds the rate of total life expectancy – by something approaching three years by 2050.

D.16 This means that, given the past trend for healthy life expectancy to increase at a slower rate than life expectancy in general, increasing the State Pension age to 68 by 2050 could potentially result in people having approximately the same number of healthy years post-retirement as they have at present. This would equate to some reduction in the proportion of healthy years post-retirement compared with the situation as it stands today. This analysis is, however, sensitive to future developments in both overall life expectancy and healthy life expectancy, and it will be one of the issues that the proposed periodic reviews of pensions policy, described in more detail in Chapters 2 and 3, will keep under consideration.

Differences in trends for different groups in society

D.17 The Pensions Commission highlighted the fact that, while life expectancy has risen for all groups of society, some groups, in particular those who work in manual professions, have lower life expectancy than the average.

D.18 However, while these groups have seen lower increases to their life expectancies, they have still seen significant improvements. For social class I, mortality rates are down to just a third of those faced by the beginning-of-the-century generation; for class V they are down to just three-fifths.[4]

D.19 Looking back, available evidence from the ONS's *Longitudinal Study* would suggest that, had the State Pension age increased by two years between 1981 and 2001, all social classes of men and most of women would still have seen an increase in the number of years spent in retirement (as shown in Figure D.i). Equally as important is the fact that increasing the State Pension age by one year per decade in these years would not have decreased the proportion of those in any social class reaching State Pension age. Figure D.ii compares the probability of those in social classes I to V reaching 65 in 1977–81 and 67 in 1997–2001 and shows that, in all cases, because of the improvements in life expectancy in this period, the probability of reaching the age of 67 was greater than the probability of reaching 65 had been 20 years earlier.

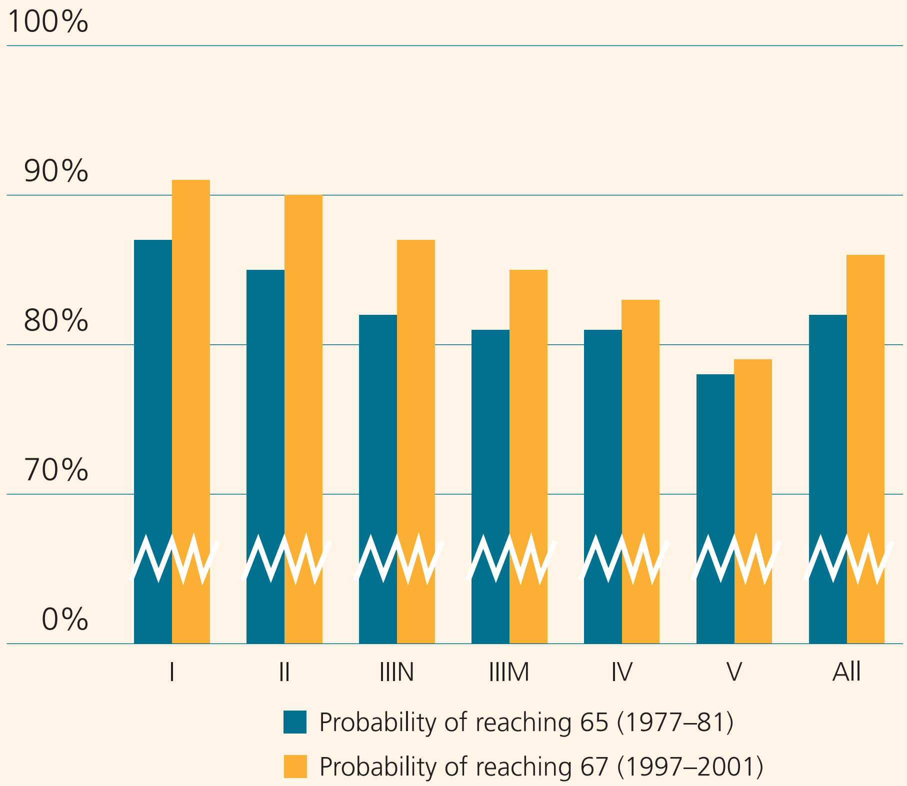
Figure D.i Period life expectancy at selected ages

Years		I	II	IIIN	IIIM	IV	V	All
	Men							
1977–81	At 65	15.5	14.2	13.3	12.6	12.2	11.9	12.7
1997–2001	At 67	16.7	15.6	15.2	13.8	12.9	12.3	14.3
	Women							
1977–81	At 65	19.9	17.8	17.6	16.9	16.8	16.3	16.7
1997–2001	At 67	18.8	18.4	18.2	16.7	16.3	15.4	17.2

Source: Detailed life tables by social class provided by the ONS's Longitudinal Study.

[4] Class I includes people in professional/managerial jobs, while class V includes unskilled workers. Around 5 per cent of the population are in the lowest social class, down from 8 per cent in 1971. If past trends persist, this is projected to fall still further, to 3 per cent by 2050. Figures based on a sample of 1 per cent of the population of England and Wales (ONS's *Longitudinal Study*, 1972 to 2001).

Figure D.ii Survival probabilities of men aged 55–59 for selected years



Source: Detailed life tables by social class provided by the ONS's Longitudinal Study

Notes: Survival probabilities represent the percentage of men aged 55–59 who, on average, would survive to reach a given age in a particular year.

KEY:

Class	***Description***	***Examples of occupations***
Non-manual		
I	*Professional*	*Doctors, chartered accountants, professionally qualified engineers*
II	*Managerial and technical/ intermediate*	*Managers, school teachers, journalists*
IIINM	*Skilled non-manual*	*Clerks, cashiers, retail staff*
Manual		
IIIM	*Skilled manual*	*Supervisors of manual workers, plumbers, electricians, goods vehicle drivers*
IV	*Partly skilled*	*Warehousemen, security guards, machine-tool operators, care assistants, waiting staff*
V	*Unskilled*	*Labourers, cleaners and messengers*

D.20 Looking forward, if we base projections on the existing (1997–2001) differentials in life expectancy by social class and assume that they remain static over time, a man in social class V would see an increase of more than two years in life expectancy at age 65 between now and 2020, and a further slight increase even with the proposed increase in State Pension age to 68 over the following three decades. For women, there would be only a slight reduction (of between four to six months) compared with the situation in 2020, and life expectancy for women beyond State Pension age would still exceed that of men.

D.21 It should be noted, however, that this analysis is based on England and Wales, and comparable analysis of differential life expectancy by social class in Scotland and Northern Ireland is not available. Across the population as a whole, life expectancy on average for both men and women in Scotland is about one year less than in England and Wales; in Northern Ireland the figures are much closer to the average for England and Wales. Future projections do not show any significant change in this disparity.

Implications for individuals

D.22 People's expectations for their incomes in retirement tend to be linked to their incomes while in work. This idea, characterised by the concept of replacement rates, is what gives rise to the measurement of undersaving as a phenomenon.

D.23 This is an inexact science. But what is clear is that, all other things being equal, longer living has an impact on the sorts of replacement rates people might expect in retirement. The natural response to longer life expectancy ought to include some combination of longer working and/or higher saving to secure a similar income level in retirement. Put simply, if people are now living for 20 per cent longer after 65, they will need a pension pot that is at least 20 per cent larger in order to provide the same weekly income as previous generations received, or they will need to work sufficiently longer to keep the number of years saving and the number of years drawing on those savings in balance.

D.24 Yet this is not what is happening. Elsewhere in this paper we have made it clear that many people are not saving at sufficient levels to meet their expectations for incomes once they retire. Longer life expectancy has been accompanied in recent years by changes in the patterns of work that people undertake, so that, while living longer, people are starting work later and, until recently, leaving it earlier.

D.25 This is perhaps at least in part because people consistently underestimate their own life expectancy. Recent survey evidence[5] suggests that, while the probability of a woman currently aged 60–64 living to reach her 75th birthday is over 80 per cent, only 65 per cent of women asked believed that they would live this long. For men the story is little better, with an actual likelihood of 75 per cent as opposed to a reported expectation of less than 65 per cent.

Implications for society

D.26 At a macro level, whether through direct, 'pay as you go' provision from the State or from private savings, ultimately all pensioner incomes are driven by the wealth created by those in work.[6] And as average life expectancy increases and fertility remains low, the proportion of those in work compared with those in retirement is falling.

D.27 In recent years, the underlying downward trend in the old-age 'support ratio' has been masked by the effects of the 'baby boom' generation born in the years following the Second World War. The resulting large cohorts have maintained the ratio against the rise in life expectancy as they have moved through working age.

D.28 But the first of these people are now starting to move into retirement. Coupled with sharp decreases in the birth rate in the 1960s and early 1970s, the ratio will now rise rapidly to catch up to where it otherwise would have been.

D.29 Figure D.iii shows the pensioner population as a percentage of the working-age population. Today, it is around 27 per cent – there are just under four people of working age for every pensioner. By 2050, when the ratio has caught up with the underlying trend, this will be 47 per cent – there will be only just over two people of working age to every pensioner. These support ratios matter. State pensions are paid for by today's taxpayers. And private pension incomes, via annuity rates, are driven by the purchasing power of people of working age buying the assets that retirees are decumulating.

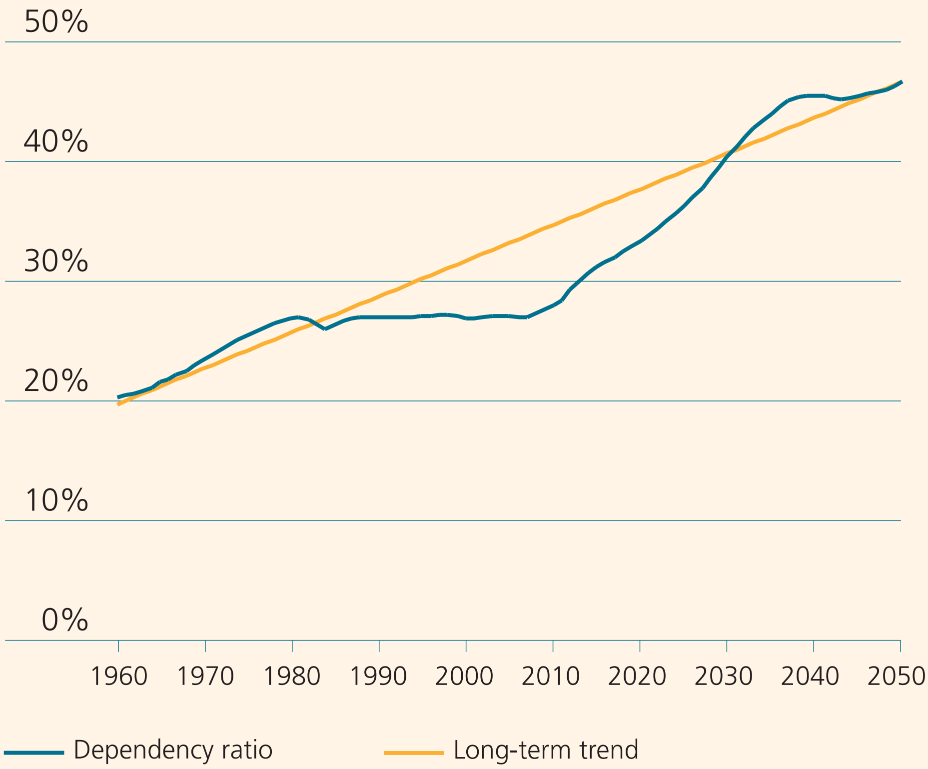
D.30 Today's pension system is working well. Average incomes for pensioners are high. Pensioner poverty is historically low, and getting lower. Economic stability means that there will be no repeat of dramatic inflation wiping out pensioner savings, and high employment means that people have a greater opportunity to build entitlements while in work.

[5] Banks, Emmerson and Oldfield, 2005, *Seven ages of man and woman*, Economic and Social Research Council (ESRC). Note that this study was based on the 2003-based GAD population projections. Updated life tables, consistent with the 2004-based GAD projections, indicate that the 'true' probability of a woman aged 60 going on to reach 75 is over 85 per cent, while for a man the probability now stands at 78.4 per cent.

[6] Individual countries can break this strict relationship between the number of pensioners and the working-age population by taking advantage of different demographic trends internationally, for example by investing abroad and by consuming the returns at a later stage.

D.31 But if this position is to be sustained in the face of the declining support ratio, something must be done. If state pensions were to maintain their value relative to the wealth of the rest of society, the burden on those in work through taxation would have to rise significantly. State spending on pensioners[7] would need to rise from its current level of 6.3 per cent of GDP to around 9.7 per cent of GDP by 2050.

Figure D.iii Old-age dependency ratio

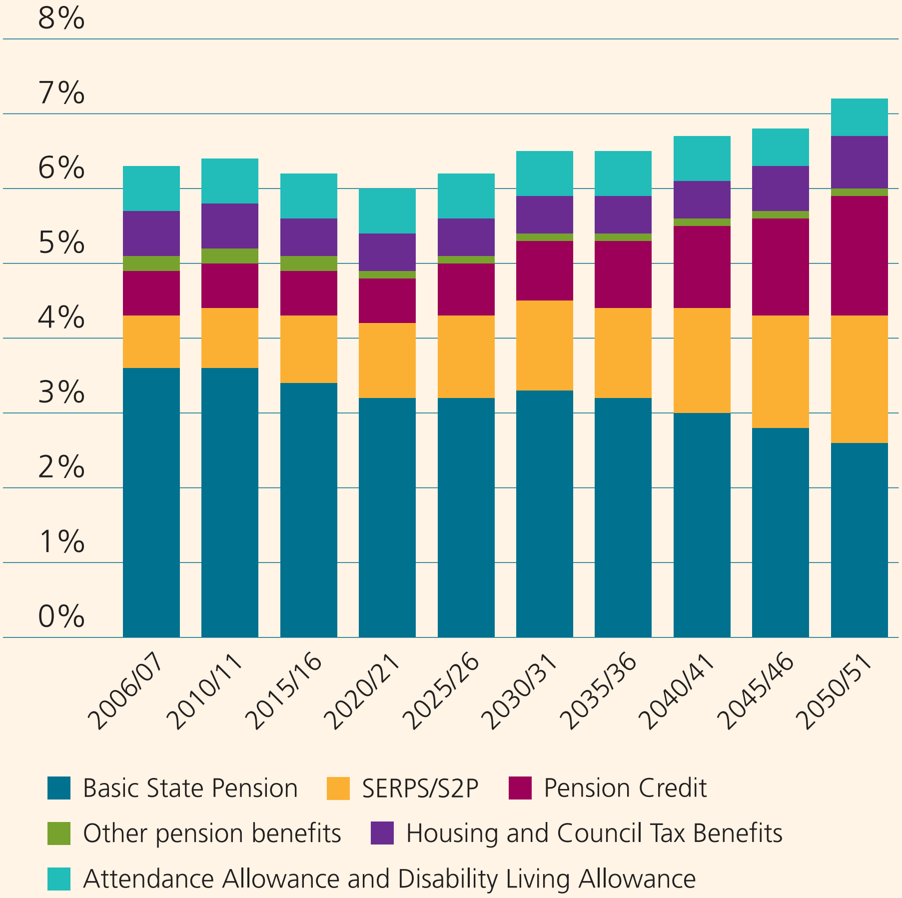


Source: DWP estimates based on Government Actuary's Department's 2004-based principal projection, UK

Notes: The old-age dependency ratio shows the number of people aged 65 and over divided by the number of people of working age (ie men and women aged between 20 and 64). The long-term development of this ratio was captured using a modified linear trend.

[7] References in this annex to 'state spending on pensioners' differ from those for 'state pension spending' in the 2005 *Long-term public finance report*, due to the inclusion of 'housing-related benefits' and 'Attendance Allowance/Disability Living Allowance'. These are included under 'other spending' and not 'state pension spending' in the *Long-term public finance report*.

Figure D.iv Projections of state spending on pensioners as a percentage of GDP



Source: DWP modelling, UK

Notes:

(a) *Projections are based on those underlying HM Treasury's Long-term public finance report 2005, and assume Guarantee Credit increases in line with earnings in all years. See PBR 2005 for a discussion of this assumption.*

(b) *The figures presented here for the numbers for 'state spending on pensioners' differ to those for 'state pension spending' in the 2005 Long-term public finance report, due to the inclusion of 'Housing and Council Tax Benefits for pensioners', and 'Attendance Allowance and Disability Living Allowance for pensioners'. These are included under 'other spending' and not 'state pension spending' in the Long-term public finance report.*

(c) *'Other pension benefits' comprise Winter Fuel Payments, other age-related payments, over 75s TV licences and Christmas Bonuses.*

(d) *'Housing and Council Tax Benefits for pensioners' comprise Housing Benefit, Council Tax Benefit in Great Britain, Rate Rebate in Northern Ireland, and Discretionary Housing Payments.*

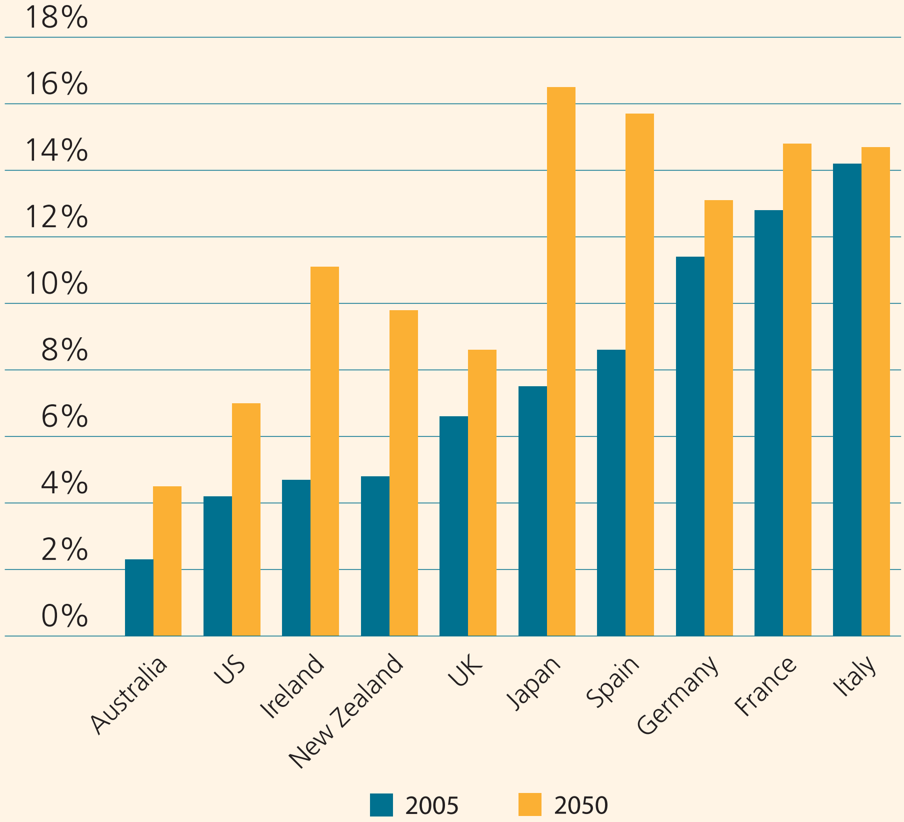
D.32 In fact, as Figure D.iv shows, spending is currently projected to rise to only 7.2 per cent of GDP over this period. This contrasts well with other countries. Recent analysis, carried out jointly by Member States and the EU Commission, revealed that, despite the impact of ageing, the level of state spending on pensions as a percentage of GDP in the UK will remain around two-thirds of that across the 25 Member States of the EU (EU25).

D.33 Due to their higher level of spending, most European countries are left with little alternative but to make their systems less generous in order to face the challenge of ageing. The latest projections of pension spending within the EU25 made by the European Commission suggests that benefit generosity will on average decline by more than 10 per cent by 2025 and by nearly 25 per cent by 2050.[8] Despite this, average spending will still have risen from 10.6 per cent of GDP in 2004 to 12.8 per cent of GDP in 2050, an increase of just over a fifth in the burden of state pensions on the economies of these countries.

D.34 As described later in this annex and at Figure D.v, projected increases in state pension expenditure in the UK compare well with other countries. But, without reform, the relatively modest projected increase in the UK will be manageable only if state pensions become less generous over time relative to the incomes of those in working age as the number of pensioners increases.

[8] Economic Policy Committee, 2006, *The impact of ageing on public expenditure: Projections for the EU25 Member States on pensions, healthcare, long-term care, education and unemployment transfers (2004–2050).*

Figure D.v International comparisons of the current and forecast percentage of GDP spent on state pensions



Sources: For EU data, The impact of ageing on public expenditure: Projections for the EU 25 Member States on pensions, healthcare, long-term care, education and unemployment transfers (2004–2050), Special Report No 1/2006, European Commission Directorate-General for Economic and Financial Affairs, February 2006.
For non-EU countries, Ageing populations, pension systems and government budgets: Simulations for 20 OECD countries by Roseveare, Liebfritz, Fore and Wurzel, Economic Department Working Paper No. 168, OECD 1996

Notes: These estimates cannot be directly compared to UK-based figures used elsewhere in this paper because they use a different definition of state spending on pensioners. Data for EU countries and non-EU OECD countries are not strictly comparable because they are derived from two separate projection exercises, done in different years, using study-specific methodologies and assumptions.

D.35 The gains made against pensioner poverty must be sustained. In practice, this would mean that levels of targeted support to protect pensioners against poverty must rise in line with earnings growth in the long term. But, combined with contributory benefits that are falling in value relative to this targeted support, this is unsustainable if our policies to reverse the decline in pension saving are to be successful. Otherwise:

- an increasing proportion of state pension incomes will come from income-related benefits, to which an increasing proportion of the population will be eligible; and
- the savings decision will become more complicated for people, whose savings behaviour will have to respond not only to longer life expectancy but also to the need to offset a declining foundation of income from the State.

D.36 This is a deeply complex picture. Reforms to introduce greater simplicity and stability into the state pension system will help people to make decisions about saving.

International experience of demographic change

D.37 The ageing of societies is a long-term and widespread trend, and in many developed countries is predicted to be more rapid than in the UK. EUROSTAT, the EU's statistical agency, estimates that the old-age dependency ratio[9] in the EU will rise from 25 per cent in 2004 to 53 per cent in 2050 (while for the UK, which at present has a similar ratio to the EU average, the rise will be to less than 50 per cent).[10] Throughout Europe the ratio today is below 30 per cent. By 2050, it will be above 30 per cent across Europe. Outside Europe, in developed and developing countries, the trend is the same. Figure D.vi shows the trend in the dependency ratio in a sample of countries.

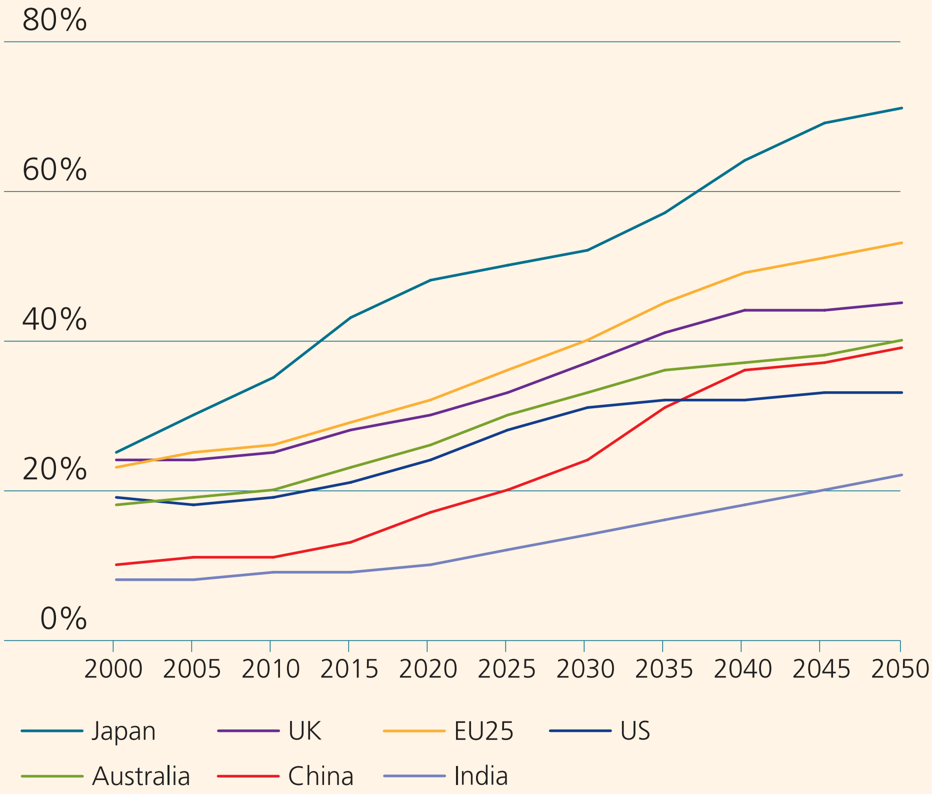
D.38 While demographic patterns are similar, pensions systems vary widely. In much of Western Europe, pensions systems are dominated by state pensions based on past earnings. In contrast, the New Zealand pensions system gives a flat rate to all pensioners satisfying a residence condition, while in Australia employers have to contribute to private pension plans for their employees and the state pension is means-tested.

D.39 Given these differences, it is not surprising that different countries have chosen different approaches to demographic change. The need to extend working lives is, however, widely recognised. Many countries are increasing their state pension ages, either directly (Austria and the Czech Republic), by increasing women's state pension age to match men's (Germany and Belgium) or by toughening early retirement conditions (Germany, Denmark, Italy, Austria and Australia). Iceland and Norway already have retirement ages of 67, and the US and Israel are increasing theirs at present. Germany and Denmark have also announced that they will increase the retirement age beyond 65 over the coming decades.

[9] Defined as the number of people aged 65 and over per person aged 15 to 64.

[10] EUROSTAT, 2005, *Baseline scenario of 2005 EUROSTAT projections,* EUROSTAT.

Figure D.vi Worldwide dependency ratios



Sources: For non-EU countries, Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: The 2004 Revision; for EU countries, Ageing Society Indicators, EUROSTAT 2005

D.40 Similar proposals are being discussed elsewhere in Europe. Sweden and Finland have flexible retirement ages that go up to 67 or 68, with better treatment for those who retire towards the end of the age period. Bonuses for later retirement have been introduced in several countries (for example Germany, Austria and France). Social contributions for older workers have been reduced (for example in Spain) and some countries no longer require people to give up employment in order to receive a pension (such as Slovakia).[11]

D.41 Some countries have also introduced more fundamental reforms. Sweden, Italy and Germany have built in mechanisms to their pensions systems to offset increases in life expectancy through lower pension benefits and/or later retirement. Similarly, in France from 2009 the number of contribution years needed to be entitled to a pension will increase in line with life expectancy.

[11] http://europa.eu.int/comm/economy_finance/about/activities/sgp/country/countryfiles/sk/sk20032004_en.pdf

D.42 Ireland and New Zealand have sought to build up buffer funds to help pay for the pensions of the baby-boomers, much of Eastern Europe and Latin America have moved to privately-funded pension systems,[12] and Sweden and New Zealand have introduced a new tranche of funded provision through some form of individual accounts. Some countries – such as the Czech Republic and Estonia – have either increased levels of contributions to state pensions or reduced their generosity, for example through lower indexation.

D.43 All the countries affected by ageing have realised that there are essentially only four different choices before them – people work more, they save more, or else taxes increase or benefits decrease. The choices they have made and are continuing to make reflect the size of their ageing problem and the particular characteristics of their current pension regime.

[12] http://europa.eu.int/comm/employment_social/social_protection/docs/2005/sk_en.pdf

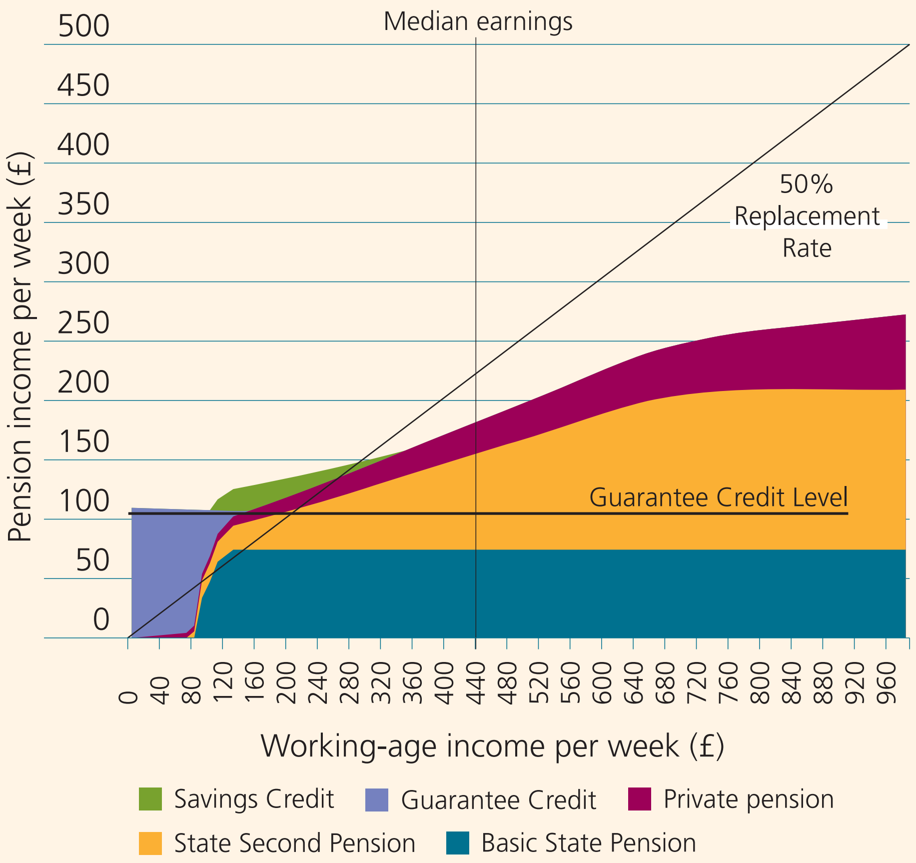
Annex E: Outcomes under the reformed system

E.1 This annex assesses outcomes under the new system and demonstrates how the reforms to the state and private systems interact to improve overall pensions outcomes.

The shape of the new system

E.2 Figure E.i shows the incomes that people retiring in 2010 might receive from state pensions and private saving. It assumes that people save 5 per cent of their income in a personal pension. A median earner can expect a replacement rate including private saving of around 40 per cent. For a lower earner earning at the Lower Earnings Threshold, this is more like 68 per cent, and for a higher earner it is around 30 per cent. This, coupled with other assets and further savings, could be expected to take them to an income in retirement that meets their expectations. The Pensions Commission suggested that those lower down the income distribution might expect a higher replacement rate than those with higher incomes during working age. The figure shows that the current system performs well in helping people to achieve these expectations.

Figure E.i Forecast results from state and private pension in 2010

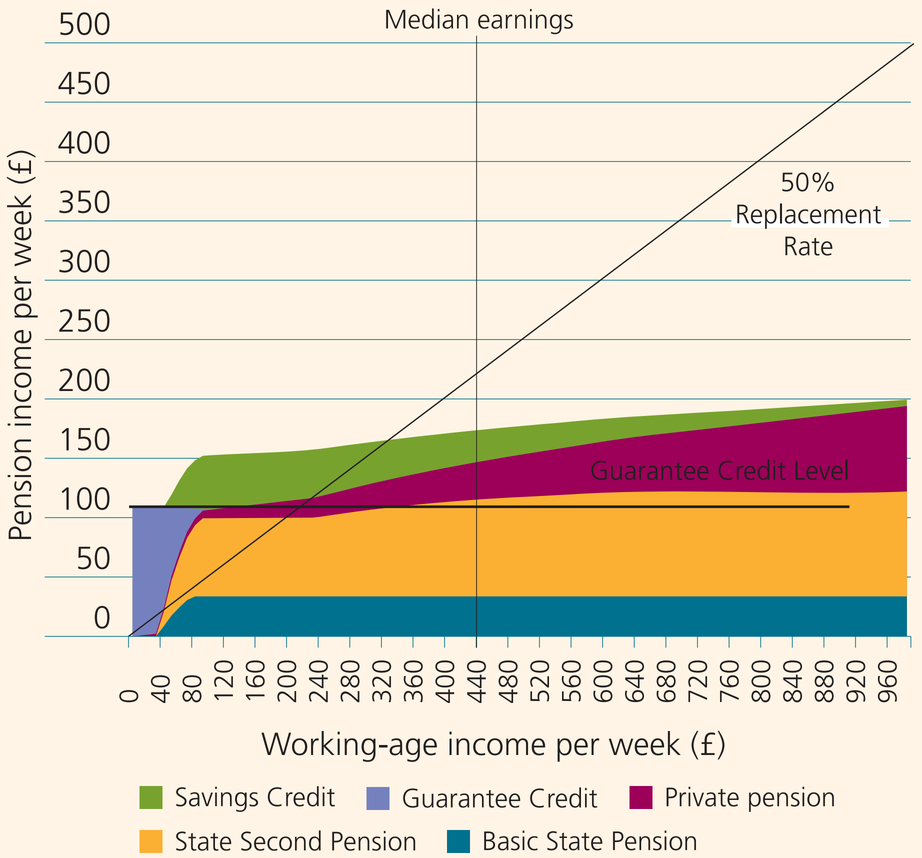


Source: DWP modelling

Notes: Assumes 49 years of saving 5% of salary between the Primary Threshold and Upper Earnings Limit into a stakeholder pension, with a 1.5% annual management charge. This is equivalent to the employee-only contribution rate into the new personal accounts.
25% tax-free lump sum is taken and annuitised, with annuity income included in private pension.
These figures do not reflect rights to basic State Pension and State Second Pension that may be accrued due to caring, or receipt of disability or unemployment benefit.
In 2005/06 earnings terms.
State Second Pension includes other forms of additional State Pension.

E.3 However, the shape of the pensions system is changing over time. The value of contributory benefits is falling relative to earnings. Assuming that all current indexation within the state system remains the same, Figure E.ii shows outcomes under the system as it might look by 2050. It assumes no change in the level of private saving.

Figure E.ii Forecast results from state and private pension in 2050 – current indexation rolled forward indefinitely

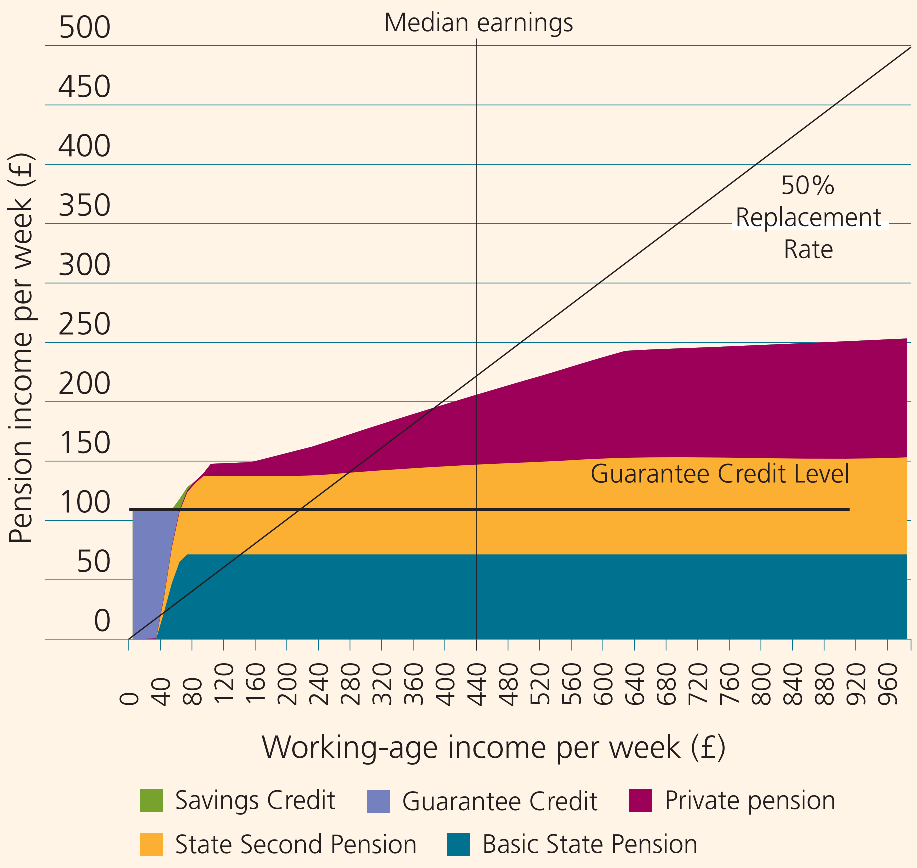


Source: DWP modelling

Notes: Assumes 49 years of saving 5% of salary between the Primary Threshold and Upper Earnings Limit into a stakeholder pension, with a 1.5% annual management charge. This is equivalent to the employee-only contribution rate into the new personal accounts.
25% tax-free lump sum is taken and annuitised, with annuity income included in private pension.
These figures do not reflect rights to basic State Pension and State Second Pension that may be accrued due to caring, or receipt of disability or unemployment benefit.
In 2005/06 earnings terms.

E.4 If current uprating policies continued, by 2050 the shape of the system would change considerably. While replacement rates at the lower end of the income distribution, up to around median earnings, would have remained similar or even grown slightly, an increasing proportion of this income is from means-tested benefits. Further up the income distribution, replacement rates would have fallen due to the decline in the level of the State Pension, and targeted benefits would have spread so that a majority of the population were entitled to Pension Credit. Under this approach, by 2050 we would be spending an additional 0.9 per cent of GDP compared with today.

Figure E.iii Forecast results from state and private pension in 2050 under reforms



Source: DWP modelling

Notes: Assumes 49 years of working and saving at 8% of salary between the Primary Threshold and the Upper Earnings Limit into a personal account (which includes a 3% employer contribution).
25% tax-free lump sum is taken and annuitised, with annuity income included in private pension.
These figures do not reflect rights to basic State Pension and State Second Pension that may be accrued due to caring, or receipt of disability or unemployment benefit.
In 2005/06 earnings terms.

E.5 It has never been the intention of the Government for a significant majority of the pensioner population to be entitled to Pension Credit. Figure E.iii shows how the reformed system will look by 2050. The level of contributory state support will have retained its value relative to earnings. And the introduction of personal accounts will have increased the value of that saving as a result of lower charges and the presence of an employer contribution. Most people will see a higher replacement rate, and those who see a lower replacement rate will already have a replacement rate of around 100 per cent.

Longer working

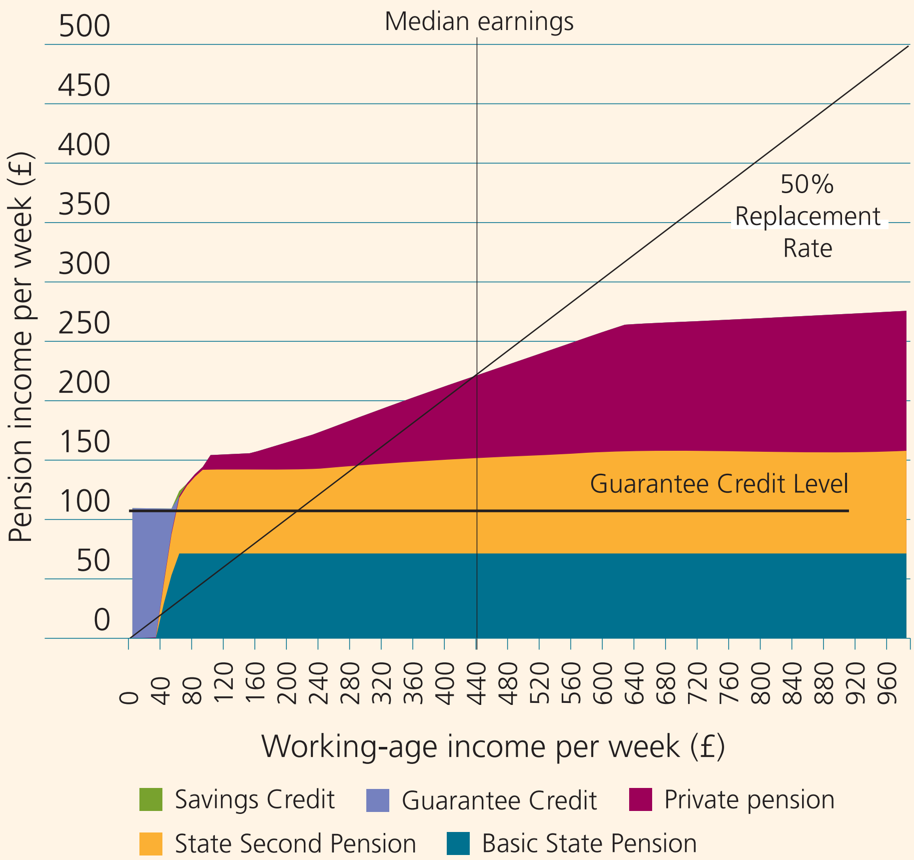
E.6 It is also important within this analysis to recognise the impact of longevity. Figure E.iii assumes that people retire and annuitise their private pension savings at age 65. This would mean that people's savings would have to cover them in a longer period of retirement than today, and they would get a correspondingly lower annuity rate.

E.7 A key element of our proposals for reform is to engender a culture change in respect of people's attitudes towards longer working, something which we are signalling now by announcing our intention to increase the State Pension age in line with growing life expectancy from 2020. If these increases in State Pension age are accompanied by corresponding increases in average retirement ages, the impact on pension incomes will be considerable. Figure E.iv shows the outcomes under the assumption that people have worked and saved for a further three years (by 2050, the State Pension age will have risen by three years to 68). Private incomes will be higher – both as a result of more having been saved, and because they will be drawn down over a shorter period.

E.8 The rise in State Pension age and any accompanying increase in average retirement ages are also critical to the affordability of reform. Increasing the State Pension age is expected to save almost 1 per cent of GDP by 2050. This will considerably offset the costs of the rest of the reforms. As described earlier in this annex, without reform we expect to be spending almost 1 per cent more on state pensions by 2050 than we do today. At the same time, average incomes from state pensions would have fallen by almost a quarter. With the reforms outlined in this paper, we will be spending around 1.4 per cent of GDP more than today – at 7.7 per cent[1] still considerably less than most industrialised nations – having maintained spending per pensioner at almost its current level.

[1] Excludes spending on working-age benefits as a result of State Pension age changes. References in this annex to 'spending' and 'spending on state pensions' differ from those for 'state pension spending' in the 2005 long-term public finance report, due to the inclusion of 'housing-related benefits' and 'Attendance Allowance/Disability Living Allowance'. These are included as 'other spending' and not 'state pension spending' in that report.

Figure E.iv Forecast results from state and private pension in 2053



Source: DWP modelling

Notes: Assumes 52 years of working and saving at 8% of salary between the Primary Threshold and the Upper Earnings Limit into a personal account (which includes a 3% employer contribution).
25% tax-free lump sum is taken and annuitised, with annuity income included in private pension.
These figures do not reflect rights to basic State Pension and State Second Pension that may be accrued due to caring, or receipt of disability or unemployment benefit.
In 2005/06 earnings terms.

E.9 Success in our policies to extend working lives, as part of our aspiration to meet an 80 per cent employment rate, will help still further. Increasing the employment rate will result in greater national productivity and a higher tax yield, making pensions relatively less expensive. Today, state spending on pensioners is 6.3 per cent of GDP. By 2050, with no reform, this will be 7.2 per cent. With our planned reforms, it will be 7.7 per cent. But were we to reach an 80 per cent employment rate by 2030, the figure might be lower.

How the new system will affect individuals

Coverage within state pensions

E.10 The analysis in the previous sections focuses on the replacement rates that people can expect from the new pensions system as it evolves into the future, assuming people have relatively full working lives (and therefore full state pension entitlements). But this obscures another dimension of our reforms – those which will ensure increased coverage within the state pension system. These reforms mean that most people will be able to plan for their retirement in the confidence that the foundation income they receive from the State will provide them with an income above the level of the Guarantee Credit, and will thus ensure that they achieve a higher effective rate of return on any additional private saving that they make.

Outcomes for individuals

E.11 The combined impact of reform for individuals can be illustrated by demonstrating incomes in retirement for illustrative individuals with simulated employment and earnings histories, before and after reform. In this section, we focus on a lifetime median earner case study – someone who is employed from 25 until State Pension age and receives median earnings throughout his or her working life.

E.12 Figure E.v compares the outcomes for a median earner retiring in 2050 under:

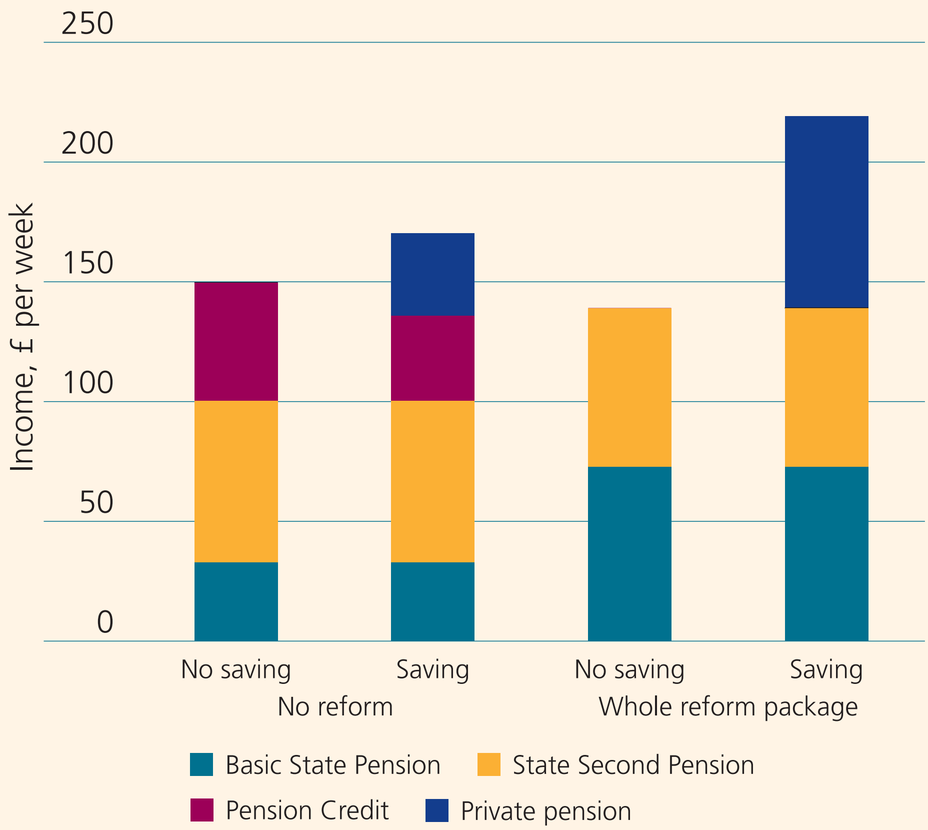
- the system with all current indexation policies persisting into the future, and the impact on their income if they saved 5 per cent of earnings in a personal pension; and

- the reformed system, and the impact on their income if they saved 5 per cent of earnings in a new personal account.

E.13 In the current system, this individual sees an improvement in their income from having saved. But in the reformed system, the lower charges and presence of an employer contribution within personal accounts results in a higher private pension income and a higher income overall, with less displacement of state pension income as a result of having saved.

E.14 This comparison represents only part of the story. While lower charges should be an outcome specific to the new scheme of personal accounts, many employers already offer a contribution into their employees' pensions. But one of the key characteristics of many of those who are currently undersaving for retirement is that they do not have access to such a contribution. Figure E.v therefore shows the sort of benefit that someone in this group might experience as a result of reform.

Figure E.v Income for median earner – with and without reform – outcomes in 2050/53



Source: DWP modelling

Notes: In 2005/06 earnings terms, income shown before tax.
Saving under no reform assumes saving 5% of salary between the Primary Threshold and Upper Earnings Limit into a stakeholder pension, with a 1.5% annual management charge. This is equivalent to the employee-only contribution rate into the new personal accounts.
Saving under reform package assumes saving 8% of salary between the Primary Threshold and Upper Earnings Limit into a personal account (which includes 3% employer contribution, and has 0.5% annual management charge).
No reform assumes 40 years of saving and working, retiring in 2050.
'Whole reform package' assumes 43 years of saving and working, retiring in 2053.

A cohesive set of policies

E.15 Some commentators have suggested that we do not need action to increase saving within the private pensions sphere **and** state pension reform to respond to the pensions challenge. This argument would suggest one of two things. Either:

- that the introduction of a scheme of automatic enrolment into personal accounts alone would overcome inertia in financial decision-making, leading to better outcomes in retirement. Reforms to the state pension system are not therefore a necessary condition for a successful response to the undersaving problem; or

- that a simplified and bolstered State Pension, under which people could be confident of the value of additional saving, would in itself be enough to overcome remaining barriers to saving, even within the existing private pensions framework.

E.16 We do not accept either argument. The key proposition underpinning the introduction of personal accounts is that people must have access to a low-cost, high-quality pension-saving vehicle, and that the decision to save in that vehicle must be framed in the right way. Evidence suggests that the most effective way to frame this decision is through opting people into the scheme automatically, giving them the right to opt out if they wish.

E.17 We need to be confident in requiring employers to enrol their staff into the scheme. If this were not the case, and individuals or their employers did not think membership was in their interests, the resultant reduction in the numbers of people with personal accounts would reduce the flow of funds in the scheme and result in higher charges. This would further reduce the numbers for whom it would make sense to remain in the scheme and, just as crucially, impact on people's perceptions of the trade-off between current and future consumption as it was then being presented to them.

E.18 Earnings uprating of the basic State Pension provides the solid foundation for private saving so that we can have this confidence. We are aware of the argument that, had current uprating policies persisted indefinitely, a majority of pensioners would have become entitled to Pension Credit; and that there is a perception that such a scenario could have damaged incentives. As is made clear above, this was never the intention. Our reforms make this clear.

E.19 Essentially, without accompanying reform of the state pension system, the objectives of a low-cost savings product utilising automatic enrolment to overcome individual inertia might not have been possible.

E.20 We also do not believe that state pension reform alone is sufficient to prompt individuals to voluntarily save more in the numbers required to meet the challenges raised by current levels of undersaving. As outlined earlier a considerable volume of evidence suggests that even in an environment of fully available information, and where saving would be 'worthwhile' for the individual concerned, people often fail to make the decision to start saving.

E.21 We therefore judge that an adequate response to the undersaving problem, which places responsibility for saving on the individual in an environment that is conducive to their taking that responsibility, requires the introduction of a scheme of personal accounts underpinned by a reformed state pension system.

Annex F: DWP research and evidence

DWP-commissioned research already published

Pensions 2002: Public attitudes to pensions and saving for retirement
Research Report No. 193
By Victoria Mayhew
July 2003
ISBN 1 84123 599 7

Factors affecting the labour market participation of older workers
Research Report No. 200
By Alun Humphrey, Paddy Costigan, Kevin Pickering, Nina Stratford and Matt Barnes
November 2003
ISBN 1 84123 626 8

Combined Pension Forecasts: A report on the experiences and views of CPF providers and recipients
Research Report No. 212
By Karen Bunt, Lorna Adams and Catherine Mottram
July 2004
ISBN 1 84123 695 0

Effective means of conveying messages about pensions and saving for retirement
Research Report No. 239
By Emma Green and Clarissa White
June 2005
ISBN 1 84123 797 3

Micro-employers' attitudes towards pensions for themselves and their employees: A report on small-scale qualitative research with employers
Research Report No. 266
By James Noble
October 2005
ISBN 1 84123 854 6

Financial education: A review of existing provision in the UK
Research Report No. 275
By Jude England and Papiya Chatterjee
August 2005
ISBN 1 84123 870 8

Factors affecting the labour market participation of older workers: Qualitative research
Research Report No. 281
By Pat Irving, Jennifer Steels and Nicola Hall
September 2005
ISBN 1 84123 880 5

Advice on pensions and saving for retirement: Qualitative research with financial intermediaries
Research Report No. 289
By Elaine Kempson and Sharon Collard
November 2005
ISBN 1 84123 895 3

An evaluation of scheme joining techniques in workplace pension schemes with an employer contribution
Research Report No. 292
By Sarah Horack and Andrew Wood
November 2005
ISBN 1 84123 903 8

Combined Pension Forecasts: A survey of their impact on recipients
Research Report No. 293
By Sarah Horack and Andrew Wood
November 2005
ISBN 1 84123 904 6

Providing pensions information and advice in the workplace where there is little or no employer contribution
Research Report No. 294
By John Leston and Margaret Watmough
November 2005
ISBN 1 84123 905 4

Women and pensions: The evidence
www.dwp.gov.uk/publications/dwp/2005/wp/women-pensions.pdf
November 2005

Extending working life: A review of the research literature
Research Report No. 299
By Chris Phillipson and Allison Smith
December 2005
ISBN 1 84123 917 8

The effects of means-testing pensions on savings and retirement
By Martin Weale, Justin van de Ven and James Sefton
(National Institute of Economic and Social Research)
December 2005

Survey of employers' policies, practices and preferences relating to age
Research Report No. 325
By Hilary Metcalf with Pamela Meadows
March 2006
ISBN 1 84123 974 7

Employers' Pension Provision Survey 2005
Research Report No. 329
By Stephen McKay
March 2006
ISBN 1 84123 980 1

The Pension Service Customer Survey 2005
Research Report No. 331
By Nicholas Howat and Lorraine Sims
March 2006
ISBN 1 84123 982 8

The importance of incentives in influencing private retirement saving: Known knowns and known unknowns
By Richard Blundell, Carl Emmerson and Matthew Wakefield (IFS Working Papers series)
April 2006

DWP-commissioned research to be published in 2006

Pensions and savings
By Karen Bunt, Lorna Adams, Zehra Koroglu and Eoin O'Donnell (IFF research)

Public attitudes to pension reform omnibus survey
By Michael Kelly (DWP)

Public attitudes to personal accounts: Report of a qualitative study
By Suzanne Hall, Nick Pettigrew and Paul Harvey (Ipsos MORI)

Employer attitudes to personal accounts: Report of a qualitative study
By Helen Marshal & Andrew Thomas (BMRB)

Employer attitudes to personal accounts: Report of a quantitative survey
By Keith Bolling, Catherine Grant, Alice Fitzpatrick (BMRB)

Review of research relevant to assessing the impact of the proposed National Pension Saving Scheme on household saving
By Jonathan Hawksworth (PriceWaterhouseCoopers)

This research is part of a larger continuing programme of economic and social research, which is contributing to the Government's efforts to improve the evidence base. These wider efforts include the development of a new *Wealth and Assets Survey* which will provide key longitudinal data on pensions and savings, housing, debt, financial planning and attitudes. We will publish details of our plans and research activities to improve the quality of the evidence base later this year.

Annex G: Glossary

Active members	Current employees who are contributing (or having contributions made on their behalf) to an organisation's **occupational pension** scheme. The scheme may be open or closed but cannot be frozen.
Additional Pension (AP)	The earnings-related state pension paid in addition to the **basic State Pension**. From 1978 to 2002 it accrued under the **State Earnings-Related Pension Scheme** (SERPS) and from 2002 under the **State Second Pension** (S2P) scheme.
Additional Voluntary Contributions (AVCs)	**Personal pension** contributions made by someone who is also a member of an **occupational scheme** as a top-up to their occupational entitlement. AVCs can be made into the occupational scheme or to a stand-alone product called a free-standing AVC plan.
Annual management charge (AMC)	The charge generally applied to **personal pension** plans where the fee is levied as an annual charge on the value of the fund. This charge covers the sales, administration and fund management costs of the fund.
Annuity	Purchased with an individual pension pot, which has been built up in a **defined contribution pension scheme**, to provide an income that is usually payable for life. A single-life annuity pays benefits to an individual. A joint-life/survivor's annuity pays benefits to the spouse/dependent partner after the death of the first. A level annuity pays constant payments, whereas an index-linked annuity pays benefits relating to an index (for example, the **Retail Price Index**).
Automatic enrolment	A system whereby an individual is made a member of a pension scheme by default and has to actively decide to leave the scheme.
Average earnings terms	Figures have been adjusted to remove the effect of increases in average earnings over time. Thus, if something shown in average earnings terms increases, it is rising faster than average earnings, whereas if it is constant, it rises at exactly the same pace as average earnings.
Baby boom	A temporary marked increase in the birth rate. There were two baby booms in the second half of the 20th century: immediately following the Second World War and in the early 1960s.

Basic State Pension	There are four main types of basic State Pension:
Category A	Based on contributions paid or credited over a person's working life. Normally someone needs 44 years of contributions or credits to qualify for a full basic State Pension (women born before 6 April 1955 need fewer), but the number of years needed can be reduced by **Home Responsibilities Protection**. Payable on claiming at **State Pension age** at the rate of £84.25 per week (2006/07). Those with less than full contribution records receive a pro-rata amount subject to the 25 per cent *de minimis* rule. There is an age addition of 25p per week for individuals aged over 80.
Category B	A pension payable under the same conditions as Category A except that the spouse's contribution record is used. Widows and widowers receive Category B pension at the same rate as Category A pension. Married women (and married men and people in civil partnerships from 2010) receive Category B pension at £50.50 per week (approximately 60 per cent of the Category A rate).
Category C	Largely obsolete – non-contributory pension now only paid to the widows of men who had already reached **State Pension age** when the National Insurance scheme started in 1948.
Category D	A non-contributory pension paid to residents of the UK aged over 80 who satisfy a residency test of at least 10 years in any continuous 20-year period after their 60th birthday. The pension is £50.50 per week (2006/07).
Behavioural economics	A class of economic theories using insights from psychology to understand how individuals make economic decisions.
Bond	A debt investment with which the investor loans money to an entity (company or government) that borrows the funds for a defined period of time at a specified interest rate.
Buffer funds (national)	A number of countries have chosen to smooth the age-related expenditure associated with the **baby boom** generation by establishing national reserve or buffer funds. Most stipulate a certain annual level of contributions or source of income which is then invested. Most countries with national buffer funds invest (at least partially) in overseas assets and in higher-return but higher-risk assets such as equities.
Citizens' Pension	Proposal for a state pension payable to every individual over **State Pension age** who meets defined residency criteria. The level usually suggested is equal to the **Guarantee Credit** component of **Pension Credit** (£114.05 per week in 2006/07).

Contracting out	The system by which individuals can choose to opt out of **State Second Pension** and use a proportion of their **National Insurance** contributions to build up a **funded** pension. There are four types of schemes into which an individual may contract out. The rules and rebate levels are different for each. These are: Contracted-out Salary-Related Scheme, Contracted-out Mixed Benefit Scheme, Contracted-out Money Purchase Scheme and approved personal pension.
Council Tax Benefit	A **means-tested benefit** through which the UK Government helps qualifying individuals meet their Council Tax payments. Qualification criteria include income, savings and personal circumstances.
Decumulation	The drawing down of pension assets to fund retirement. In the UK it is permitted to access pension assets partially as a tax-free lump sum and partially as an income stream (i.e. **annuity** or income draw down).
Default fund	In compulsory or auto-enrolled **defined contribution** pension schemes, some members do not make a choice of investment fund. These members will have their contributions paid into a default fund, designated for the purpose.
Defined benefit (DB) pension scheme	A pension scheme where the pension is related to the member's salary or some other value fixed in advance.
Defined contribution (DC) pension scheme	A scheme where the individual receives a pension based on the contributions made and the investment return that they have produced. They are sometimes referred to as money purchase schemes.
Disability Living Allowance	A non-means tested benefit which is mainly paid to people under **State Pension age** if they have additional needs because of illness or disability.
Earnings-related provision	The pension rights accrued in the scheme are linked to earnings. In a state pension scheme, the formula may take account of average earnings over the working life or be based on a certain number of years as well as the number of contribution periods. The alternative to earnings-related provision is **flat-rate provision**.
European Economic Area	The European Economic Area consists of all 25 Member States of the European Union as well as Iceland, Liechtenstein and Norway.
Equity	Share or any other security representing an ownership interest.
Final salary scheme	A **defined benefit pension scheme** that gives individuals a pension based on the number of years of pensionable service, the accrual rate and final earnings as defined by the scheme.

Flat-rate provision	The pension rights accrued in the scheme are on a flat-rate basis. Thus, the level of earnings is not taken into account by the formula, which is based on the number of contribution years. The alternative to flat-rate provision is **earnings-related provision**.
Free-standing Additional Voluntary Contribution	An **Additional Voluntary Contribution** plan which is separate from the individual's **occupational pension** fund.
Funded	Pension schemes whereby pension contributions are paid into a fund which is invested, and pensions are paid out of this pot.
Gross Domestic Product (GDP)	A measure of economic activity in a country, calculated by adding the total value of a country's annual output of goods and services.
Guarantee Credit	A **means-tested benefit** which is part of **Pension Credit** and provides pensioners with a minimum level of income. In 2006/07 the standard level of Guarantee Credit for a single person is £114.05 per week. For a couple the level is £174.05 per week.
Guaranteed Minimum Pension	The minimum pension that must be provided by a **Contracted-out** Salary-Related Scheme for pensions accrued between 1978 and 1997. The GMP is roughly equivalent to the **SERPS** foregone from **contracting out**.
Her Majesty's Revenue and Customs	The new department responsible for the business of the former Inland Revenue and HM Customs and Excise. It is the department responsible for **National Insurance**.
Home Responsibilities Protection (HRP)	This helps protect the **National Insurance** records of people who have caring responsibilities by reducing the number of years of contributions or credits they need to qualify for a full **basic State Pension**.
Inertia	People often accept the situation with which they are presented as a given. As a result, **automatic enrolment** increases participation rates, and the Save More Tomorrow schemes lead to an increase in saving over time.
Informed Choice	The Informed Choice programme is a Government programme of initiatives, which aims to foster an increasingly proactive approach by individuals to saving for retirement.

Life expectancy	Life expectancy (or the expectation of life) at a given age, x, is the average number of years that a male or female aged x will live thereafter, and is calculated using age- and gender-specific mortality rates at ages x, x+1, x+2 etc. Period life expectancy is calculated using age-specific mortality rates for the period under consideration and makes no allowance for changes in age-specific mortality rates after that period. Cohort life expectancy is calculated allowing for subsequent known or projected changes in age- and gender-specific mortality rates after that period as he or she gets older. For example, a period life expectancy calculation for a male aged 50 in 2000 would use male mortality rates for age 50 in 2000, age 51 in 2000, age 52 in 2000 (and so on). The cohort life expectancy would be calculated using male mortality rates for age 50 in 2000, age 51 in 2001, age 52 in 2002 (and so on). The cohort definition is the better measure of true life expectancy.
Long-dated gilts/bonds	Gilts or **bonds** with many years (for example, 20) left until maturity.
Longevity	Length of life.
Longitudinal study	A research study which follows a group of individuals over a period of time.
Lower Earnings Limit (LEL)	The level of earnings at which an individual is treated as if they have made **National Insurance** contributions. In 2006/07 the limit is £84 per week or £4,368 per year.
Lower Earnings Threshold (LET)	For the purposes of calculation of **State Second Pension**, anyone earning less than the Lower Earnings Threshold (£12,500 in 2006/07) and above the **Lower Earnings Limit** is treated as if they had earnings at the Lower Earnings Threshold.
Macroeconomics	The study of aggregate economic activity focusing on variables such as **Gross Domestic Product**, economic growth, unemployment and inflation.
Means-tested benefits	State benefits where the amount paid depends on the level of income and capital and other personal circumstances.
Median	The median of a distribution divides it into two halves; therefore, half the group are above the median value and half below.
Minimum Income Guarantee	The forerunner of **Guarantee Credit**.

National Insurance (NI)	The national system of benefits paid in specific situations, such as retirement, based on compulsory or voluntary contributions. There are four main classes of contributions:		
	Employment status	**Contribution level**	**Income band**
Class 1	Employed	12.8 per cent for the employer and 11 per cent for the employee unless contracted out	Pay from **Primary Threshold** to **Upper Earnings Limit** but credited from **Lower Earnings Limit** to Upper Earnings Limit
Class 2	Self-employed	Flat-rate payment of £2.10 a week (2006/07)	If earnings below £4,465, eligible for certificate of small earnings exemption
Class 3	Voluntary	Flat-rate contribution of £7.55 a week (2006/07)	Voluntary for those not contributing through Class 1 or 2
Class 4	Self-employed	8 per cent	Between Lower Profits Limit (£5,035 in 2006/07) and Upper Profits Limit (£33,540 in 2006/07)
There are special rates of Class 1 contributions for mariners and of Class 2 for share fishermen and volunteer development workers. In relation to pensions, Class 1 contributions accrue rights to **basic State Pension** and **State Second Pension**, while Class 2 and 3 contributions accrue rights only to the basic State Pension. Class 4 contributions do not accrue rights to any benefit.			
Occupational pension	A pension that is provided via the employer, but the pension scheme takes the form of a trust arrangement and is legally separate from the employer.		

Old-age dependency ratio	Used in this paper to measure the number of people above age 65 compared with the number of people aged 20–64 in the population.
Pay As You Earn (PAYE)	A mechanism used to collect Income Tax, **National Insurance** and some other statutory payments (for example, Student Loan repayments) from employees and employers at source. The employer makes the appropriate deductions from weekly or monthly earnings and sends the contributions to **Her Majesty's Revenue and Customs**. The payments are usually made monthly, on an aggregate basis, with annual returns of individual information to enable the reconciliation of individuals' contributions and accounts. PAYE is not normally used as a collection method for the self-employed.
Pay as you go (PAYG)	A pensions system in which the pension is paid out of current revenue and no funds are accumulated to pay future pensions. The **National Insurance** system is PAYG.
Pension accrual	The build-up of pension rights. In a **defined benefit** scheme this may be based on the number of years of contributions.
Pension Credit	The main **means-tested benefit** for pensioners, which combines **Guarantee Credit** and **Savings Credit**.
Persistency	Where someone continues to make contributions to a pension scheme over time.
Personal pension	A pension which is provided through a contract between an individual and a pension provider. The pension produced will be based on the level of contributions, investment growth and **annuity** rates. A personal pension can either be employer-provided (a Group Personal Pension) or purchased individually.
Price-indexation	Increasing each year in line with inflation.
Primary Threshold	The point at which employers and employees become liable for **National Insurance** contributions. In 2006/07 the threshold is £97 per week or £5,035 per year.
Protected rights	The element of the **defined contribution** pension arising from contracted-out rebates.
Rate of return	The gain or loss of an investment over a specified period, expressed as a percentage increase over the initial investment cost. Gains on investments are considered to be any income received from the asset, plus realised capital gains.

Real terms	Figures have been adjusted to remove the effect of increases in prices over time (inflation), usually measured by the **Retail Price Index**. Thus if something shown in real terms increases, then it is rising faster than prices, whereas if it is constant, it rises at exactly the same pace as prices.
Replacement rate	This measures income in retirement as a percentage of income before retirement.
Retail Price Index (RPI)	This is an average measure of the change in the prices of goods and services bought for consumption by the vast majority of households in the UK.
Savings Credit	Part of **Pension Credit**. It is a **means-tested benefit** for people aged 65 or over, which accrues at the rate of 60p for each pound above the equivalent of the full **basic State Pension** up to a maximum of £17.88 for a single person (£23.58 for a couple).
Stakeholder pension	A **personal pension** product which complies with regulations which limit charges and allow individuals flexibility about contributions.
Stakeholder price cap	A 1.5 per cent **annual management charge (AMC)** for the first ten years of the policy, and thereafter a 1 per cent **AMC**.
State Earnings-Related Pension Scheme (SERPS)	The forerunner of the **State Second Pension**, which provides an earnings-related **National Insurance** pension based on contributions.
State Pension age	The age at which an individual can claim their State Pension. It is currently 65 for men and 60 for women. The State Pension age for women will gradually increase to 65 between 2010 and 2020.
State Second Pension	The earnings-related **National Insurance** pension paid on top of **basic State Pension** – gives a more generous pension than would have been provided by **SERPS** for: low and moderate earners; carers who are looking after young children or a disabled person; and long-term disabled people with broken work records.
Tax relief	Individuals making contributions to tax-approved pension schemes receive tax relief at their marginal tax rate (for example, a standard-rate taxpayer will receive tax relief at 22 per cent). Individuals contributing to **stakeholder pensions** receive tax relief at a minimal rate of 22 per cent. Individuals with very low or no tax liabilities can also receive 'tax relief' at 22 per cent on contributions of up to £2,808 per year. Employers' contributions are made from gross profits and thus are both tax- and **National Insurance**-privileged.

Upper Earnings Limit (UEL)	The upper limit on earnings for the purposes of calculating entitlement to the **State Second Pension**. Also the upper limit for most employee **National Insurance** contributions. In 2006/07 it is £33,540 per year or £645 per week.
Upper Earnings Threshold (UET)	An intermediate point prior to the **Upper Earnings Limit**, which affects the accrual of the **State Second Pension**.
Withdrawal rate	The rate at which a **means-tested benefit** is reduced for an additional pound of pre-benefit income.
Working-age population	Generally defined today as those aged 16–59 for women and 16–64 for men.

Printed in the UK for The Stationery Office Limited
on behalf of the Controller of Her Majesty's Stationery Office
05/06 187878

Printed in the UK for The Stationery Office Limited
on behalf of the Controller of Her Majesty's Stationery Office
05/06 187878

Additional copies of this publication are available from Stationery Office bookshops. A list of their bookshops is given below.

The Welsh version of this publication is available online at www.dwp.gov.uk/welsh/pensionsreform

A summary version of this report is available free of charge from:

Pension Guide
Freepost
RLXH-JUEU-GZCH
Northampton
NN3 6DF
Telephone: 0845 7 31 32 33

A service for textphone users is available on **0845 604 0210**.

The lines are open Monday to Friday, 8am–8pm, Saturday and Sunday, 9am–5pm. **Please quote code PWP1 for the summary.**

Copies of the summary version are also available in Welsh (code PWP2), Braille (code PWP4), large print (code PWP6) and on audio cassette (code PWP5) from the above address.

This publication, the accompanying Regulatory Impact Assessment and the summary version are all available online at www.dwp.gov.uk/pensionsreform

Published by TSO (The Stationery Office) and available from:

Online
www.tso.co.uk/bookshop

Mail, Telephone, Fax & E-mail
TSO
PO Box 29, Norwich NR3 1GN
Telephone orders/General enquiries 0870 600 5522
Fax orders 0870 600 5533
Order through the Parliamentary Hotline *Lo-call* 0845 7 023474
E-mail book.orders@tso.co.uk
Textphone 0870 240 3701

TSO Shops
123 Kingsway, London WC2B 6PQ
020 7242 6393 Fax 020 7242 6394
68-69 Bull Street, Birmingham B4 6AD
0121 236 9696 Fax 0121 236 9699
9-21 Princess Street, Manchester M60 8AS
0161 834 7201 Fax 0161 833 0634
16 Arthur Street, Belfast BT1 4GD
028 9023 8451 Fax 028 9023 5401
18-19 High Street, Cardiff CF10 1PT
029 2039 5548 Fax 029 2038 4347
71 Lothian Road, Edinburgh EH3 9AZ
0870 606 5566 Fax 0870 606 5588

TSO Accredited Agents
(see Yellow Pages)

and through good booksellers

ISBN 0-10-168412-6
9 780101 684125