

Principles for reform

The national pensions debate

Foreword



The challenges facing the future of UK pensions are higher in the public consciousness than ever before.

The Pensions Commission recently produced a valuable interim report on private pensions –

probably the single most comprehensive piece of analysis of the British pension system that we have seen. In parallel with this work, it is right that we should also turn our attention to the state system.

Most of the issues the Commission identified will not apply with full force for two decades or more. It is therefore essential that we ensure we get the right policies for the long term, and heed the Commission's plea to avoid knee-jerk reactions to their work, instead developing our thinking through considered debate.

We have already introduced a wide range of reforms that have helped ensure that pension incomes are high now, but further steps are needed to ensure that people get the retirement income they expect in the future.

Changes in society mean that we cannot rely on old ideas and structures to provide the same outcomes as we move further into the 21st century. We need to strike a new balance of rights and responsibilities between the State, employers, the financial services industry and individuals for provision of long-term savings and retirement income. We need to ensure that everyone who has made a contribution to society is appropriately rewarded through the pension system.

The State has made important progress in removing the fear of poverty in old age, but this is not its only role. The State should also give everyone a base upon which to build adequate incomes in retirement. Recent reforms have made progress on this too, but getting this role right in a future with more pensioners is a big challenge.

Employers need to help employees build decent pensions on the state foundation. An investment in an employee's pension provision is an important part of the reward package.

The financial services industry has a role in providing investment and administrative services to many employers who might run occupational schemes and in providing savings products to individuals.

Individuals also have a big part to play, taking more responsibility for their own retirement provision. They should be supported by the State and their employer to feel confident in investing and saving more to build up their future retirement income, and they should have the option to work for longer if they choose to do so.

We have already made great strides over the last seven years in tackling the immediate problem of pensioner poverty and putting in place the necessary reforms to help people plan for the future. This paper sets out the principles for wider reform of the pension system, which will guide our work in designing a pension settlement that meets the challenges set out so clearly in the Pensions Commission's first report.

The Right Honourable Alan Johnson MP

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1: Introduction

1. The UK pension system today is delivering better average retirement incomes than any previous generation has ever enjoyed. And the Government's reforms have ensured that the least well off have seen big improvements. Over 1.8 million pensioners have been lifted out of absolute poverty, two-thirds of them women. Pension Credit is now benefiting 3.2 million people – over 2 million of them women. At the same time, our programme of reforms has radically improved security for occupational pension scheme members; helped women and carers to build new pension rights; and improved choice and value in the private pensions sector.

2. But looking to the future, changes in society and demography mean that we cannot necessarily rely on the existing structures to provide the same outcomes as we move further into the 21st century. That is why the Government established the Pensions Commission to keep under review the regime for UK private pensions and long-term saving, and to make recommendations on whether there is a case for moving beyond the current voluntarist approach. It produced interim findings¹ last autumn and will report with its recommendations later this year.

3. Good pension policy is always about striking a fair balance. It has to be fair to the poorest, but also rewarding those

who have saved. It has to ensure that all pensioners share fairly in rising prosperity, but also be fair to future generations by avoiding saddling them with excessive tax increases. As Chapter 2 will explain, in the last few years we have radically reformed the system and have achieved a fair balance between these principles for today's pensioners. But, as the analysis of the independent Pensions Commission has made plain, demographic and other pressures make maintaining this balance for the future a major challenge.

4. The Pensions Commission has counselled against rushing to immediate conclusions. The main issues it identifies will not apply with full force for two decades or more, so the Commission has stressed that it is important to avoid knee-jerk reactions and instead, in a considered way, to develop policy that will endure for the long term. The Government agrees and believes it is important to move towards a national consensus on the next stage of reform following well-informed public debate and the publication of the Commission's recommendations. As a first step towards promoting debate and building consensus, this document summarises the reform programme to date and sets out six key principles – inherent in our approach to date – which we believe should also guide the next stage of reform.

¹ Pensions Commission, *Pensions: Challenges and Choices. The First Report of the Pensions Commission* (October 2004).

1.1 Principles for reform

The pensions system must tackle poverty effectively

5. The Government believes that the prevention of poverty in retirement is a fundamental role of the State. Too often, either pensions policies themselves or the way they have been delivered have let down those in most need. That position is now being corrected, particularly through Pension Credit. There must be no return to the pensioner poverty of the past, and indeed we must make further progress: the recent pledge made in the Pre-Budget Report to increase Pension Credit in line with earnings through to 2007/08 will keep over half a million pensioners from poverty. The prime test of any system must be its success in tackling poverty in retirement.

The opportunity to build an adequate retirement income should be open to all

6. As the Pensions Commission has shown, many of today's pensioners are enjoying incomes and living standards higher than any previous generation. Pensioners are now sharing in rising national prosperity, and this must continue. The challenge as we look to the future is how to ensure, in a world of growing longevity, that **all** of today's working-age generation, regardless of ethnic group or gender, have the best possible opportunity to build adequate retirement incomes. We therefore seek to build consensus that reform should open this opportunity to all, particularly to those – many of them moderate earners – who have not always been well served in the past.

Affordability and economic stability must be maintained

7. Fiscal prudence, economic stability and commitment to improving productivity are prerequisites for a stable and fair pensions system, since pensioners are less able to react to economic instability. Improving the productive capacity of the economy to respond to the global challenges ahead will equip the UK to meet the demographic challenge. Unaffordable promises are not just a technical issue – when they are reneged on, pensioners will see their expectations for retirement undermined. Looking forward, the projected growth in the number of pensioners will lead to growing demands on the pensions system and on other public services. This makes it all the more important to ensure that promises made are sustainable. The challenge is how to keep the system affordable and underpinned by a productive economy, as it is currently projected to remain, while continuing to move forward on the other principles set out here.

The pensions system should produce fair outcomes for women and carers

8. The origins of the UK pension system lie in an era when women were seen as dependent on men. The system has evolved a great deal since then, and recent changes such as Pension Credit and State Second Pension have further improved pensions for both today's and tomorrow's generations of women and carers. But it is in the nature of this pension system that the outcomes it produces have tended to lag behind changes in the social and economic position of women. We therefore seek to build consensus that reform should have

fair outcomes for women and carers within an acceptable timescale as a central objective.

Reform should seek to establish a system that people understand

9. The Pensions Commission has observed that the UK has one of the most complex pensions systems in the world, reflecting the cumulative impact of many changes and decisions over the last few decades. We propose that the aim of a better understood and simpler system should be a key principle for reform, so as to make it easier for individuals and employers to make informed choices.

Reform should be based around as broad a consensus as possible

10. Successful provision for retirement must involve a wide set of partners working together. Employers, the financial services industry, trade unions, advisers, individuals and government must all play their part. Creating a stable environment in which they can do so requires a greater consensus – among these partners and among politicians – than has previously been achieved. The establishment of the Pensions Commission provides an opportunity to start to build a lasting national consensus. We intend to seize that opportunity.

11. The Government welcomes debate on the progress set out in this document, on the challenges the UK faces for the longer term, and on the principles proposed here to guide further reform. This document is intended to begin that national debate as a first step towards building a new consensus.

2: Security in retirement for today's pensioners

1. This section focuses on the current generation of pensioners and how their position has been improved over the last decade. It shows that reform has ensured that for today's pensioners we are now meeting many fundamental objectives – the reduction of poverty, fairness to those who have saved, and the chance for pensioners as a whole to share fairly in rising national prosperity.

2.1 The position in the mid-1990s

2. From the 1970s to the 1990s pensioner incomes increased, but those at the top did far better than those at the bottom. By 1997:

- median incomes of the poorest fifth of pensioner couples had lagged behind, growing by only 34 per cent from 1979 to 1996/97 while those of the richest fifth had grown by over 80 per cent;
- the poorest single pensioners were expected to live on just £69 a week in 1997/98; an income that was declining as a proportion of average earnings;
- in 1996/97 2.7 million pensioners had disposable incomes, after housing costs, of less than 60 per cent of the median; meaning pensioner households were significantly more likely to be poor than other households;
- VAT had recently been imposed on fuel. Pensioners on low incomes were exposed to lump sum costs, including their winter fuel bill;
- poorer pensioners with modest private pensions and/or incomes faced pound-for-pound withdrawal of state benefits, which made their saving worthless and sent the strongest possible signal that it did not pay to save;
- poor pensioners needing to apply for income-related benefits faced a 40-page form from the old Benefits Agency;
- women and carers were particularly at risk of poverty in retirement, partly as a result of lower lifetime earnings and partly because their working lives had been interrupted. In 1996/97, single female pensioners had incomes 15 per cent lower than incomes of single male pensioners;

- high unemployment in the 1980s and early 1990s had deprived many older workers of the chance to build a decent retirement income – employment rates of men aged 50 to State Pension age fell from 84 per cent in 1979 to a low point of 64 per cent in 1993; and
- a long era of high inflation had eroded the incomes and savings of two generations of pensioners.

2.2 The changing position

Box 2.1

April 1997	April 2005
Poorest expected to live on £69 per week	Poorest entitled to over £109 per week
Benefits means-tested £1 for £1, rendering modest savings in many cases worthless	Pension Credit ensures it pays to save on top of the foundation of the basic State Pension
2.7 million pensioners lived in absolute poverty	Pensioner households now less likely to be in poverty than non-pensioners
Pensioners faced a range of large irregular costs	Pensioners receive £200 Winter Fuel Payment (with an extra £100 for the over-80s), free prescriptions for the over-60s and free television licences for the over-75s

3. Improving the position of today's pensioners has been a key priority for Government action with the result that today's picture is now very different:

- Macroeconomic stability has created a stable low-inflation environment, protecting pensioners from the economic hazards they faced in the past. It has also provided employment opportunities for all who wish to work, including many who make a positive choice to keep working above State Pension age. We know that in previous recessions it has often been older workers who have suffered most.
- Average pensioner household incomes have continued to rise – by 26 per cent in real terms between 1996/97 and 2002/03. This outstrips average income growth, so pensioners are sharing fairly in the nation's rising prosperity.
- Pension Credit now ensures that no pensioner has to live on less than £105

per week (£109 from April 2005) compared with the minimum of just £69 in 1997. Pension Credit is claimed by a simple freephone call and is now reaching 3.2 million individuals, with an average payment on top of other state pensions of around £40 per household per week. Among the poorest pensioners initial estimates are that take-up is now exceeding 80 per cent.

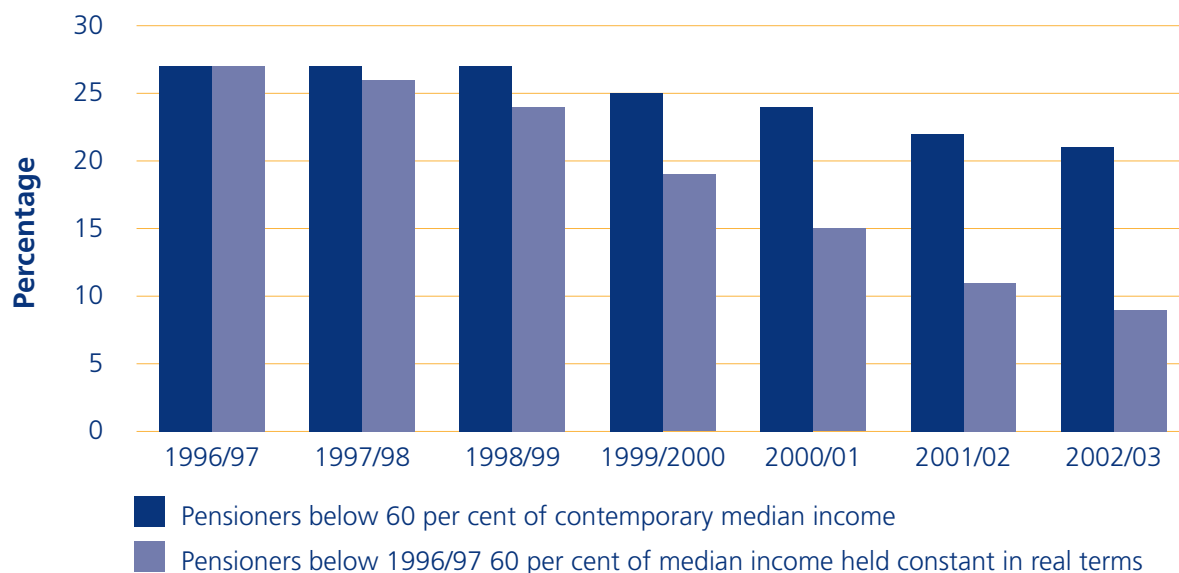
- Around 2 million pensioner households qualified for more help or became entitled to Council Tax Benefit for the first time courtesy of the introduction of Pension Credit. And many of these began claiming their Council Tax Benefit entitlement through the Pension Credit take-up campaign.
- Absolute pensioner poverty (which compares incomes to the 1997 poverty line,² adjusted for inflation) was already down two-thirds by 2002/03. That means 1.8 million fewer pensioners – of whom 1.3 million are women – are living in poverty. Numbers below the relative poverty line (increased each year in line with average incomes) are down too, by 20 per cent, in spite of rapid average income growth (see Box 2.2).
- Today – and for the first time during a period of buoyant economic growth – a pensioner is no more likely to live in a poor household than anyone else in the population.³
- Pensioner households across the income distribution have benefited from increases in the basic State Pension (which has risen by more than inflation three times in recent years) and from Winter Fuel Payments, age-related payments and free television licences (see Boxes 2.3 and 2.4).
- Women's incomes have benefited disproportionately from Pension Credit and initial estimates suggest that take-up for the poorest single women may be running as high as 90 per cent.
- As the Pensions Commission has noted, single male and female pensioners now receive similar levels of state benefits in total.⁴
- Pensioners with modest private incomes are now rewarded for their saving through Pension Credit. Nearly 2 million pensioners are benefiting in this way, with gains of up to £15.51 for a single pensioner and £20.22 for a couple.
- A dedicated Pension Service has been introduced to provide a customer-focused state pension service, proactively helping pensioners to take up their entitlement (see Box 2.5).

² Pensioners who had disposable incomes, after housing costs, of less than 60 per cent of the median. This is a widely quoted measure of poverty.

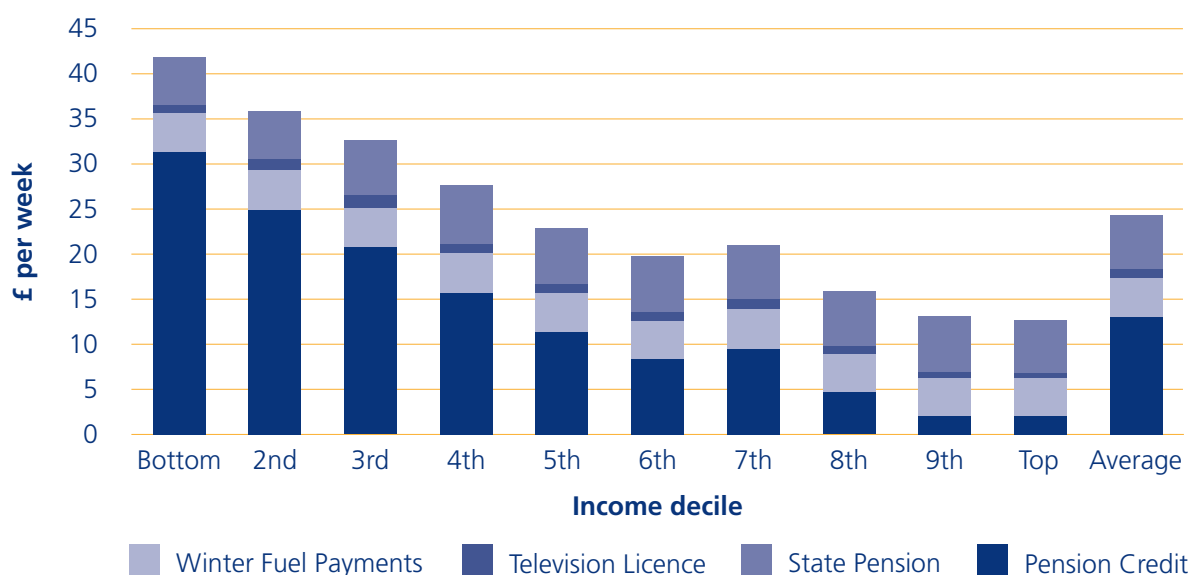
³ See, for example, Institute of Fiscal Studies, *Poverty and Inequality in Britain* (March 2004).

⁴ Pensions Commission, *Pensions: Challenges and Choices. The First Report of the Pensions Commission* (October 2004), page 260.

Box 2.2: Proportion of pensioners below 60 per cent of contemporary median income and proportion below 60 per cent of 1996/97 median income held constant in real terms (after housing costs)



Box 2.3: Overall gains for pensioner families from pensioner policies. Gains by income, £ per week



Source: DWP simulations based on the 2002/03 Family Resources Survey projected forward to 2005/06 (in 2004/05 prices) compared with the 1997/98 system of benefits, indexed to 2004/05 prices. Excludes the effect of tax changes.

Box 2.4: How today's pensioners have benefited

Strengthening the foundation of the basic State Pension has been crucial. In the last few years the rate has gone up by more than inflation three times, so that between April 2000 and April 2004 the cash increase was over £12 per week (and over £19 per week for couples). And the Government pledged that throughout this Parliament the pension would rise each year by at least 2.5 per cent, even where inflation was lower than this.

Other measures too have benefited all pensioners. The Government has introduced Winter Fuel Payments at £200 for every household with someone aged 60 or over. In 2003/04, around 8 million households received a payment, benefiting over 11.5 million people. In addition, households where someone is aged 80 or over are receiving £100 extra, over and above the Winter Fuel Payment, for the rest of this Parliament. Pensioners are also benefiting from free prescriptions for those aged 60 or over; free television licences for people aged 75 or over; and in 2004/05 a one-off payment of £100 for households with someone aged 70 or over.

These reforms have ensured that even when pensioners are not entitled to benefits targeted on the basis of income, they are still significantly better off than under the 1997 system. Take, for example, a single pensioner aged 75, living alone but with an income too high to be eligible for Pension Credit. Her basic State Pension has increased in real terms by 7 per cent; she receives a £200 fuel allowance; a free television licence worth £121 a year; and a £100 age-related payment.⁵ As a result of these reforms, she has £13.55 a week more than the 1997 system would have provided. This is a bigger gain than the earnings-indexation of the basic State Pension in each year since 1997 would have given her. For someone aged 80 or over, the gains are larger still.

⁵ Based on 2004/05 rates.

Box 2.5: Developing The Pension Service

The Government consulted with pensioners and with groups who represent them and as a result introduced The Pension Service. This service is based on what people have said they wanted. The Pension Service reaches pensioners wherever they feel most at home. They can do their business by phone, post, fax or e-mail or they can get help and information in a relaxed and friendly environment such as their local coffee morning or at a library. Those people who are unable to phone or use local facilities can be visited at home. The Pension Service supports customers by working in partnership with voluntary organisations, local authorities and other government departments to provide a more joined-up service. The Pension Service will take an active role in promoting equality of opportunity in the local community and the local service will actively target ethnic minority groups to increase take-up, awareness and accessibility of Pension Service services.

There have also been dramatic improvements in the application process to make it easier for pensioners to obtain the money they are entitled to. As opposed to completing a lengthy claim form, details for Pension Credit can be taken via the dedicated freephone line with a call that need take just 20 minutes. The form then only has to be checked and signed by the customer and returned with any appropriate supporting documents.

For the first time customers are being provided with a service based on what they want and not on 'where they fit into our system'.

2.3 Next steps

4. As this chapter shows, the Government's programme of reform to date has dramatically changed the picture for the current generation of pensioners. There is of course more to do, such as:

- increasing take-up of Pension Credit;
- extending take-up efforts into Council Tax Benefit and looking to make better use of data to help pensioners to get their entitlements more automatically. For example we need to explore the scope for using the information collected for Pension Credit to process

Council Tax Benefit applications more automatically;

- moving to a position where we will be able to award Pension Credit more automatically;
- continuing to uprate the Guarantee element of Pension Credit in line with earnings right throughout the current spending review period, that is until 2007/08; and
- ensuring all public services meet the needs of an ageing population.

5. The Government will shortly publish its wider strategy on the ageing population.

3: Providing for future generations of pensioners

1. The Pensions Commission's first report last autumn set out a detailed analysis of the outlook for future generations of pensioners. It showed that while there is no crisis now, there could be problems in the future if society and government do not respond to a changing demographic and economic outlook. To ensure that our objectives for pensions are met in future we need to help more people build on the foundation of a decent state pension and to support individuals who choose to work longer or save more. This section summarises the recent history and action the Government has already taken to start to address these issues. Some key remaining challenges are then set out in Chapter 4.

3.1 Recent history

2. Reform of pensions during the 1980s and early 1990s focused on reducing the cost of state pensions. Measures included the breaking of the earnings link, the equalisation of State Pension ages at 65 from 2010 to 2020 and also measures to reduce significantly the generosity of the

State Earnings Related Pension Scheme (SERPS). However, these reforms:

- did little to help those on low and modest incomes save for retirement;
- made the system progressively more complex;
- did little to help women and carers save for retirement;
- left too few women and carers with a decent state pension; and
- made a diminishing contribution to earnings replacement in retirement.

3. Private pension policy in the 1980s and early 1990s focused on promotion of one type of retirement saving – the personal pension. The most important changes to the occupational pensions framework were the outlawing of the facility for employers to make scheme membership a condition of employment, and then, in response to the Maxwell scandal, the introduction of complex regulation. But, as the Pensions Commission has now demonstrated, deep-seated and adverse trends were at work beneath the surface:

- The underlying trend in private sector employer contributions turned downwards in the early 1980s.⁶
- Irrational equity markets and delayed appreciation of life expectancy increases concealed the underlying financial pressures facing defined benefit schemes.⁷
- Rapidly declining employment among older workers, exacerbated by macroeconomic instability, denied increasing numbers the opportunity to work and save for retirement. Indeed, pension scheme surpluses were used to pay for packages to encourage early retirement.
- The number of people with occupational pension coverage declined.⁸

4. In contrast, although the personal pension market was expanding rapidly in the 1980s and early 1990s, in theory offering the prospect of more flexible individual pension provision, many of the products then on offer were unsuitable for moderate – and intermittent – earners because of high charges and inflexible contract terms. This, combined with poor information and education and the lack of workplace access, made the private pensions market unsuitable and inaccessible for many people of moderate means. In the end hundreds of thousands of pensions were mis-sold, with lasting adverse consequences for people's willingness to save for retirement. Meanwhile, the housing equity release market made a faltering start, quickly suffering reputational problems as a result of the sale of unsuitable products through unregulated channels.

3.2 Creating the right economic environment

5. The Government's response to this inheritance started with the creation of an environment of economic stability and high employment. The Government will maintain macroeconomic stability, ensuring the fiscal rules are met and that inflation remains low. This framework is designed to ensure lasting stability so that everyone can plan effectively for the long term. These policies have helped deliver the longest period of sustained low inflation for the last 30 years and promote high employment and productivity.

6. The longer and more productive a person's working life the better their opportunities to save for their retirement. The number of people in work has risen by 2 million since 1997 and unemployment is at its lowest level for nearly 30 years. The Government's employment policies have aimed to increase employment rates for all groups, and in particular to reverse the trends that have in the past seen many people in their 50s stopping work altogether. Between spring 1997 and spring 2004 the employment rate of older workers has increased by 4.6 per cent, significantly more than for the population as a whole.

7. It is not just unemployed people who have been helped: the total number of people claiming inactive benefits has fallen by around 150,000 since 1997. There is clearly more to do in this area and the Department for Work and Pensions' five-year strategy, published on 2 February,⁹ sets out the Department's plans to tackle this challenge.

⁶ See figure 3A.6, *Pensions: Challenges and Choices – The First Report of the Pensions Commission* (October 2004).

⁷ Pages 124–5, *ibid.*

⁸ Page 115, *ibid.*

⁹ *Department for Work and Pensions Five-Year Strategy: Opportunity and security throughout life* (February 2005).

8. Alongside high and stable levels of employment, productivity growth is central to long-term economic performance and rising living standards. The UK has historically experienced low rates of productivity growth compared with other major economies, partly due to past macroeconomic instability and historic under-investment in capital, skills and research and development. In recent years, however, data suggest that the UK's performance has improved. Between 1997 and 2001, the UK trend rate of underlying productivity growth (on an output per hour basis) is estimated to have grown by 2.7 per cent a year, compared with a growth rate in the previous economic cycle of just over 2.2 per cent a year. The Government is committed to further action to improve productivity both now and over the long term, which will be key to continuing prosperity for today's and tomorrow's pensioners.

3.3 Action to date

9. Against this essential background of a stable macroeconomic framework, the Government has put in place a reform programme which, in accordance with our principles, gives everyone the opportunity to plan and save for their retirement.

10. Rights to the new **State Second Pension** (reforming SERPS) began to accrue from 2002. This reform is particularly important for low earners and those with caring responsibilities since they are credited in as if they had earnings of £11,600 per annum.¹⁰ Some 2 million carers, almost 6 million low earners (two-thirds of them women) and over 2 million disabled people are given the chance to build up a decent second pension for the first time as a result of this change.

11. No barrier to pension saving is more important than lack of confidence and trust that pensions offer a fair deal, and will be there when they are needed. The Government started by **clearing up pensions mis-selling**. By the end of 2002 over 99% of consumers with mis-selling claims had been compensated and total compensation reached £11 billion.

12. The Pensions Act 2004 has improved security and confidence for occupational pension scheme members by creating the **Pension Protection Fund**. It means that over 10 million members of salary-related pension schemes know that they should receive a meaningful income in retirement based on their occupational pension provision, even if their employer becomes insolvent leaving its pension scheme under-funded. Additionally, the new **Pensions Regulator** will proactively assist in protecting members' benefits, while the **Financial Assistance Scheme** will provide help to some of those who will have lost out before the Pension Protection Fund is established.

Other changes in the Act provide for enhanced numbers of **Member-Nominated Trustees** to ensure that workers have more say in how their scheme is run, and protection to ensure that company takeovers can no longer be used as the excuse for scrapping pension contributions.

13. In the personal pensions market, the introduction from 2001 of **stakeholder pensions** has brought about simpler, better value and more flexible products. These have driven down charges across the industry by around one-third, so more money goes straight into the pension pot. People are now free to change provider and to stop and start payments without suffering penalties, a flexibility which is

¹⁰ 2004/05 figure.

particularly important for women and carers. By requiring all but the smallest employers to designate a stakeholder pension, this reform has started to improve workplace access to pensions where an employer-based scheme is not available. By December 2004, around 2.3 million stakeholder pensions had been sold. Around two-thirds of sales are to people earning under £20,000 a year and one-third are to women. The latest data shows that, in the first half of 2004/05, contributions into stakeholder pensions were up by over 20 per cent compared with the same period in the previous year.

14. The **equity release** market is now being regulated to improve its operation and bring greater protection to customers.

15. Alongside these simpler products in the personal pensions sector, the Government has sought to **simplify the private and occupational pensions framework**. The central change, in the Finance Act 2004, sweeps away the complexity of eight separate taxation regimes replacing them with a single flexible regime based on the simple concept of a lifetime limit of £1.5 million for pension saving. The new system will be simple for individuals and for businesses – saving the latter £80 million a year. Supporting changes in **pension regulation** have started to cut through the layer-cake of regulation, for example by **amending the old Section 67** so that firms can rationalise into a single system rights accrued under different regimes in the past. The **new regulator** will also help companies get on with running good schemes by adopting a light touch with those which are demonstrably lower risk.

16. The Government's **Informed Choice programme** is starting to empower

individuals to take charge of their retirement planning by making clear to individuals their own prospects for retirement and how the choices on working and saving that they face today relate to these. Good information about their future pension position is crucial – it is provided through the new programme of state and private pensions forecasts. By the end of December 2004, over 2.5 million combined **pension forecasts** had been issued, which set out clearly the provision that people can expect in total from state and occupational savings in retirement. Our aim is to reach 6.3 million people with combined pension forecasts by the end of 2005/06. In addition, the Government is increasing state pension forecasts with the target of ensuring that by 2007/08 15.4 million individuals will be regularly issued with a pension forecast. We also intend to launch, in spring 2006, a web-based Retirement Planner, which will show individuals, in black and white, the total income they will receive from various state and private pensions. It will also show the effects of changes such as increasing saving or working longer. The improved access to pension information is empowering individuals to make choices about investing in their future retirement income.

17. Facilitating longer working lives is crucial. In considering retirement incomes pensions are only half of the picture, people's ability to choose to keep working for longer is equally important. From this year we are offering **a better deal to those who take their State Pension later**. Those who choose to work longer will receive a higher State Pension. Those who choose to retire at 70 could receive an enhancement of more than 50 per cent to their weekly pension or

alternatively they could receive a lump sum of £25,000. This is complemented by separate forthcoming legislation on **age discrimination**¹¹ in employment and occupational training, so that people will have both greater opportunity to and greater rewards from choosing to work for longer – but they will not be forced to do so. The Government's long-term aim is to give people complete choice about when to stop working. To that end, the age discrimination legislation will outlaw all retirement ages below 65 (except where they can be objectively justified) and will set out a national default retirement age of 65, with a new duty on employers to consider requests to work longer. The default retirement age will be

formally reviewed five years after implementation, taking account of the latest evidence, including on longevity, older people's work patterns and the growing number of businesses managing without a default retirement age, to judge if it remains appropriate. A further important change is to alter tax rules so that people can continue to work for the same employer while also drawing their pension.

3.4 Next steps

18. Chapter 4 sets out the next steps in developing a principled approach to the next stage of reform.

¹¹ The Government is addressing age discrimination through legislation that will implement the age strand of the European Employment Directive adopted in November 2000 (2000/78/EC). The Government will consult in summer 2005 on draft regulations covering the full rights against discrimination on grounds of age in employment and vocational training. Subject to that consultation and the approval of Parliament, the legislation will be brought into force on 1 October 2006.

4: A principled approach to tomorrow's challenges

1. As we have set out, recent generations are on average enjoying living standards much higher than previous retirees. And our success in reducing poverty is starting to change what it means to be old, with pensioners no longer facing a higher risk of poverty compared with the rest of the population. The reforms introduced over the last few years have also improved the framework for people who are currently working and looking to build up their future retirement income. These are huge steps forward. But, following on from the Government's own Green Paper¹² analysis, the Pensions Commission also concluded that, unless people save more or work longer than they are doing currently, significant numbers of today's workers will not build up the level of retirement income they might expect. There is also a particular issue for women – both for the future and for today – whose pension entitlements have improved considerably but still lag behind those of men.

2. The previous chapter set out how the continued achievement of macroeconomic stability, employment opportunity for all, low inflation and sustained productivity growth will be central to meeting long-term challenges. First, the productivity growth it delivers will drive higher living standards for all, including older people. Secondly, it is only in an environment of macroeconomic stability and employment opportunity for all that individuals and families will be able to plan for their retirement and make real and meaningful choices about their working lives and savings. Thirdly, in the UK's economic history we know that high inflation has often penalised savers, many of whom have incomes that are not protected from high or unexpected increases in prices. Consequently, government action will be guided by the need not to undermine the macroeconomic progress made since 1997.

¹² Department for Work and Pensions, *Simplicity, security and choice: Working and saving for retirement* (December 2002).

3. Many people have already put forward suggestions on how the pensions system could be reformed (see Box 4.1). We welcome the fact that organisations are putting forward such diverse propositions. We will engage seriously with them, because they are crucial to stimulating the debate on retirement incomes that the country needs. But, as we have emphasised, good pensions policy is always going to involve striking a fair balance between different objectives. Hard questions need to be asked about these and a wide range of other possible options for reform. Any reform needs to strike a balance between the responsibilities of individuals, employers,

the financial services industry and government. Above all, we must ask of all options whether they will help tackle poverty, secure fairer outcomes for women, remain affordable in the longer term and meet our other principles for reform.

4. In order to make sense of the wide range of options available, it is important to build a consensus around the framework within which specific options should be judged. This section highlights some of the challenges presented by each of the principles and discusses a number of issues the Government intends to explore further.

Box 4.1: Some alternative proposals for pension reform

Some of the options put forward by non-government organisations are set out below. Many organisations, including Age Concern and Help the Aged as well as the organisations quoted below, have expressed their views both on state pensions and on wider income issues for older people. In addition, the Government is paying attention to the development of retirement income policies in other countries. In considering these and other options, we must ask whether they will help tackle poverty, secure fairer outcomes for women, remain affordable in the longer term and meet our other principles for reform.

"We recommended in October 2002 that the basic State Pension, the State Second pension and Pension Credit be replaced by a simple universal state benefit which we called the Citizen's Pension ... a Citizen's Pension set at £105 a week." – **National Association of Pension Funds**

"The voluntary private pensions system has failed ... can see no alternative to introducing a system of compulsion...TUC consider that its target figure of 15 per cent of pay is reasonable, necessary and practicable.

"... all workers, including those with caring responsibilities, should accrue an additional earnings-related pension ... a minimum benefit equal to the basic State Pension plus, in addition, a second-tier pension with a replacement rate of 50 per cent of income in excess of £6,000 ... [and] ... both the basic State Pension and the earnings threshold for the second-tier pension would need to be increased each year in line with increases in national average earnings." – **Trades Union Congress**

Box 4.1: Some alternative proposals for pension reform (continued)

“Universal Protected Pension ... a pension of 25–30 per cent of average earnings throughout retirement ... [providing] universal membership ... with all paying a similar proportion of their income for a pension that is, like the basic State Pension, the same for all ... with the basic State Pension remaining pay-as-you-go and making up the first element of the 25–30 per cent of average earnings guarantee.

*“Having a part-pay-as-you-go, part-funded scheme also means that risk is spread between capital and labour markets, which may further lessen the possibility of the scheme not being able to meet its liabilities.” – **Pensions Reform Group***

*“The Confederation of British Industry supports the retention of a second-tier state pension ... targeted at low earners, those individuals without access to a good-quality occupational pension and those for whom saving via a private/personal pension product is unattractive or uneconomic ... The Confederation of British Industry’s proposal to raise the basic State Pension will increase the percentage of gross domestic product that is devoted to state pensions ... this increased expenditure should be financed partly through a rise in the State Pension age ... over time additional resources will probably also be required.” – **Confederation of British Industry***

“We do not believe voluntarism is damaged beyond repair, or that the barriers to reviving an effective voluntarist system are so great as to require a move to a wholly compulsory system.

*“... a higher State Second Pension targeted at low earners. Higher earners should be encouraged to contract out, receiving incentives to do so. To help address the serious problem of women’s pensions poverty, the Commission should explore whether the basic State Pension could become a universal state pension, paid at its current level of £79.60.” – **Association of British Insurers***

*“A universal basic level of state provision for all, based upon residency, either at the level of the current basic State Pension or higher, with rises linking to earnings ... Strengthened supplementary state provision, focused on low earners, and those undertaking unpaid parenting and caring commitments.” – **Equal Opportunities Commission***

*“We want to see a basic State Pension of £105 a week and a State Second Pension, funded through National Insurance, linked to earnings and paid to all men and women of pensionable age.” – **National Pensioners Convention***

4.1 Tackling poverty effectively

5. As previously highlighted, recent reforms have greatly improved the effectiveness of the system in tackling poverty. This has been achieved by following the principle of progressive universalism, whereby state benefits are payable to people at all income levels but reforms have focused particularly on those least able to provide for themselves. The challenge for the future is to maintain – and indeed improve – the effectiveness of the system in tackling poverty, while also ensuring that a fair balance is struck with regard to the other key principles. Our recent commitment to earnings indexing the Pension Credit through to the end of the spending round might mean as many as 600,000 fewer pensioners in poverty than if we had followed the alternative of indexing in line with prices.

6. To maximise the effectiveness of policies in tackling poverty, we need to build a consensus on how it should be measured. The Government's ground-breaking approach on child poverty has demonstrated that poverty is a multi-dimensional problem requiring a co-ordinated response using a range of policy levers. Following the same principles, the Government is exploring how best to measure poverty and well-being among pensioners.

4.2 Opportunity for all to build adequate retirement incomes

7. The scale of the challenge here was first set out in the Government's Green Paper *Simplicity, security and choice*, which estimated that between 8 and

13 million people may need to consider saving more or working longer to achieve a retirement income that meets their aspirations. The Pensions Commission – working on a slightly different approach – reached a similar view that some 9 million people may be under-saving.

8. The measures set out in Chapter 3 are starting to tackle this set of issues. But in moving further forward on this principle, there are several major issues on which there is a need to move towards more of a national consensus:

- If current trends continue, the State Second Pension will eventually become almost flat rate. Is this desirable, or should the State maintain its role in building an earnings-related element for some groups?
- For instance, if the state system were flat rate, how could the private sector increase opportunities for all those who wanted a second pension to build one up?
- Should the decision on whether to join a pension scheme be framed differently so the presumption is that people are automatically enrolled unless they opt out?
- Given that individual savings products have fixed costs, is there scope for harnessing the power of the State through collective products run through local or central collection mechanisms to help secure lower charges for savers? Might running such a product on an auto-enrolment basis help more people save?
- The Employer Task Force has urged employers to contribute more to pensions. What can be done to promote this?

9. It is the responsibility of individuals to make decisions about how much income they want in retirement and to make choices about consumption today. As Chapter 3 explains, too often such an opportunity has often been confined to higher earners, and those with steady earnings growth throughout their careers. The Government is determined to build a foundation that enables all people to build incomes in retirement.

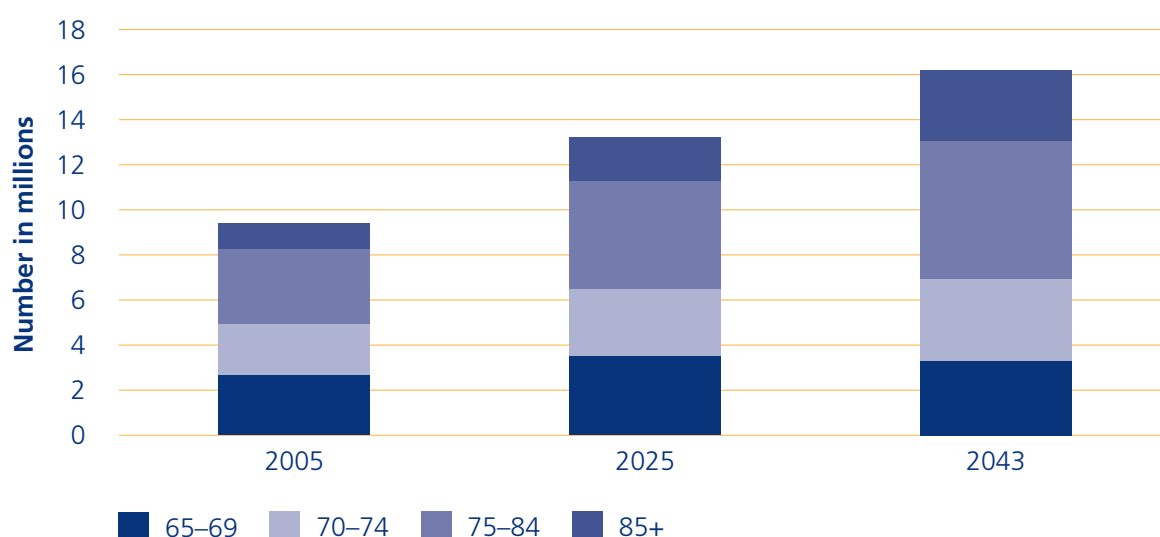
10. There is a clear interaction here between decisions on the future of the state pension system and private/occupational pensions. The Government intends to examine these issues holistically, drawing on the next stage of the Pensions Commission's work.

4.3 Sustainability: affordability and economic stability

11. We face serious demographic challenges over the next 50 years. Life expectancy has increased significantly over the last century, and is expected to continue increasing. In 1981, a man aged 65 would live on average for a further 14 years – by 2051 we expect that to rise to 22 years, an increase of over 50 per cent.

12. This increase in longevity, along with low projected birth rates, will result in a large increase in the proportion of older people in the UK. This creates a challenge in maintaining a sustainable pensions system. We must meet the challenge of meeting pensioners' expectations while keeping government expenditure at sustainable levels. An ageing population will also lead to growing demands on

Box 4.2: Number of people aged 65 or over



other public services such as health and social care. And, with wider pensioner well-being as a key objective, it will be necessary to continue to strike a balance between state spending on pensions and on other services for older people.¹³

13. Sustainable public finances are a prerequisite to achieving high and stable rates of long-term economic growth, which is shared by all, and to ensuring that spending and taxation impact fairly between generations. On current policies and projections, expenditure on state pensions is set to remain at around 5 per cent of gross domestic product through to 2050. Compared with many European countries (see Box 4.3) our system is prudent and affordable.

14. As well as endangering the macroeconomic stability at the heart of Government long-term policy, fiscally unsustainable policies also carry the clear risk of the need for subsequent corrective adjustment in the future. Such sudden and unexpected changes in policy could be very harmful and unfair towards the individuals affected, possibly including pensioners, who are often those least able to respond. Maintaining an affordable state pension system ensures that workers in the UK can be more confident than those in some other countries that the pension that the State is promising them will be there for them when it is needed.

Box 4.3: Public pension expenditure as a percentage of GDP¹⁴

	2008 ¹⁵	2010	2020	2030	2040	2050	changes
Belgium	8.8	8.8	10.0	11.8	12.6	12.6	3.8
Germany	11.0	11.1	12.1	13.8	14.4	14.9	3.9
Spain	8.0	8.0	8.5	9.9	12.0	13.0	5.0
France	12.7	13.0	14.2	14.9	14.5	14.5	1.8
Italy	14.0	14.0	14.7	15.8	15.6	14.1	0.1
Greece	12.3	12.2	14.7	17.3	19.9	22.6	10.3
UK	5.1	5.1	4.9	5.3	5.3	5.3	0.2

Source: 2003–2004 examination of the stability and convergence programmes.

¹³ See also the HM Treasury publication *Long-term public finance report: fiscal sustainability with an ageing population* (December 2003).

¹⁴ Including most public replacement incomes to people aged 55 or over and before taxes.

¹⁵ UK figures relate to 2009, Greece to 2007.

15. However, a number of the reforms to the state pension system currently being proposed by some bodies would add very substantially to state pensions expenditure. Any proposal will need to be carefully tested for its affordability – both short and long term.

4.4 Fair outcomes for women and carers

16. The Pensions Commission found today's pensioners are enjoying record prosperity – so most aspects of the pensions challenge will not apply with full force for some years to come. But it also made clear that today's female pensioners are on average still experiencing lower retirement incomes than men. Life events – like childbirth, marriage, divorce and widowhood – often have particularly

significant pension implications for women and this is reflected both in the incomes of today's pensioners and the predicted incomes of women retiring in the future.

17. The National Insurance system has delivered poor pension outcomes for women, especially those who have taken considerable time off paid work to care for children or adults. In addition, total retirement income is projected to remain lower for women than men. Women remain half as likely as men to be in full-time work and are on average less well paid (see Box 4.4). These are some of the reasons why, even among newly-retiring women, only 16 per cent have a full basic State Pension on the basis of their own contributions, as against 78 per cent of men, and why a gender differential in pension outcomes is set to continue for the foreseeable future.

Box 4.4

	Men	Women
Number currently in work (% of working age)	15m (79%)	12m (70%)
Number working full time (% of working age)	14m (74%)	7m (41%)
Occupational pension coverage of full-time workers	60%	60%
Average gross weekly earnings ¹⁶	£492.60	£293.30
Number of employees earning below the Lower Earnings Limit for National Insurance contributions	0.5m	1.4m

¹⁶ HM Treasury, *New Earnings Survey* (2003).

18. More women than men work part time and many of them may not accrue the basic State Pension.¹⁷ Sometimes this is because they earn below the Lower Earnings Limit in total; sometimes it is because they are combining multiple part-time jobs, none of which on their own pay more than the Lower Earnings Limit.

19. Those looking after adults with care needs are another group that miss out too often. The care work of some is recognised through Carer's Allowance, and in these cases a National Insurance Class 1 credit is awarded each week.¹⁸ Carer's Allowance is available only if the care provided is full time (35+ hours) and if the care recipient receives particular disability benefits. But these conditions are not met in many cases where care is given. Much care is thus not 'visible' to the system, leaving major gaps in terms of pension coverage. Even among full-time carers,¹⁹ some 60,000 have no pension protection, while another 60,000 caring for at least 20 hours a week are in this position. There are even more people – some 315,000 in all – caring for up to 20 hours a week and not building up basic State Pension entitlements.

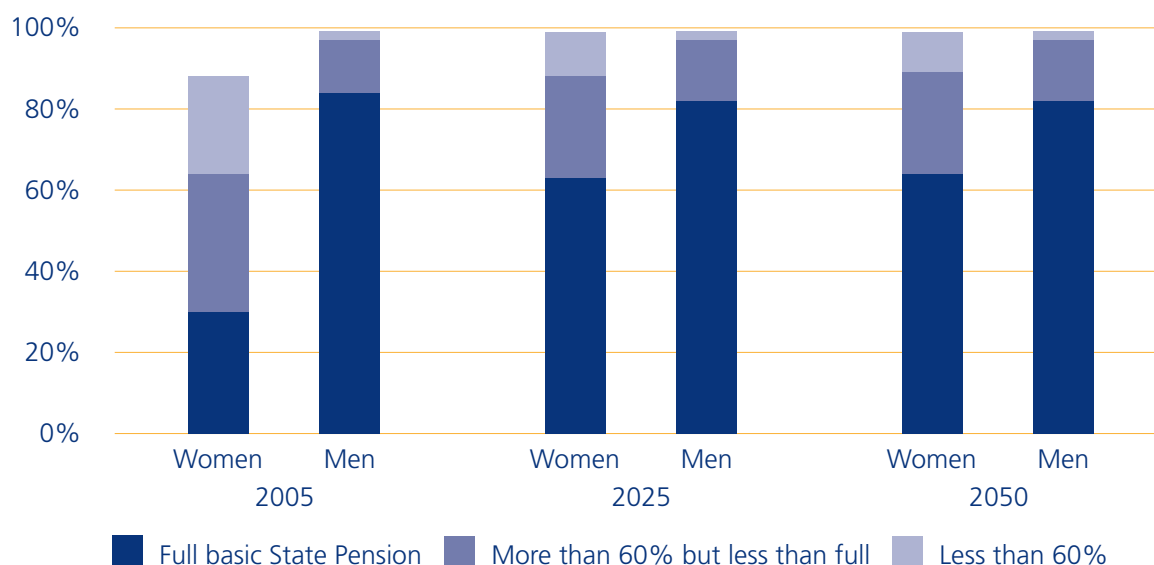
20. Successive reforms have sought to address these problems. In the 1970s, Home Responsibilities Protection was introduced allowing women bringing up children after that time to build up entitlement to the basic State Pension while caring for children. And the State Second Pension, introduced in 2001, will allow more women and carers to build up a second pension. As these mature over time, the pensions gap in retirement is set to reduce somewhat. In addition, increases in female employment over recent decades, supported by the Department for Work and Pensions' labour market policies set out in the five-year strategy, will give more women the opportunity to work and save for their retirement.

21. Many women retiring now will not have benefited from these reforms but the Government has accepted that more has needed to be done and sooner. The Pension Credit has greatly improved the income from the State for many of today's women pensioners who were unable to build up National Insurance entitlements comparable with those of men.

¹⁷ Some may be receiving credits through receipt of benefits.

¹⁸ Unless the carer is a married woman who has elected to pay reduced-rate contributions, or contributions are being received with another benefit. Receipt of other benefits will also maintain entitlements.

¹⁹ 35 hours or more per week.

Box 4.5: Basic State Pension entitlement of newly-retired men and women

Source: DWP calculations based on Government Actuary's Department data.

22. The Government has committed to produce a further report this year on women and pensions and its response to the Pensions Commission will be guided by the principle of ensuring that policies give women and carers opportunities to build up security in retirement. In pursuit of the principle of fair outcomes for women and carers there are a number of key questions. Where the suggestions they raise imply extra spending, before committing to these we would, of course, have to be satisfied that this was a better use of funds than competing government priorities in pensions and other areas:

- How can Pension Credit be refined further to tackle gender inequalities in outcomes?
- Would there be benefits from altering the National Insurance rules and qualifying conditions to create entitlements to the basic State Pension to better reflect today's society?
- Would the gains from a residence-based (as opposed to contributions-based) eligibility for the basic State Pension provide a cost-effective and practical alternative way of improving equity of entitlements?
- How can coverage of personal and occupational pensions be widened to include more women, especially part-time workers, low-earners and carers?

4.5 A better understood system

23. The reforms set out in Chapter 3 are already starting to simplify the private pensions system. And Pension Credit – with a five-year award period in place of the old weekly means test; and a claims process done through a freephone call rather than a 40-page form – is much simpler for pensioners to claim than the income-related benefits it superseded.

24. The Government's Informed Choice programme is also starting to empower individuals to make the choices that are right for them both in considering saving and extending their working lives. However, the pension system overall remains complex and the Government aims to simplify it wherever possible.

25. Moving from one system to another – even if the new one is simpler – can require detailed transitional arrangements, sometimes for decades ahead. Nevertheless, the Government believes that a system that people understand is a very worthwhile goal. In looking at options for reform, simplicity – whether of the underlying rules or of the outcome for individuals – will therefore be an important consideration.

4.6 Building a national consensus

26. The range of ideas put forward for pension reform over the last year – and most recently in submissions to the Pensions Commission – demonstrates that there is no consensus about the shape of that reform.

27. Differences exist on fundamental aspects such as:

- whether the State Pension should be wholly flat rate or have an earnings-related component;
- whether higher amounts should be paid to older pensioners;
- how the State can best help those least able to provide for themselves; and
- whether the degree of compulsion on employers and employees to provide for future retirement income should be increased.

28. This wide range of ideas and differences shows that more work is needed to build a consensus about the underlying principles. Achieving that is the best way to ensure that any particular way forward can form the basis of a lasting settlement. The Government's approach is therefore to seek to build a national consensus first about the principles for reform – as set out in this document – and then later about the detailed way forward.

5: Conclusion

1. The Government believes that individuals must take responsibility for their own retirement provision; they must make decisions about how much they are going to invest in increasing their own future retirement income. Employers also have a key role in helping their employees to build up adequate pensions: investment in an employee's pension provision should be an important part of the reward package. But, underlying the roles of both individuals and their employers, there needs to be a state system that not only removes the fear of poverty in old age but also gives individuals a base upon which to build up an adequate retirement income, and which provides the information and the regulatory framework that enables people to save.

2. The Government's reforms have significantly improved the outcomes for today's pensioners. However, changes in society mean that we cannot necessarily rely on the existing structures to provide the same outcomes as we move further into the 21st century. This publication has set out the record of successes achieved so far and the principles on which it has been based – the same principles that will be used in evaluating future reforms.

3. The Government agrees with the Pensions Commission that it would be wrong in an area as complex as pensions to make immediate knee-jerk reactions to either rule out or commit to specific proposals aimed at addressing a long-term challenge. But there are significant

Principles for reform

- The pensions system must tackle poverty effectively.
- The opportunity to build an adequate retirement income should be open to all.
- Affordability and economic stability must be maintained.
- The pensions system should produce fair outcomes for women and carers.
- Reform should seek to establish a system that people understand.
- Reform should be based around as broad a consensus as possible.

inequities in retirement incomes, particularly affecting women, and the Government has placed tackling this specific problem high on the agenda.

4. A number of options have already been put forward to reform the pensions system. All of these options deserve consideration and the Government is keen to engage all stakeholders in this national pensions debate.

5. The Pensions Commission process represents a unique opportunity to establish a consensus behind pension reforms that will last for the long term. The national interest will best be served if this chance is seized. The Commission's recommendations, expected later this year, will be best received in an environment of informed and considered debate. Ahead of these recommendations, therefore, the Government will seek to engage with the public – and other key stakeholders – over the principles outlined in this document. In this way we hope to achieve a shared framework of criteria with which the recommendations of the Commission and others can be assessed.

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