

Increased Pension Compulsion in the UK

Scoping Paper for the SMF Working Group

Robin Harding and Ann Rossiter

Contents

1. Purpose of the scoping paper	3
2. Introduction	5
3. The objectives of pension compulsion	8
4. The pensions shortfall	13
5. The pension system today	19
6. Compulsion system design	26
7. Other issues for a compulsion scheme	37
8. The effects of compulsion	39
Appendix A: Demographics of the pensions shortfall	41
Appendix B: The current pension system in detail	46
Appendix C: International experience of compulsion Australia Chile Sweden Singapore Switzerland USA Implications for the UK	60
Appendix D: Questions for the Working Group	95

1. Purpose of this scoping paper

The SMF working group on pension compulsion (WGPC) will not address the question of whether compulsion is the correct answer to the problems identified by the Pensions Commission. Instead, it will work on the basis of the following hypothetical. If the Pensions Commission decides that the third of its potential solutions, an increased level of compulsory private pensions saving, is a preferred route, how might that best be achieved? WGPC members have a range of views as to whether this is indeed a desirable option, but are committed to examining what a compulsory scheme might look like in practice, with a view to analysing its advantages and disadvantages. By setting out how further compulsion might work in the UK we hope to contribute to the debate on whether to introduce it.

This paper is intended to provide the SMF working group on pension compulsion with a starting point for discussion and a preliminary agenda for its meetings.

At the first stage of the work, WGPC members are invited to consider whether the issues and questions identified in this paper are the right ones, and whether there are any other issues critical to the development of a model for pension compulsion.

If the WGPC agrees, we propose the following agenda:

- Meeting 1:** WGPC invited to agree the outline of the project as set out in the scoping paper
WGPC invited to agree the objectives of the policy
WGPC invited to agree what assumptions are to be made about:
- the benefits system
 - taxation
 - the retirement age
- WGPC invited to agree the agenda for future meetings.
- Meeting 2:** WGPC invited to consider questions around the establishment of a target income in retirement, how the state might approach the situation of those on low incomes, the range of income to which compulsion might apply, and how any perverse incentives might be avoided.
- Meeting 3:** WGPC invited to consider the relative responsibilities of the state, the employer, and the employee
WGPC invited to consider how the scheme might treat the self-employed and those with broken work records.
- Meeting 4:** WGPC invited to consider which investment vehicles would be appropriate, the overall system design, and appropriate regulatory structures.
WGPC invited to consider whether a state guarantee is feasible or desirable.
- Meeting 5:** WGPC invited to consider the conditions under which funds can be accessed.

WGPC also invited to consider other aspects of the scheme including interaction with bankruptcy laws; the legal status of compulsion and the treatment of certain age groups.

Meeting 6: WGPC invited to consider the transition arrangements for the introduction of the scheme
WGPC invited to consider the possible impacts of the scheme.

This paper will form the basis for discussion at the first meeting. For each of the subsequent meetings the SMF will produce a briefing paper setting out the issues in detail.

2. Introduction

The scene set by the Pensions Commission

The Pensions Commission's first report sets out the future of the UK pension system in stark terms. Life expectancy is growing rapidly, the birth rate is low, and the percentage of the population aged over 65 will likely double by 2050 as a result. That means a choice between four options:

- a. pensioners will become poorer relative to the rest of society
- b. taxes/National Insurance contributions devoted to pensions must rise
- c. the savings rate must rise
- d. average retirement ages must rise.¹

The Pensions Commission argues that the solution must be some combination of options b to d. In terms of raising the available funding for pensions it points to the following options:

1. a revitalised voluntary system and/or
2. significant changes to the state system and/or
3. an increased level of compulsory private pension saving.

The British pension system already features compulsion. Anybody earning more than £4,108 in 2004/05 must pay National Insurance contributions to earn an entitlement to the Basic State Pension. Extending compulsion would mean increasing the percentage of earnings that had to be contributed to a pension. These contributions could be paid to the government or saved privately; they might come from employers, employees, or both; they might be at any level and over any range of income: these are the questions the working group will seek to answer.

Why consider compulsion?

Compulsion is an option because a significant proportion of people in the UK are not saving enough voluntarily to ensure a comfortable or even a poverty-free retirement. There are a number of reasons why this might be so, which include:

- Individuals do not always make rational decisions about pensions. Not only do we tend to be bad at discounting the long-term future, but we find it difficult to make a decision unless prompted, and are often poor judges of risk and investment strategy. The result is that we are unlikely to save a 'rational' amount if left with a choice.
- Many are put off saving by distrust of the pensions industry and concern about the stability of pensions policy although some may have an exaggerated perception of the risks. Media coverage and criticism of the difficulties experienced by Equitable Life and its policyholders; of endowment mortgage shortfalls; and, most of all, of pensions mis-selling has undermined trust in the

¹ Pensions Commission, *First Report - Pensions: Challenges and Choices*, 2004, HMSO: London. <http://www.pensionscommission.org.uk/publications/2004/annrep/fullreport.pdf>. (16th Feb 2005)

industry. The perception of political risk arises from a belief that the government has frequently changed the rules upon which an individual's past decisions about savings have been based and may do so again.

- Britain's voluntary system is fragmented and there is a trend for the fragmentation to become worse. Individuals may hold a number of different pension pots because the nature of a modern career means they are likely to have worked for numerous different organisations, each offering a different pension. Increased service sector employment and the growth of personal pensions since the 1980s have increased the number of pension schemes. A fragmented system imposes higher average charges, meaning a lower pension for a given level of savings. The answer to this is not necessarily compulsion, but compulsion would likely mean simplicity, and funds with greater scale.
- Means testing in the state system makes it rational for those who see low incomes in their future not to save. This has arisen because of the current government's determination to tackle pensioner poverty through means-tested benefits, which currently means that savers lose 40p of benefits for each £1 of private pension income they receive, for the first £60 per week of private savings. This creates a disincentive to save which, over time, may increase reliance on state benefits. Compulsion would prevent this, and allow the state, through means testing, to focus benefits on those in greatest need.
- Demographic change is increasing the percentage of pensioners in the population. Unless pensions are funded, this will mean government will spend increasing amounts on pensions, paid for through higher taxation, or less spending on other priorities. This might be politically unpopular and prevent the accomplishment of other social goals. Compulsion is the only sure way to increase pension funding.
- Employers have reduced overall pension scheme benefits through the shift from defined benefit to defined contribution provision. In addition, expected retirement income is necessarily less transparent under a defined contribution scheme as compared to a defined benefit scheme. This will mean the number of people likely to be saving an insufficient amount for retirement will be increasing, rather than decreasing.

Several countries, most notably Australia and Chile, have introduced a high degree of mandatory, funded, private pension provision. These schemes have generally achieved some improvement in pension adequacy (although there is debate about how much); all have achieved greater security in funding and proof against future demographic change.

The greatest objection to compulsion is just that: it is compulsory, and there should be a presumption against exercising the powers of the state, and taking away citizens' liberty, unless it is truly necessary to do so. There are also economic arguments: compulsion would raise the factor price of labour (regardless of whether employers or employees contributed) and, though it could be offset by lower tax, it might lower competitiveness or distort economic activity. Another argument against compulsion is that it would not work: people would offset compulsory pensions by borrowing or

lowering other savings. Some argue that this has happened in Australia, where the overall savings rate has not risen, though the majority of economists put this down to other factors.²

Relation of the WGPC to the Pensions Commission

The Pensions Commission published its First Report in October 2004 and plans to release its second, including policy recommendations, in Autumn 2005. The goal of the SMF working group is to contribute to its deliberations and to policy discussion in its aftermath.

The Pensions Commission has asked for comment on two particular issues related to compulsion: its impact on aggregate savings and the system design necessary to control administration costs. We hope to provide input on these and other issues, and to provide interested parties, including the Commission, with copies of all the papers produced throughout the working group process.

About this paper

This paper sets out the background on the UK pension system, international experience of compulsion, and the issues that need to be addressed. Questions for the working group are in italics. It contains no original primary research and is heavily indebted to others, especially the Pensions Commission, the ABI, and the Pensions Policy Institute, for its data. It sets the scene for a discussion of compulsion in the UK.

² See Appendix C part 1 on the Australian experience.

3. The objectives of pension compulsion

Objectives and the design of a compulsory scheme

The purpose of a compulsion policy is to increase the level of savings; how far savings need to be increased, however, and who needs to be compelled to save more, depends on the overall objectives of the pension system, and the philosophy that underlies it. The Pensions Commission has not yet declared what it considers the objective of pensions policy to be, but for the purposes of its report it has chosen a mid-point on the income range as a marker: it states there is a social interest in ensuring that those up to the 75th percentile of earnings (£29,000) have made provision that they themselves would consider adequate, but that a purely individualist approach should be allowed for those earning above the 90th income percentile (£40,000).

The objective of a compulsion system will determine key features of its design, so it must be decided before the rest of the system. Possible objectives for compulsion include:

1. to avoid poverty in retirement for anyone who had reasonable earnings during their working life
2. to ensure comfort in retirement for anyone who had reasonable earnings during their working life
3. to reduce reliance on state benefits (i.e. to compel saving to the level implied by the Minimum Income Guarantee)
4. to increase aggregate savings to an adequate level
5. to reduce the proportion of pensions paid by the state (possibly from 60/40 to 40/60).

Options one, three and five; avoiding poverty in retirement, reducing reliance on state benefits, and reducing the proportion of benefits paid by the state, would be likely to produce similar outcomes: a minimum income, rather than adequate pensions. Option 2, ensuring comfort in retirement, is roughly equivalent to the Pensions Commission's mid-point of provision people would consider adequate. All four of these options would, to a greater or lesser extent, result in option 4, and increase aggregate savings.

All of these objectives are legitimate to some extent in that they would be likely to attract broad-based support. In particular, options one, four and five would win support from all of the main political parties operating in the UK. However, some on the left of the political spectrum would not agree that reducing reliance on the state should be an objective in itself (options 3 & 5). Some on the right might consider that a minimalist state should restrict itself to minimalist solutions and should not be about ensuring comfort in retirement (option 2).

However, our preference is to adopt option 2 – ensuring a degree of comfort in retirement. Objections on the basis that comfort in retirement is a “big state” solution should not detain us since they would also apply to compulsion itself. We have reached this conclusion through a process of elimination:

Under both options 4 and 5 it would be possible to raise aggregate savings and/or reduce the proportion paid by the state whilst still leaving a substantial percentage of pensioners poor or facing a disappointing retirement. This would be unfair, particularly if those pensioners compelled to save more were still left in poverty. For Option 3, whilst less reliance on benefits is generally considered desirable for the state and for individuals, it has nothing to say about the degree to which income in retirement should outstrip benefits. It is therefore not a helpful starting point for a full-scale compulsory scheme.

Option 1 is insufficient for the following reasons. In general people aspire to comfort in retirement. A minimum retirement income would therefore disappoint most pensioners, which suggests a compulsory level beyond the minimum. Second, by setting a level of compulsory savings, government would be giving an important signal, which would be read by many as the level at which they need to save. Messages about the need to save beyond this would be difficult to communicate. Third, predicting the amount of saving required to generate a given income in retirement is an inexact science. Setting a level that is predicted to take people just above the poverty level would entail a substantial risk: that in fact many people would find themselves below it.

Ben Jupp, in his paper for Demos, argues in favour of an Option 1 approach.³ He contends that compelling people to fund a pension that is a proportion of their earnings is overly paternalistic and cannot provide for the diversity of peoples' needs. He does, however, accept the argument that non-savers present an unfair burden on the state. In contrast, the TUC explicitly favour comfort in retirement as an objective in their work on compulsion.

On this basis, we advocate that, *to ensure that people with a reasonable working income retire in comfort*, be adopted as an objective. Of course, this asks important questions about the size of a "reasonable" working income, and what should be considered "comfort".

Q1 Do you agree that ensuring comfort in retirement should be the objective of compulsion? Is the mid-point chosen by the Commission an appropriate benchmark?

Target for income in retirement

This overall objective needs to be translated into a target income in retirement. This can then be used to calculate the percentage of income over a set period that must be contributed to achieve it. The TUC has used this approach to suggest that a compulsory scheme would require a savings level of 15% of income.⁴ Working backwards from the level of compulsion people will accept, the ABI found that a 10% level of savings would produce low-to-moderate retirement incomes with the existing

³ Jupp, B., *Reasonable Force: The place of compulsion in securing adequate pensions*, January 1998, Demos: London. www.demos.co.uk/reasonableforce_pdf_media_public.aspx (31st March 2005).

⁴ *Occupational Pensions for All*, Statement of the TUC General Council, September 2002.

retirement age.⁵ The table in the next section shows the percentage of salary this would generate for those on the median income.

Focusing on median incomes, however, hides the wide variation in final retirement income that would result from taking straightforward percentages as the basis for compulsion. For example, the Pensions Commission suggests a necessary replacement rate (retirement income as a percentage of income in work) of 80% for someone on £9,000 per year and 67% for someone on median earnings (£21,250), falling to 50% for someone on £50,000 per year. The following table shows what 10% or 15% contribution rates would mean for people on such incomes. This still ignores those in the bottom earnings deciles, many of whom not only have no income from work (and are thus unaffected by compulsion), but do not accrue a Basic State Pension, and would continue to receive only the state Minimum Income Guarantee, currently £105.45. This still falls short of the minimum £113.85 that Age Concern calculate is needed by an owner occupier and £142.60 needed by a tenant to live a basic, low cost lifestyle.⁶

Table 1: Weekly income in retirement from 10% and 15% contribution rates at different earnings levels (including Basic State Pension)

	Income in work		
	£9,000 p.a.	£21,250 p.a.	£50,000 p.a.
10% contributions	£132.10	£208.02	£375.48
15% contributions	£162.35	£269.91	£521.10

Source: SMF modelling. All estimates are for a single pensioner who makes 40 years of contributions at national median earnings. Real returns are assumed to be 3% and annuity rates to be 5%. Please note that this modelling is basic and abstracts from a host of issues including earnings growth, and the lifetime pattern of earnings and contributions, though it includes taxation and the Basic State Pension. A compulsory system is assumed to replace the Additional State Pension. It provides a rough guide to the level of saving needed to deliver different levels of pension.

A more sophisticated approach is preferable. This might involve either (a) specifying the range of income to which compulsion should apply with income below or above a certain level being exempt or (b) applying differing percentage rates of compulsion to different ranges of income.

Defining comfort in retirement

This analysis also highlights the difficulties surrounding defining a comfortable income in retirement. Issues include whether to adopt an absolute or relative measure of comfort, whether to measure relative to average income or the pre-retirement income of that individual, and whether it is possible to define an objective measure of comfort at all.

Three possible standards are defined below based on three possible objectives for compulsion: removing disincentives to save, avoiding poverty, and providing comfort

⁵ *Compulsory pensions – an analysis of public attitudes*, Occasional Paper No. 1, Association of British Insurers, August 2004.

⁶ *Low Cost but Acceptable Budget for Pensioners*, Family Budget Unit, York University for Age Concern, April 2004. <http://www.york.ac.uk/res/fbu/documents/Pensionerswebpage.pdf> (22nd March 2005). Figures are for a single man who drinks, but does not smoke, and does not own a car.

in retirement. The first two are derived from the present minimum income defined by the benefits system (i.e. the Guarantee Credit level for pensioners) and a ‘bottom-up’ estimate of what a pensioner might need to buy necessities (based on an Age Concern household budget covering food, clothing, transport etc.) of £118 p.w.

This final estimate, the best approximation to comfort in retirement, is based on the Pensions Commission’s survey of evidence on actual retirement incomes achieved and of peoples’ preferences. These show high actual median rates, often above 70%, but a desire for even higher levels: 56% of people believe they need as much or more income in retirement than they had in work. The Pensions Commission concludes from this that current actual replacement rates are an appropriate benchmark, and adopts the figures of 80%, 67% and 50% for its own modelling.⁷

The Pensions Commission tends to an empirical definition of ‘comfort’ or ‘adequacy’. The EU’s Social Protection Committee, meanwhile, argues that pensions “...should enable people to remain financially autonomous in old age and, within reasonable limits, to maintain the living standard achieved during their working life.”⁸ This is an absolute standard, to which a 50%, 67% or 80% replacement rate at different income levels is only an approximation, and as the Pensions Commission concedes, it does not account for how the cost of ‘comfort’ evolves as pensioners grow older. Given the difficulties of translating an absolute standard into a measurable target (the amount needed will be different for each pensioner) the Pensions Commission approach is attractive.

Table 2: Replacement and contribution rates for different pension system objectives

	Replacement Rate	Implied Contribution Rate
Avoid poverty in retirement/reduce reliance on state benefits	35-40% (Sufficient income to meet basic needs plus rent?)	9-10%
Provide comfort in retirement	60-70%	15-18%
Remove existing disincentives to save	22% (Delivers pension equal to Minimum Income Guarantee)	5-6%
Increase aggregate savings	Not applicable	Any compulsory contributions likely to increase aggregate savings

Source: SMF modelling. All estimates are for a single pensioner who makes 40 years of contributions at national median earnings. Real returns are assumed to be 3% and annuity rates to be 5%. Please note that this modelling is basic and abstracts from a host of issues including state pension provision, taxation, earnings growth, and the lifetime pattern of earnings and contributions. It provides a rough guide to the level of saving needed to deliver different levels of pension.

⁷ Pensions Commission (2004), pages 138-143.

⁸ *Adequate and Sustainable Pensions*, Report by the Social Protection Committee to the the Gothenburg European Council, June 2000, European Commission: Brussels.
http://europa.eu.int/comm/employment_social/social_protection/docs/goteborg_en.pdf (5th April 2005).

On this basis, it appears that 15% of income may be an appropriate minimum target income to ensure comfort in retirement. This is in line with the level advocated by the TUC but above the 11% suggested by the Demos paper. It is, however, substantially above the levels seen in most overseas compulsion systems including Australia, where the level is 9%.

Q2 Is 15% an appropriate target rate to ensure comfort in retirement? Should we adopt a single rate with a floor and ceiling on the income range to which compulsion should apply, or should we adopt 15% as a median rate, with higher and lower percentages applying to different income ranges?

4. The pensions shortfall

Comprehensive estimates of the shortfall in pension saving are limited. All suffer from a grave shortage of data, especially on existing pension savings, and are over-reliant on one-period measures of savings flows. This section reviews three main studies; demographic analysis of the type of people under-saving is in Appendix A.

First Report of the Pensions Commission

The Pensions Commission modelled how much different income groups need to save to achieve a given pension, compared that to actual data, and estimated the number of people with insufficient provision for retirement. The key assumptions are:

- *replacement rates*: fall from 80% for someone on £9,000 per year to 67% for someone on median earnings (£21,250) to 50% for someone on £50,000 per year
- *average retirement age*: 65
- *investment returns*: real return of 3.8% after costs (occupational schemes) and 3.3% after costs (personal schemes)
- *period of saving*: start saving at 35 and save continuously for 30 years. All savers accrue full Basic State Pension (BSP) rights
- *DB/DC*: the current balance of Defined Benefit (DB) and Defined Contribution (DC) schemes continues. Current members of DB schemes all have adequate provision
- *other*: housing benefit fully covers rent for pensioners who do not own their home.

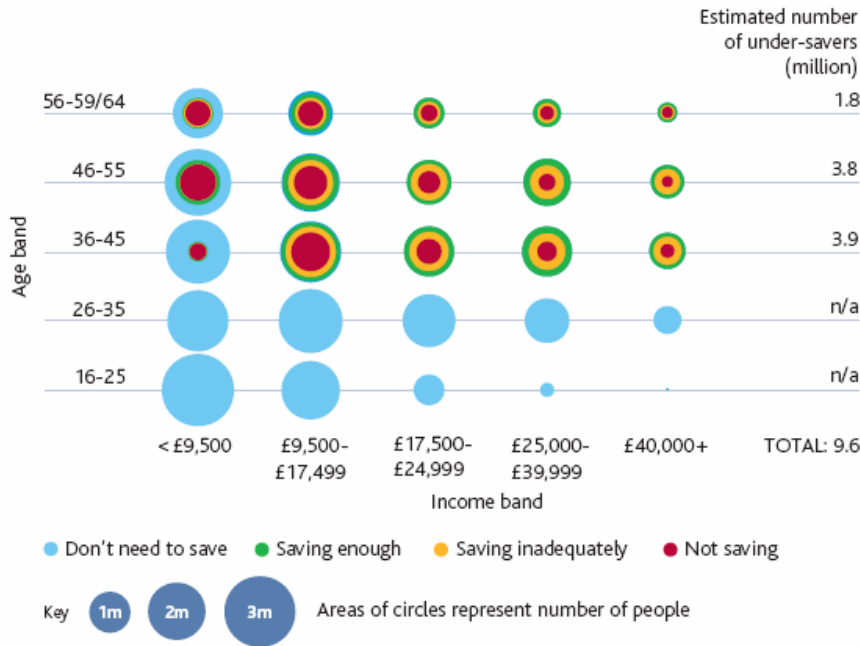
In this base case they estimate there are around 9.6 million people making insufficient provision for retirement, of whom 5.2 million are not saving at all, and 4.4 million are not saving enough. There are several alternative scenarios:

	Replacement Rate	Investment Returns	Period of Saving	Number Under-saving
Base	50%-80%	3.8%/3.3%	30 years	9.6 million
Scenario 1	50%-80%	3.8%/3.3%	40 years	12.1 million
Scenario 2	45%-75%	3.8%/3.3%	30 years	8.5 million
Scenario 3	50%-80%	4.3%/3.8%	30 years	9.5 million
Scenario 4	45%-75%	4.3%/3.8%	40 years	10.5 million

The Pensions Commission argues these numbers should be treated as the minimum number of people under-saving. This is because:

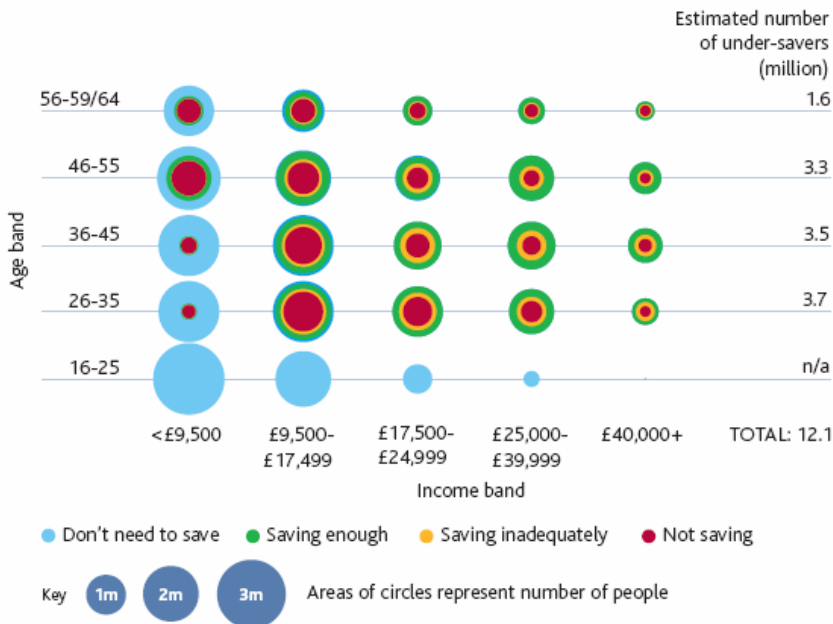
- many people do not save continuously for 30-40 years
- not everyone accrues a full BSP
- the existing level of DB provision is assumed to continue
- executive pension schemes distort the average of DC contributions
- housing benefit is unlikely to cover all the costs of pensioners who have to rent.

Figure 4.16 Base Case Results: Savings Start at Age 35



Source: Pensions Commission analysis based on FRS 2002-03, NES, GAD and Inland Revenue data

Figure 4.17 Alternative Scenario 1 Results: Saving Starts at Age 25



Source: Pensions Commission analysis based on FRS 2002-03, NES, GAD and Inland Revenue data

Source: *First Report of the Pensions Commission*

ABI State of the Nation's Savings Report 2004

The ABI carries out a similar modelling exercise annually using a proprietary survey by the YouGov polling agency.⁹ Those with adequate provision are defined as having pension contributions greater than 10% of salary, under-savers as having contributions less than 10% of salary, and non-savers as those with no private pension. The key assumptions are:

- *replacement rates*: a flat 50%, suggested as a minimum level by the 2002 Green Paper on pensions
- *average retirement age/investment returns/period of saving*: not stated but implicit in the assumption that 10% contributions will provide a 50% replacement pension
- *DC/DB*: the current balance of DB and DC schemes continues. Current members of DB schemes all have adequate provision
- *other*: current savings behaviour is constant through time.

The study identifies 12.2 million people who are not saving enough: 43% of the working population. Of these 7.4 million are not saving at all and 4.8 million are only saving small amounts. These numbers are somewhat affected by the definition of non-savers and under-savers. Low earners, defined by the Pension Commission as not needing to save (because the state pension will meet their replacement rate), are included as non-savers because they have no private pension. Nonetheless, the high number of under-savers, even when assuming a low replacement rate, supports the idea that the Pension Commission numbers are a minimum.

ABI Oliver Wyman Report

A study by actuaries Oliver Wyman, also for the ABI, estimates the “savings gap,” essentially the number of people under-saving multiplied by the amount they are under-saving by.¹⁰ The principal assumptions are:

- *replacement rates*: average of 68%
- *average retirement age*: 65
- *investment returns*: 7% gross, which after 2% inflation and 1% costs implies a real return around 4%
- *period of saving*: not stated
- *DC/DB*: remains constant.

The study finds a total savings gap of £27 billion. It suggests that more than half the 18 million working households have a saving shortage greater than 10% of their current income. This is broadly consistent with the 12.2 million individuals, 43% of the working population, found to be under-saving by the other ABI report.

⁹ ABI, *The State of the Nation's Savings 2004*, November 2004, ABI: London.
http://www.abi.org.uk/Display/File/364/2004_State_of_the_Nations_Saving.pdf (17/02/05)

¹⁰ Oliver, Wyman & Company, *The Future Regulation of UK Savings and Investment*, September 2001, ABI: London.

Age	Household Annual Income (£)						Total
	<9,500	9,500 – 13,500	13,500 – 17,500	17,500 – 25,000	25,000 – 35,000	>35,000	
under 25	767	368	393	574	761	1,211	4,074
25 – 35	1,128	891	999	1,623	1,620	965	7,226
35 – 45	845	997	1,232	1,631	2,333	0	7,038
45 – 60	528	1,389	1,130	1,921	3,718	0	8,686
Totals	3,268	3,645	3,754	5,749	8,432	2,176	27,024

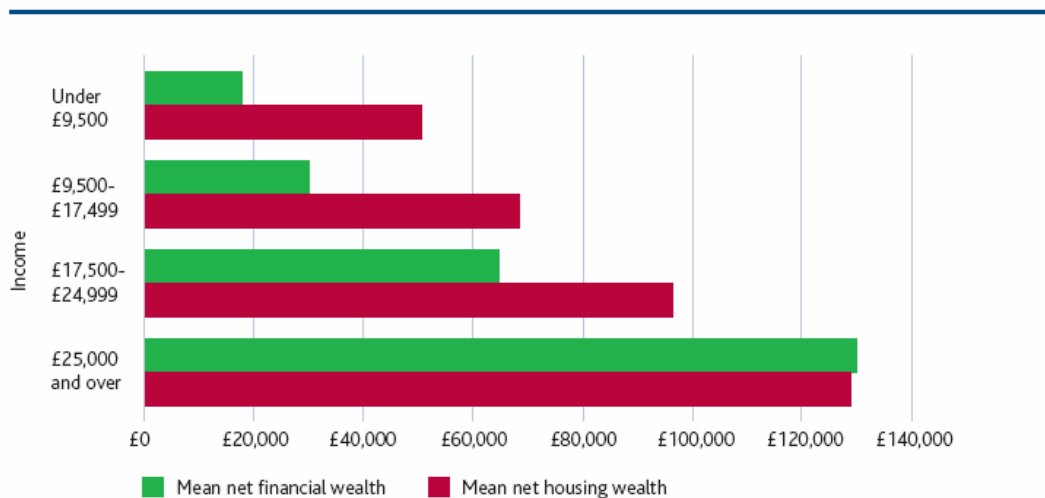
Source: Oliver Wyman for the ABI

Other Savings & Debt

Savings outside of pensions may compensate for under-saving; debts may exacerbate it. The level and distribution of net non-pension savings therefore has an important effect on pension adequacy.

The Pension Commission found non-pension savings to be potentially significant, noting a net £1,150bn in financial wealth, and a net £2,250bn in housing wealth. For one of the income groups most at risk of under-saving, those on £17,500 - £24,999 per annum, mean net assets excluding pensions are around £160,000.

Figure 5.7 Mean Net Financial Wealth and Mean Net Housing Wealth among those approaching Retirement, by Income



Source: Banks J, Emmerson C and Oldfield Z (2004)

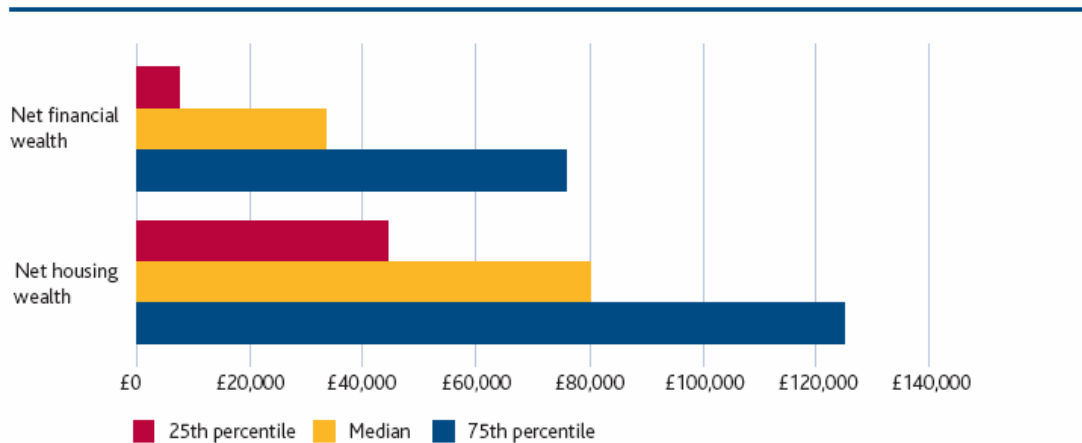
Note: Data is shown for non-retired 55-59 year olds. The non-retired include all those in work and all not in work who do not describe themselves as retired, even though some of these may never work again. Income is on an equivalised family basis and is net of income tax. Equivalisation refers to adjustments made to wealth or income to take account of the size of the family with a claim on that resource. ELSA uses the OECD equivalence scale which gives a weight of 0.5 to another adult, 0.3 to a child aged 0-13 years and 0.5 to a dependent child aged 14-18 years. Wealth is calculated on a family basis and is not equivalised.

Source: *First Report of the Pensions Commission*

This wealth, however, is unevenly distributed, with median wealth of approximately £110,000, and bottom quartile wealth approximately £50,000. Turning all of this into an annuity at a rate of 5% (the approximate average for men and women with 3% escalation to allow for inflation) gives additional annual retirement income of £8,000 at the mean, £5,500 at the median, and £2,500 at the bottom quartile. For an

individual with an income of £21,250, mean wealth would replace 37.6%, median wealth 25.9% and bottom quartile wealth 11.8% of income.

Figure 5.8 Percentiles of Net Financial Wealth and Net Housing Wealth Among Those Approaching Retirement with Income £17,500-£24,999



Source: Banks J, Emmerson C and Oldfield Z (2004)

Note: Data is shown for non-retired 55-59 year olds with income £17,500-£24,999. The non-retired include all those in work and all not in work who do not describe themselves as retired, even though some of these may never work again. Income is on an equivalised family basis and is net of income tax. Wealth is calculated on a family basis and is not equivalised.

Source: *First report of the Pensions Commission*

In theory, this would go a long way to reaching the 67% replacement rate that the Pensions Commission uses for this income group, and reducing the number of under-savers. In fact, for a number of reasons, the reduction may not be that great:

- those without an adequate pension are no more likely than others to have large non-pension assets
- those with financial assets are likely to keep some back for a rainy day, so not all can be converted into income, especially for the poorest
- housing equity is highly illiquid, so few pensioners will be able to trade down or release equity, and those that do will pay high fees.

The Commission considers inheritances to be a potentially more important source of retirement funds, but again, these assets are unevenly distributed, and more likely to be received by those who already have a reasonable pension.

The Pensions Commission may be unduly negative about the role of non-pension wealth in funding retirement: it tends to assume that the distribution of this wealth is independent of retirement needs, though it seems logical that at least some people are holding assets specifically to provide for retirement, and deliberately not saving into a pension. In this, as in many other areas, the data is inadequate. Given that estimates of the numbers under-saving in pensions are likely to err on the low side these problems probably offset each other to some extent. It therefore seems reasonable not to modify the number making insufficient provision in light of other savings.

In Appendix A we go into more detail about those who may be under-saving. In particular, the working group will need to bear in mind the needs of three particular

groups of under-savers: women; the self-employed, and those with unusual working patterns.

Implications for compulsion

The Pensions Commission estimates are the most detailed but, as stated, they are a minimum not an actual estimate. The two ABI reports suggest a somewhat higher figure but offsetting this are considerable non-pension savings and assets. It would seem reasonable, therefore, to adopt the basic Pension Commission estimates, and assume there are 9-10m working Britons who are not saving enough for their retirement. In practice, this will mean large numbers of low-earners retiring on means-tested benefits, and many middle-earners with retirement incomes less than 50% of their earnings in work.

Of the 9-10 million, 55-60% appear not to be saving at all, while the remaining 40-45% are not saving enough, though it is not clear by how much the second group is under-saving. The authors of all these reports rightly emphasise the inadequacy of available data and all these figures must be taken as best guess estimates rather than a reliable description of the problem.

Q3 Is the Pensions Commission's definition of the pensions shortfall satisfactory for the purposes of developing a model for compulsion?

5. The pension system today

This section describes the British pension system as it stands today, and as it will change to 2050 based on current policies. Private pensions are discussed first, followed by the state system; as before, there are serious data issues. A more detailed and complete description of the current system is presented in Appendix B.

Private Pensions

Out of an overall working age population of 34.3m, of whom 25.6m are in work, the Pension Commission finds 14.3m who make some contribution to a private pension (including personal, defined contribution and defined benefit occupational schemes) and 11.3m who do not. The table below gives a rough indication of the numbers covered by different kinds of pension schemes. Reasons the numbers do not sum to the 14.3m total include ongoing falls in the number of DB pensions, people holding several kinds of pension, and double counting of personal pensions.

Type of Scheme	Numbers Enrolled	Average Level of Contributions	Annual Charges
Defined Benefit	9.1m (falling to 6.2m medium-term)	16-18%	0.5% (public) 0.75% (corporate) ¹¹
Occupational Defined Contribution	1-2m	8-9%	1%
Group Personal Pension	1m (?)	7-8%	1%-1.25%
Approved Private Pension	5-6m	3-6%	1%-2%
Stakeholder Pension	1m	3-6%	1%
Self-Invested Personal Pension	100,000	N/a	0.5%-2%

Defined Benefit:

The Government Actuaries Department (GAD) survey of 2000 found 9.1m people with DB pensions, of which 0.5m were in schemes closed to new members, down from around 10m in 1995.¹² Since then, as the Pensions Commission have pointed out, the number of open DB schemes has declined rapidly, and their modelling estimate is an ultimate fall of 60% from 2000 in private sector membership.¹³ This seems as good a prediction as any.

¹¹ Estimates for a median-sized pension fund using US data. Collins, S. "The Expenses of Defined Benefit Pension Funds and Mutual Funds," *Perspective*, No. 9(6), Investment Company Institute, December 2003.

¹² *Occupational Pension Schemes 2000*, Government Actuary's Department, April 2003. http://www.gad.gov.uk/publications/docs/opss2000_final_results_final_7april2003.pdf (24th March 2005).

¹³ Pensions Commission (2004), page 85.

Defined Contribution:

The 2000 GAD survey found 61,400 employer DC schemes covering 0.9m workers. This figure has risen from almost nothing in 1979 but is down on its peak in the early 1990s. Additional DC schemes may have opened to replace DC schemes that have closed since 2000 but figures to show this are not yet available. Contributions to DC schemes tend, on average, to be around half that of DB schemes.¹⁴

Personal Pensions:

The 2002 General Household Survey (GHS) found that 19% of men working full-time, 12% of women working full-time, and 9% of women working part-time had some form of personal pension.¹⁵ This is roughly in agreement with a MORI survey that found 18% of adults in employment in December 2003 had a personal pension. Personal pensions have been growing in importance, with the percentage of workers holding one rising from 11% in 1997 to 18% in 2003, and the percentage of total pension assets held in them rising above 20%.

Stakeholder Pensions:

35% of organisations provide access to stakeholder pensions, rising to more than 80% amongst those with 13-49 members of staff. Actual membership of such pensions, however, is far lower, with 42% of organisations that provide stakeholder pensions having no active members, and another 52% having less than a quarter of their workforce enrolled. About 61% of organisations that have active stakeholder members make a contribution to their plan. Approximately two-thirds of them contributed a percentage of salary, with the median and modal contribution between 3% and 5%. Though stakeholder pensions are a subset of defined contribution schemes they are reported separately in official statistics.

Self-Invested Personal Pensions (SIPP)

There is limited information available on the SIPP market, although one recent publication suggests there are now 100,000 plans in force, and the number may be growing by 30% per annum.¹⁶

State Pensions

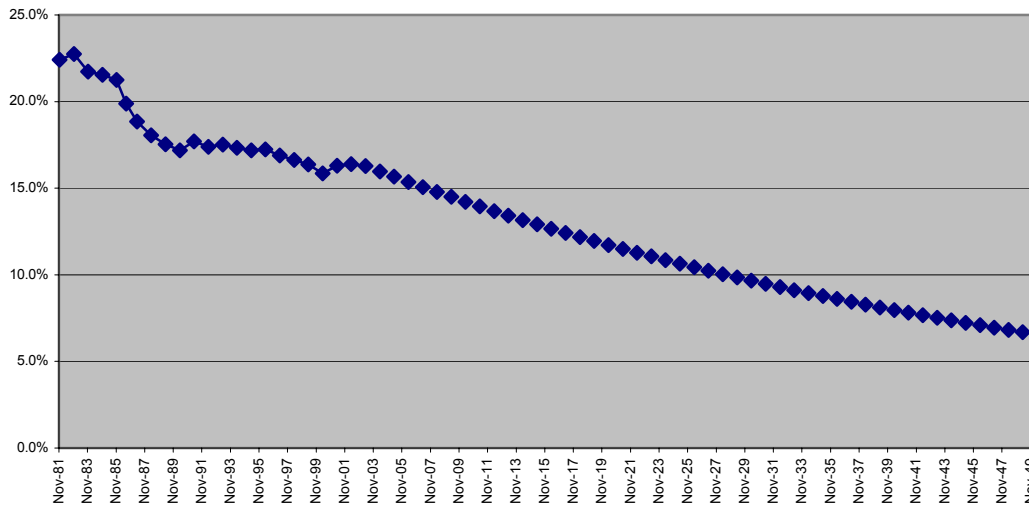
Britain's BSP is a compulsory flat-rate contributory pension run through the tax system. Making National Insurance contributions on earnings above a lower limit (currently £79 per week) builds up "qualifying years"; the number of qualifying years at the state pension age (currently 65 for men, and moving from 60 to 65 for women) determines the level of pension (currently £79.60 per week for a single person with a full contribution record).

¹⁴ Pensions Commission (2004), page 89.

¹⁵ *General Household Survey 2002/03*, National Statistics, 2003.

¹⁶ *Pension changes bring risks*, BBC News Online, 22nd June 2004.
<http://news.bbc.co.uk/1/hi/business/3829511.stm> (20/01/05)

Basic State Pension as a Percentage of Average Earnings



Source: DWP and Average Earnings Index. Based on the mean earnings of those in full-time work (the percentage of median earnings is somewhat higher). Projections to 2050 assume earnings growth of 4.5%p.a., inflation of 2.5%p.a., and no change to policy.

The level of the BSP has been indexed to prices since 1980. It has therefore fallen as a share of average earnings and will continue to do so.

The **State Earnings Related Pension Scheme** (SERPS) was introduced in 1978. It is a compulsory contributory pension run through the tax system, but the amount paid out depended on the amount of NI contributions paid, and therefore on earnings. SERPS became the **State Second Pension** (S2P) in 2002. This made the system more generous toward those on lower incomes and extended cover to those with caring responsibilities. The current plan is for the S2P to become a flat-rate pension after 2007. As a rough guide, the combined Additional State Pension (BSP+S2P) might pay out 15% of earnings as a pension to someone who averaged £25,000 p.a. while in employment, and had a full contribution record.

It is possible to ‘contract-out’ of the S2P. This essentially means paying less National Insurance contributions in exchange for giving up a S2P entitlement. These contributions are rebated instead, either into an occupational pension or an approved personal pension, in the hope of earning a better pension through private investment. The actual operation of contracting out is complex with different rules applying to different types of pension scheme. The over-riding principle is that the contracted-out pension should provide benefits at least equal to the state benefits foregone.

To alleviate pensioner poverty the present government has introduced a **Pension Credit** indexed to earnings (known as the Minimum Income Guarantee (MIG) until October 2003). It is means-tested with respect to savings and income and comes in two parts. The first guarantees a single person over 60 a minimum income of £105.45 p.w. in 2004, about £25 more than the BSP, and is known as the Guarantee Credit. The second part, known as the Savings Credit, awards some extra money to those with small savings, so they do not lose £1 of income for each £1 they have saved.

Pension Credit is a new benefit so statistics on those receiving it are not stable as yet. On the most recent figures (August 2004) there are 2.6m households in receipt of Pension Credit, about 23% of those receiving the BSP, of whom half get both Guarantee and Savings Credits, 29% have no savings and so get the Guarantee Credit alone, and 21% have savings producing at least £25 p.w., thus getting Savings Credit alone.

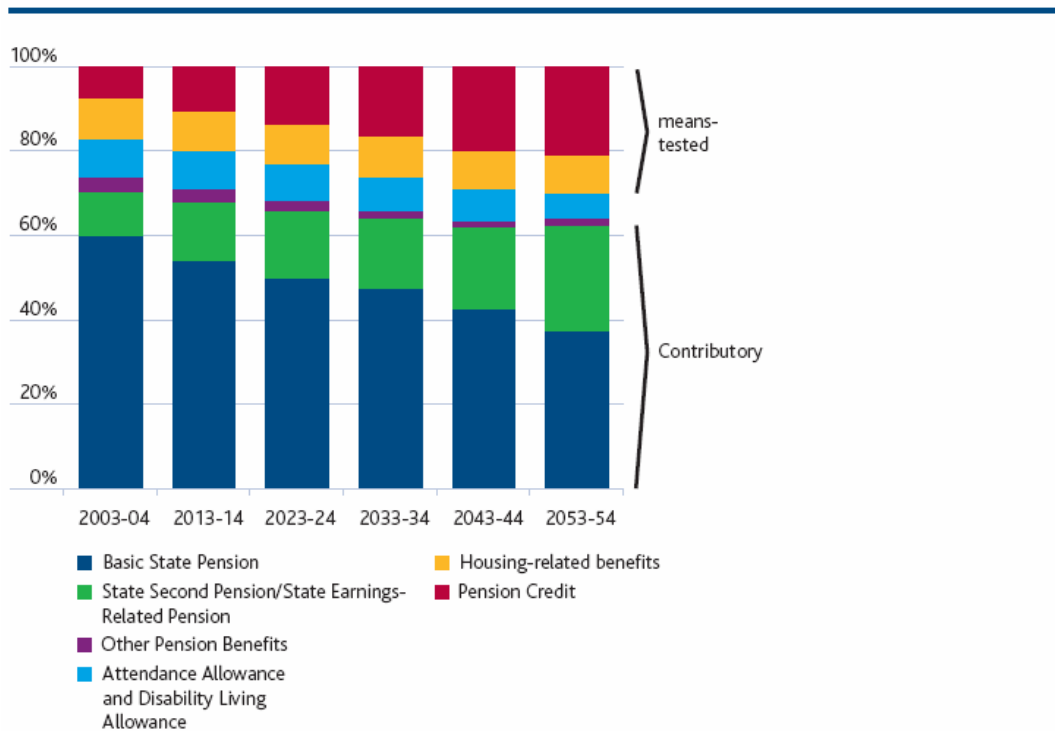
The Pension Credit makes a further contribution to the mortgage costs of homeowners; for those renting, eligibility for Guarantee Credit will mean eligibility for full Housing Benefit, which will cover the full cost of renting a suitable property. Being in receipt of Guarantee Credit should also mean eligibility for full Council Tax Benefit.

A major weakness in the system is that there is a single cut-off point – income per week below £109.45 and assets of less than £16,000 (for Housing Benefit) – at which a large range of benefits become available. The value of these benefits is greater than those achieved by compulsory saving (BSP & S2P) for those on low to medium incomes creating a disincentive to any voluntary saving. A further problem with Pension Credit is take-up with the latest Department for Work and Pensions figures showing around a third of eligible pensioners still do not receive the benefit.¹⁷

Because the Pension Credit is linked to earnings while the BSP is linked to inflation, both the number of pensioners receiving PC and its value as a percentage of government support for the elderly will rise over time, assuming present policies continue. The Pension Commission chart below shows how Pension Credit will increase as a percentage of total spending at the expense of the BSP.

¹⁷ Talbot, C., Adelman, L. & Lilly, R., *Encouraging take up: awareness of and attitudes to Pension Credit*, Research Summary No. 234, Department for Work and Pensions, March 2005. <http://www.dwp.gov.uk/asd/asd5/summ2005-2006/234summ.pdf> (March 24th 2005).

Figure 3.21 Breakdown of Forecast of State Spending per Pensioner if Current Indexation Plans Continued Indefinitely



Source: Pensions Commission analysis of data from DWP and GAD

Implications for a compulsory system

One of the major criticisms made of the current pension system is its complexity.¹⁸ This makes it difficult for individuals to understand how assets in personal and occupational pension schemes, or in other forms of savings, may affect their eligibility for state support. It makes it difficult for individuals to project how current levels of savings might translate into a final pension. It also introduces a requirement for detailed advice when making investment decisions.

The introduction of a compulsory scheme would provide an opportunity to simplify the state system. Some form of BSP or citizenship pension will probably still be necessary – to include redistribution in the system and provide for those who are able to save little or nothing.

Much of the complexity in the current system arises from large-scale means testing, introduced by this government in an attempt to alleviate pensioner poverty. It should be possible, however, for those whose incomes are insufficient to produce a comfortable pension in retirement, even with compulsion, to be treated differently than under the current system. The government would have two major options for those with incomes too low to be subject to compulsion:

¹⁸ As the Pensions Commission puts it, "...both the behavioural barriers to saving and the costs of provision have been made worse by the bewildering complexity of the UK pension system, state and private combined." Pensions Commission (2004), Executive Summary, page xiii.

1. maintain a means-tested approach for those whose final pension fell below “comfort” level and top up their income during retirement through the benefits system
2. pay actual contributions to a private scheme or nominal contributions to a state scheme on behalf of those whose income fell below the compulsory contribution level.

Both of these approaches have advantages and disadvantages. Retaining means-testing in retirement would defer spending by government, but would retain the complexity of the system. Making payments on an individual’s behalf at the point at which income is assessed means that means-testing should not be required a second time in retirement. It would, however, require a timing shift in government spending, with the risk that one generation pays twice.

The second option would have the advantage of predictability, both for the individual and the government. However, there is a danger that government would end up subsidising the pensions of those who, on average, over the course of their lifetime, would have enough income to deliver a comfortable pension. There would also need to be some criteria in place to distinguish between those who are earning below the minimum contribution level for reasons which are “justified”, for example looking after children, or “unjustified”, such as taking a year off travelling. The Australian and Swedish systems feature means testing of pensions and contributions.

There may be some simplification in prospect. The Secretary of State for Social Security has already indicated that he is considering the introduction of a Citizens’ Pension that would give all UK citizens the right to a basic state pension irrespective of their NI contribution record.

One long-term possibility would be to merge the BSP with the new compulsory system, but as the BSP is unfunded, transition arrangements would have to be carefully managed or one generation would pay twice.

One potential advantage of a compulsory system is that, when mature, all people who can provide for themselves will have to. That might make it possible to refocus state resources on the lowest paid or else reduce taxes. One way to do this would be to continue to allow the BSP to fall as a percentage of earnings while raising (or not) the MIG. Another would be to pay the BSP and S2P at a lower level and eventually make them non-contributory.

For the purposes of the working group, the important question is the future level, trajectory and conditions of the:

- BSP
- S2P
- the S2P opt-out
- MIG
- other state benefits (council tax, housing etc.)

which will form the background to the compulsory system.

Another issue under debate is the state pension age. For the purposes of our analysis there are two possible options – the status quo of 65, or a higher retirement age of 68-70.

When deciding the background conditions for a compulsory system it is worth bearing in mind that the Pensions Commission has implied it will recommend some combination of higher state benefits, later retirement, and increased saving.

Q4 What assumptions should the working group make about the state system that would exist alongside increased compulsory savings?

Q5 What assumptions should the working group make about the retirement age?

6. Other background conditions of the pensions system

Taxation

The present generous tax regime on pensions allows full income tax relief on contributions, tax-free investment returns (save a withholding tax on equity dividends), a tax-free lump sum when the pension is taken, and then normal income tax on annuity income. The purpose of these incentives is to encourage savings. If savings were compulsory this would not be necessary; it would remain to decide whether it is desirable.

High taxation would mean less pension for each pound invested and therefore higher contribution rates to achieve a given pension income. Whether it is optimal to retain the pension tax incentives, however, largely depends on whether there are less efficient and equitable taxes elsewhere in the economy that could be alleviated by removing them.

A few options for consideration are:

- Retaining the present tax system – This would minimise necessary contribution rates and might find easiest public acceptance
- Redirecting some tax relief to lower earners – It might be possible to pay for tax relief or co-contributions for low earners by reducing tax relief in another part of the system
- Reduce tax relief and use it to lower taxes or pay for other public spending

Q6 How should investments in, returns on, and income drawn from a compulsory pension be taxed?

7. Compulsion system design

This section sets out the main questions about a compulsory system on which the working group will need decide.

Minimum income for contributions

There are two reasons why the working group might define a minimum income for contributions. The first is that any deductions might leave poor people with too little to live on. From this point of view a minimum could be defined in relation to:

- The benefits system – Income Support and Job Seekers Allowance provide a minimum income from which recipients are not expected to contribute to National Insurance, and therefore to their BSP. These two benefits are currently paid at £55.65 p.w. plus £42.27 p.w. for each dependent child.
- The National Insurance system – The Lower Earnings Limit for National Insurance, the point from which people must contribute to the BSP, is £79 p.w. in 2004/05.
- A measure of poverty – The standard EU definition of poverty is earning less than 60% of median income: in the UK in 2001/02 that meant £114 p.w. for a single adult. Other measures of poverty would give a different figure.

Q7 On what basis should the income floor, below which contributions would not be made, be calculated?

The second reason why a minimum income might be set is to avoid forcing individuals to save when their projected retirement savings would either (a) be insufficient to provide them with comfort in retirement; (b) leave them reliant on means-tested benefits or (c) fail some other measure of adequacy. It should be noted that if this approach were adopted, it would mean that those who could make a partial, but not total, contribution to the cost of their own retirement would not be expected to make any contribution at all. This would increase the burden on the state dramatically – about 30-40% of the working population would be exempt from compulsion.

A decision on this issue may need to follow a decision on whether government retains means-tested benefits for those who end up with an insufficient income in retirement, or whether it chooses to pay contributions (real or nominal) for those on low incomes.

When looking at the minimum income level for contributions we will also need to consider how the system treats those close to that level. For example, if incomes below £100 p.w. pay no contributions, and incomes above £100 p.w. pay 10%, then after contributions an income of £101 p.w. is £91, but an income of £99 is just that. This would be a major disincentive to work at the margin. We will deal with this issue in more detail in the working group's papers.

Q8 Is an inadequate projected final pension under a compulsory scheme justification to set a floor below which those on low incomes should make no contributions?

Q9 If so, on what basis should that decision be made?

Maximum incomes

One approach to a maximum income would be the Pensions Commission's suggestion that above the 90th percentile, about £40,000 p.a., an individualist approach is appropriate. This would cap contributions at £770 p.w. This is somewhat, but not massively, below the cap in the Australian system.

If compulsion is levied on employers then a maximum income creates a labour market distortion: it becomes relatively cheaper to employ, or give extra work to, high-skilled, high-cost workers. In his Demos paper Ben Jupp cites this as one reason to favour employee contributions.

Q10 Does the working group agree that there should be a maximum level of income above which earning should not be subject to compulsion?

The basis for calculating income

Contributions could be paid as a percentage of weekly, monthly, annual, contract or even lifetime earnings. Important considerations are to maximise the volume and accuracy of contributions, fit in with existing business practice and systems, minimise collection costs, and be convenient for whoever is paying.

The more complex issue about the basis for calculating contributions relates to (a) the creation of disincentives to work; (b) the basis of a contribution floor and the level at which this is set; and (c) how the government provides a retirement income for those at the bottom of the income scale. Again, these issues will be dealt with in more detail in subsequent papers for the working group. In the meantime, it is worth noting that possible solutions include:

- Making (for example) the first £100 p.w. of pay free from compulsion for everyone, so the person earning £101 would only have to pay 10% of the extra £1, or 10p. This would mean that compulsion had no impact on lower paid workers. It would also raise the necessary contribution rate for the better paid. For a median earner wanting a 60% replacement rate, exempting the first £100 of contributions raises the necessary contribution rate on the remainder from 15% to 20%.
- Operating a taper so contribution rates increase with income. Contributions might be 1% between £100-109, 2% between £110-119, continuing up to 10% above £200. This reduces the work disincentive and does not change the necessary contribution rates of the better paid. It would still leave the less well paid with inadequate contributions. In the Australian system this is solved through an income-related co-contribution by government.
- Operating a tapered tax credit to reduce the effect of contributions. In the example, contributions would be 10% on all incomes above £100, but between

£100-109 90% of the contribution would be returned as an income tax rebate, between £110-119 80% would be returned, until the tax credit reached zero above £200. This is basically the same as the contribution taper, except the government makes the contribution up to 10% through a tax credit.

Q11 How should a compulsory scheme respond to potential disincentive to work for those on low incomes?

The self employed

There are good reasons why the self-employed are the least likely to contribute to a pension. Not only do they lack the incentive of a ready-made employer scheme, but as small businesspeople they often suffer cash flow problems, and may need all their capital for their business. The first problem can be removed by compulsion; the second cannot.

Compulsory saving for the self-employed needs to:

- be low enough that investment in their business is still possible
- be flexible enough to cope with variable levels of earnings and cash flow
- be able to cope with the self-assessment of income from various sources.

Neither Australia nor Chile compels the self-employed to contribute and, as a result, saving for retirement is comparatively low amongst the self-employed. There are a number of options the working group could consider in response which fall short of full compulsion, including:

- exempting the self-employed from compulsion
- changing the level of earnings, level of contributions, or the accounting period for contributions from the self-employed
- offering tax incentives, matching contributions, or other incentives to make the scheme attractive to the self-employed.

Q12 How should the system treat the self-employed? Should they be compelled to contribute at the same level as employees, or at a reduced rate, or not at all? Should other incentives to save be offered?

Uneven work records

Uneven work records are a potential problem for a compulsory system because:

- Contribution rates based on a full working life will only produce the expected pension if all of those years are worked.
- Collecting contributions for short periods of work is more bureaucratic and expensive. Those who often switch jobs may end up with multiple pension funds incurring high charges.

The issue of those with uneven work records cannot be separated from the issue of the benefits system as it would be constituted alongside a compulsory scheme. If the

working group decided to adopt the approach of making up contributions, the state might choose to contribute in place of someone unemployed or disabled, but not in place of someone who chose not to work or to travel abroad. If this approach were to be adopted it would need to be able to differentiate between the deserving and undeserving.

If state pension contributions replace a supplementary, means-tested benefit for pensioners, this effectively means funding a large part of the state's pension liabilities. The consequences of this for intergenerational equity would need careful consideration.

Q13 How should the system treat uneven work records?

Employer and employee contributions

Contributions could be made entirely by employees, entirely by employers, or by some balance of the two. The working group might also consider whether the government should rebate some National Insurance to either group to reduce the burden.

Reasons to favour employer contributions include: lower cost of collection, easier enforcement, an existing culture of and infrastructure for contributions, and lower political impact. Reasons to oppose employer contributions include: strong business opposition, lower competitiveness due to higher wage costs, and the economic inefficiency, and therefore lower economic growth, of what is effectively a tax on wages.

Employee contributions have the merits of being more economically efficient, as they do not distort a factor price (wages), and a surprisingly high level of public support. Ben Jupp argues that it may be easier to attract support for employee contributions, since they will get the money back as a pension, rather than employer contributions, where contributions will simply be tax.¹⁹ Problems include the difficulty and cost of collecting and enforcing contributions from millions of individuals and far more widespread political impact.

It is important to note that, in terms of business profits and employee incomes over the long run, it does not matter where the contributions come from. If business pays wage growth will slow to compensate.

Q14 Should contributions come from employers, employees, or both? If both, then what balance should be struck between the two?

Investment vehicles

The working group needs to consider whether, and to what extent, it allows the following vehicles to accept contributions:

¹⁹ Jupp, B., *Reasonable Force: The place of compulsion in securing adequate pensions*, January 1998, Demos: London. www.demos.co.uk/reasonableforce_pdf_media_public.aspx (31st March 2005).

- employer DB schemes
- employer DC schemes
- group personal pensions
- industry, or other collective, DC schemes
- segregated personal pensions
- self-invested pensions
- the state.

Factors that may be important include the saver’s freedom of choice, the average cost (a positive function of selling costs and an inverse function of size), and the degree of disruption to the existing system.

Q15 What vehicle should invest compulsory pension contributions? How would it interact with the existing pension system?

Savings vehicle design and regulation

The working group’s goals for investment vehicles will include high performance, low cost, and an appropriate level of risk. Approaches to achieving this include:

- limiting the number of providers through some kind of licensing system in order to control quality, increase scale and lower costs, or
- allowing any number of providers, given certain requirements, and relying on competition to deliver the desired outcome
- in either case, the WGPC might at one extreme adopt a restrictive approach to regulation based on the government’s CAT mark system, or at the other adopt a laissez faire attitude, and allow the discipline of competition to operate
- allowing employees to contribute to a scheme of their choice or requiring them to opt into their employer schemes.

Decisions on the basic approach will affect the type and degree of detailed regulation required:

	Issue	Potential Solutions
Charge levels	Products must be profitable for providers but high charges lower pension returns.	A cap on charges. A structural solution to encourage bigger funds and less advertising. Encourage competition by allowing low cost or cost free scheme transfers
Advertising and marketing	Heavy advertising increases costs. Misleading advertising would damage confidence in the system.	Advertising regulation or restrictions. Structural solution fostering large schemes so that the cost of advertising per policyholder is reduced
Investment risk	There are two potential hazards:	Regulation on

	(a) excessive risk taking means some funds lose money and deliver inadequate pensions; (b) insufficient risk taking means some funds deliver low returns and inadequate pensions.	diversification, permitted investments and risk. Possibly specify maximum and minimum portfolio beta.
Retirement timing risk	People may retire during a dip in investment markets.	Flexible retirement timing. Fund conversion to bonds during run-up to retirement.
Reporting	People need information on their fund level and performance to make informed decisions about investment, retirement, etc.	Standards for the regularity of reporting and the information reported.
Transfers	Moving between providers incurs cost and therefore charges. Frequent moves would damage investment returns. However, the ability to move from a poorly performing fund is important to ensure effective competition.	Limit on the number of transfers. Regulation of transfer costs.
Mis-selling	If employees are required to use their employer's scheme then there will be no individual purchasers. If individuals do choose their own product then regulation/advice is needed to correct the informational gap between them and providers.	Limiting the number of providers or imposing stringent CAT marks would limit the potential for mis-selling. Otherwise regulation of the sales process will be required.
Asset classes	Need sufficient diversification. Possible distortion to macroeconomy if regulation directs investment to a particular class, e.g. equity or property.	Wide range of permitted investments. Limit on holdings of any one asset class.
Fit with existing regulation	Risk of disruption to existing system or increase in bureaucracy.	Use existing regulatory structure as far as possible.
Active/passive investment	Active investment has higher charge levels and may not produce aggregate out-performance on large sums invested in compulsory pensions.	Require core passive investment. Possibly implied by a cap on charges. Allow some high performance managers – e.g. hedge funds or venture capital?

Q16 What investment system design should be adopted? How would compulsory pension vehicles be regulated within this system?

Real and perceived government guarantee

There are both moral and practical grounds on which to argue for a guarantee on compulsory pension savings. If people are compelled to save by the state, does the state not assume some responsibility for those savings? If the goal is to ensure citizens have a certain income in retirement the state might wish to guarantee that this is so. In addition, there is likely to be a perception amongst contributors of an effective guarantee, based on a belief that government will not allow schemes to fail because of the political backlash. Set against these considerations is the high cost of providing the guarantee and the risk that, knowing it is there, investors would take excessive risks with their own money, unless there was further regulation to prevent them.

Issues for consideration are:

- Whether a guarantee should operate on retirement income or on savings, i.e. should the government guarantee an income in retirement, or that the return on a pool of savings will not fall below a given level?
- Should a guarantee of income have an absolute level or be set in relation to a person's earnings while in work? How would it relate to state guarantees for those who could not save enough for retirement? Would the existing Minimum Income Guarantee be sufficient?
- Does a guarantee justify the cost?

Q17 Should compulsory pension savings carry a government guarantee? Will they be perceived to have a guarantee regardless?

Drawing a retirement income

Whatever the target level of retirement income chosen, it will be necessary to convert a pension fund into a retirement income, and the level and reliability of this will depend on the rules for drawing it.

There is a double trade-off between pension age and income: earlier retirement means less time to accumulate a pension and lower annuity rates because of a longer expected life. Examples of the necessary contribution rates are given in the table below:

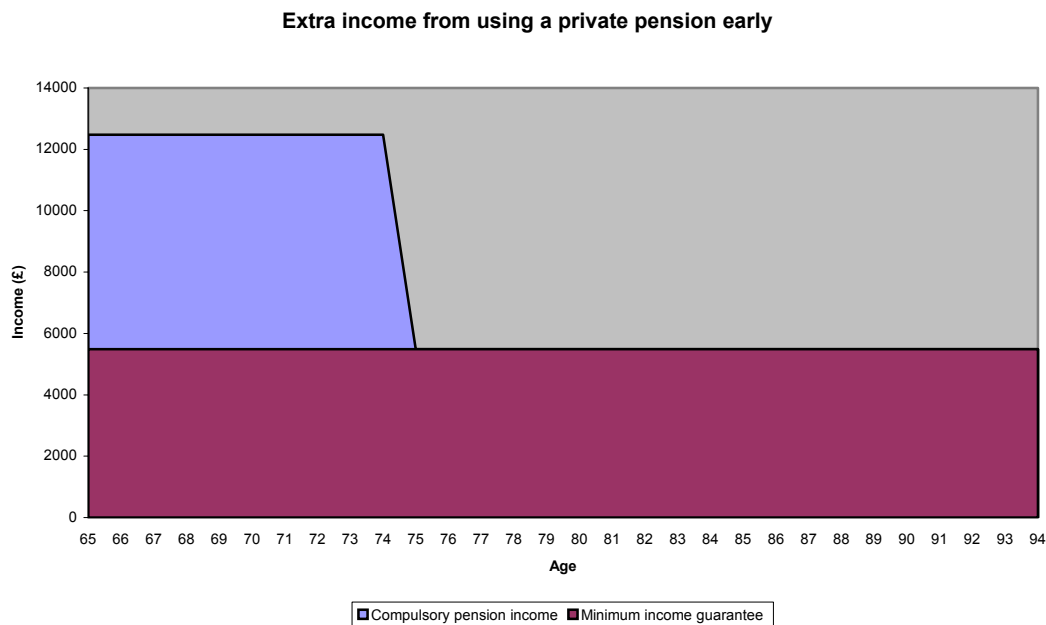
Retirement age	40% income replacement	65% income replacement
50	32%	53%
55	22%	36%
60	15%	25%
65	10%	17%
70	7%	11%
74	5%	7%

Source: SMF modelling. All estimates are for a single pensioner who works from age 25 at national median earnings. Real investment returns are assumed to be 3%; RPI escalating annuity rates are drawn from sharingpensions.co.uk. Please note that this modelling is basic and abstracts from important issues including earnings growth (which would increase the necessary contribution rates) and the tax system (which would lower them).

To state the problem another way, for a given contribution rate income will be lower the earlier someone retires, leaving them more likely to have an inadequate pension or rely on state benefit. A contribution rate and pension age need to be chosen simultaneously to achieve the desired level of retirement income.

The choice of pension age will also be influenced by the state benefits system. The BSP is currently payable from age 65 for men and is moving to 65 for women. It may be desirable to synchronise the two pension ages; this will also depend on whether the state pension age is assumed to remain at 65.

A second issue is the form the pension is drawn in. If an individual's compulsory pension income is close to what they would receive from state benefits they have an incentive to use up their own pension and fall back on the state. That will secure them a higher income early in retirement and no lower income later in retirement. The chart below shows this for an individual whose compulsory pension will produce an annuity equal to the Minimum Income Guarantee:



If they draw their compulsory pension as an annuity they will receive only the lower area equal to the MIG. If instead they draw it down over the first ten years of retirement they will receive the upper area in addition and, from 75, receive MIG to the same value as their annuity would have been.

It is therefore necessary to decide what form a compulsory pension could be drawn in, seeking to balance an individual's freedom to use their own money as they see fit with meeting the objectives of the system, and preventing exploitation of state benefits.

Options include:

- compulsory conversion of the whole fund to an annuity at the pension age
- freedom to draw the entire fund as a lump sum at the pension age

- some combination of the two: freedom to draw a percentage of the fund as a lump sum with the rest converted to an annuity
- freedom to draw income from the fund while leaving the capital invested
- allowing gradual conversion of capital to an annuity as needed
- offer tax incentives to favour annuities over lump sums

Most of these options are already present in some part of the UK pension system.

Q18 At what age and in what form should compulsory pension savings become accessible?

Extra pension savings need to remain to retirement if they are to produce increased pension incomes. Compulsory saving, however, is likely to reduce the funds people have to meet emergencies in earlier life. Criteria for emergency access to funds are therefore needed. A good basis for these is ensuring that individuals can spend their own money at a time when it will produce the greatest benefit to them. This needs to be weighed against the cost to the state, but there is no benefit in forcing someone to keep savings for retirement, if it means they will rely on state benefits now.

There is a large range of conceivable circumstances where early withdrawal could be necessary or fair. These include:

- costs of medical treatment or adjustments due to a disability
- loss of earnings due to illness
- illness resulting in a life expectancy below the pension age
- illness or disability in a family member
- loss of household income for any other reason (e.g. bankruptcy, death of a family member etc.)
- reliance on state benefit for a given period (for reason of unemployment, incapacity, inability to find housing etc.) One issue is that this could reduce incentives to find work if the conditions are less strict than those on benefits
- being in debt at interest rates higher than likely pension returns.

Q19 Are there any circumstances in which savers should be able to access their compulsory pension fund early? What would be the rules for doing this?

Other issues

There is a set of other questions that the WGPC will need to consider:

1. How will compulsion interact with the bankruptcy laws?
2. Should there be age limits for compulsion? Should there be compulsion on the wages of those under 16 or 18? Or the wages of those over the pension age?
3. Should there be compulsion or incentives to save for a non-working spouse?

4. What legal form will compulsion take? How would the enforcement mechanism work?
5. How should levels set for contribution rates, maximum and minimum incomes subject to contributions etc. vary through time? Should they be indexed to life expectancy, earnings, inflation or anything else? Should they be fixed in law? Or set at political discretion?

7. Managing the transition to a compulsory scheme

In theory, employer and employee contributions are identical: if employers make the contributions then wages will fall to match. In practice there are likely to be difficulties. There is substantial economic evidence of stickiness in nominal wages. That is to say people will rarely accept a fall in the cash amount they are paid.

The Bank of England associates nominal wage growth of 4.5% per annum with stable inflation. If a compulsory employer contribution of, say, 10% were introduced in a single year, there would need to be a 5.5% fall in nominal wages to keep the relative price of labour constant.²⁰ This is unlikely to happen in practice, and the sudden introduction of a high level of pension compulsion would mean a drop in business profits and increased unemployment.

A further question is whether, with employer compulsion introduced gradually, employees would accept slower wage growth, and whether the process needs to be managed. Compulsion could simply be introduced, and a long-run equilibrium would eventually result, but if workers did not factor it into their nominal wage demands, there might be a long period of acrimonious pay disputes.

In Australia, this was averted because, under centralised bargaining, trade unions could deliver wage restraint as compulsion was introduced. In the UK, the main issue is whether the unions could deliver a similar result.

A different way to manage the transition would be to introduce compulsion only for those in lower age cohorts initially. For example, compulsion could be introduced initially only for those aged 40 or below. As that generation aged, compulsion would spread to all employees. This would limit the initial impact, but would mean lower wages for those below an arbitrary age, which might be unpopular, and would create a disincentive to employ younger workers.

- Would it be possible to introduce a special pay bargaining mechanism for the introduction of compulsion?
- Would the public accept slower wage growth over a number of years while employer compulsion was introduced?
- Would a union policy of wage restraint be effective enough to smooth the introduction of employer compulsion?
- Is there any other way to influence wage bargaining (e.g. publicity, advice to business, central government mandates to pay review bodies, an incomes policy) and would it work?

Q20 How would any trade-off between employer contributions and wage increases be managed? Should compulsion be introduced gradually, either through a gradual ratcheting up of rates, or through the application of compulsion only to those in lower age cohorts? Over what timescale should this be introduced?

²⁰ This fall in nominal wages would not affect real wages in the long-run: privately funded pensions would mean an increased share for labour in national accounting at the expense of government.

Another important transition issue is how existing pension/investment funds would be converted to compulsion vehicles or new ones set up.

Public support, or at least acceptance, would be essential to the political process of setting compulsion up, and to its ongoing success. Issues to consider are:

- the level of public support needed to establish compulsion
- what the message about compulsion should be and its strengths and weaknesses in the eyes of the public
- the demographics and interest groups likely to support and oppose compulsion
- whether any changes to the design of the system would make it more acceptable.

Specific issues are likely to include loss of liberty to control one's own money, being forced to save when money is needed now, and the perception of compulsion as a tax.

Q21 How could compulsion be sold to the public?

8. The effects of compulsion

The main purpose of setting out a model for increased compulsion is to understand the likely consequences of its introduction.

Impact on savings and debt

The overall change in saving depends on the extent to which people offset compulsory saving by reducing their other investments. The size of this offset will vary between different income groups depending on the extra amount they have to save and their elasticity of consumption (lower earners are likely to offset more). An estimate could be made based on survey evidence or by extrapolation from the Australian experience. The effect on aggregate savings will change as compulsion matures: retirees drawing down savings will offset the greater contributions depending on the relative size of the generations.

Q22 How will compulsion change overall levels of savings and debt? What effect will this have on the macroeconomy?

Impact on the economy

The effect of an increase in savings would be to raise investment at the expense of consumption. Adair Turner assumes that increased investment causes some fall in the marginal return on capital and sets out two scenarios: one, that the increased savings are mainly invested in the UK, and cause a fall in returns to domestic capital; or two, that capital is invested overseas, though Turner does not consider this possible on a sufficient scale.²¹ The scale of this fall in returns may be substantial: Miles (1999) finds that the return on assets could fall from 4.6% in 2000 to 4.2% in 2030, due to demographic change, and to 4.0% if there is a major effort to shift people to funded pensions.²²

It will be necessary to establish (a) that there is likely to be an increase in saving, and (b) that increased saving will not cause a fall in expected returns such that the system cannot meet its objectives. One option may be to require a substantial investment allocation to overseas assets.

Q23 How will compulsion affect the economy overall?

Impact on intergenerational equity

Increased funding of pensions causes a one-off hit to the consumption of the first generation to pay for it: they must not only save for their own pension, but pay benefits (the BSP) to the elderly which they will not receive themselves. In effect, they pay twice, and this is unavoidable in a move to compulsion. It is also a feature of current arrangements, however, where the expected value of future state benefits is declining for those in work.

²¹ Turner, A., *The Macro-economics of Pensions*, Lecture to the Actuarial Profession, September 2nd 2003.

²² Miles, D. (1999) 'Modelling the impact of demographic change upon the economy,' *Economic Journal*, No. 109, pp. 1-36.

The working group will need to consider: first, the scale of the inequity between generations; second, whether this is justified by the benefits of the system; and third, whether the state can do anything to alleviate this burden. There are strategies that could spread it over a greater number of generations by, for example, paying for current benefits using long-term debt.

Q24 What effect will the system have on intergenerational equity?

Impact on the industry and existing investment vehicles

Unless a compulsion scheme demands a certain kind of provision it is unlikely to have much effect on DB pensions. DB schemes are closing because companies are unwilling or unable to bear the risk of wage growth, rising life expectancy, and volatile investment returns. There are ways to address this – e.g. changing from final salary to average salary schemes – but these are not connected with compulsion.

Compulsion will increase investment into vehicles that can receive it and decrease investment into vehicles that cannot. There is a risk that funds excluded from a scheme may stagnate or close. This would impose costs on their owners, and on investors, if firms responded by raising charges. The extent of this cost will depend on regulation and needs to be balanced against minimising investment charges.

Any closure of funds could have a knock-on effect on the overall financial service industry and any changes should still ensure ongoing competition and diversity across the range of financial products.

Q25 How would compulsion affect existing pension and savings vehicles? What would be the impact on the industry?

Criteria for success

One final important consideration is the criteria for success and the modelling needed to assess different compulsion options. A certain level of pension adequacy is a necessary but insufficient criterion for success: the working group may also want to define success in terms of effects on the wider economy, cost to the public sector, and effects on poverty in the working age population. Possible modelling requirements therefore include:

- aggregate cost to the public sector
- effect on aggregate savings rate
- effect on pension adequacy for representative individuals.

Q26 What criteria must a compulsion system meet for success? What modelling is needed of compulsion policy options?

Appendix A: Demographics of the Pensions Shortfall

Several studies provide descriptive statistics on which people are not saving enough for retirement. The Pensions Commission breaks down the number currently under-saving in its model by age and income; the ABI's survey data adds further statistics on gender and working patterns. *The Under-pensioned*, a report from the Pensions Policy Institute, models a representative individual to discover the circumstances in which they will have an inadequate pension. The assumptions behind the base case for this model are:

- *Replacement rates*: Not applicable – the level of retirement income is the target variable in this model.
- *Average retirement age*: 65
- *Investment returns*: Real return of 3% after 2.5% inflation and 1% costs.
- *Period of saving*: Start saving at 21 and save continuously for 44 years. All savers accrue full BSP rights.
- *DC/DB*: The base case individual has a DC pension with contributions of 8% per annum.
- *Other*: The individual has median earnings at each age.

These figures are not directly linked to the number under-saving but suggest their likely causes.

Age

The Pensions Commission's basic case finds under-saving gets more severe as people near retirement: 57% of 36-45 year-olds, 61% of 46-55 year-olds and 67% of 56-65 year-olds are not saving enough.

Table 4.13 Numbers of Under-Savers and Non-savers: Assuming Savings Start at 35:
as a percentage of those in work

Age band	26 - 35	36 - 45	46 - 55	56 - 59/64	All over 35
Income band					
< £9,500	n/a	16%	66%	77%	49%
£9,500-£17,499	n/a	73%	67%	69%	70%
£17,500-£24,999	n/a	63%	64%	64%	64%
£25,000-£39,999	n/a	57%	51%	56%	54%
£40,000+	n/a	62%	53%	59%	58%
Total	n/a	57%	61%	67%	60%

Source: Pensions Commission analysis based on FRS 2002-03, GAD, NES and Inland Revenue data

Note: Percentage of working age population over 35 years old in work.

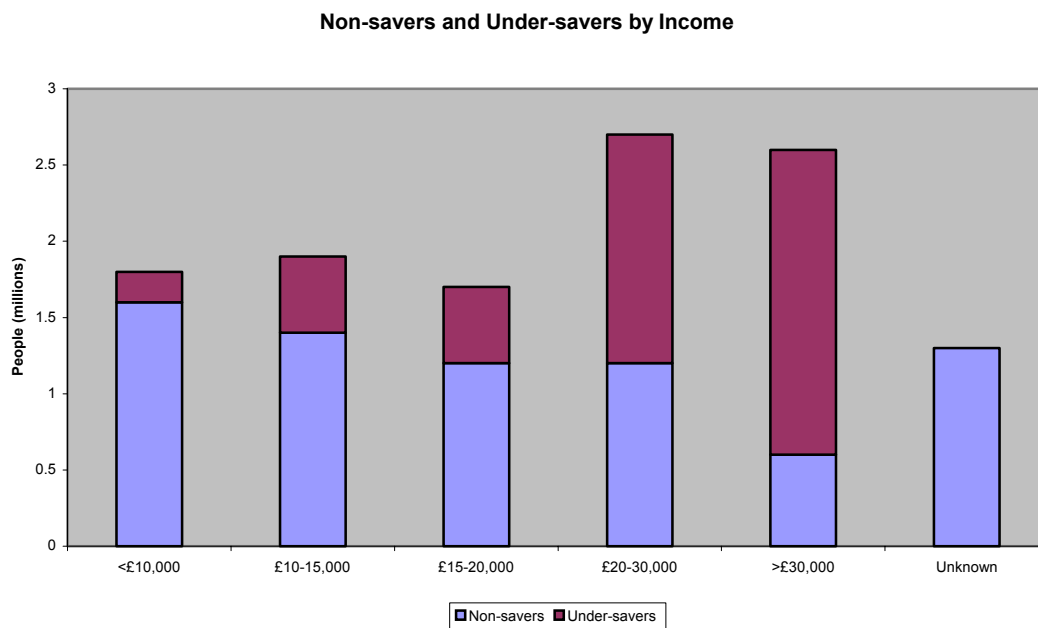
This may be a statistical artefact of the modelling, as the ABI survey finds that non-savers tend to be young, and under-savers are concentrated in middle age.

	Non-savers	Under-savers
18-29	3.2m	1.1m
30-49	3.0m	2.7m
50+	1.2m	0.9m

However, insufficient saving for retirement is prevalent in all age groups, and is best thought of as a problem throughout life.

Income

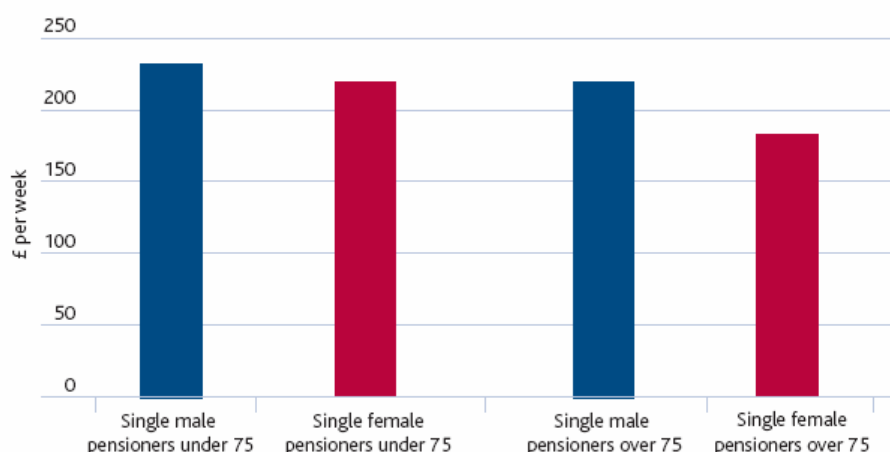
The Pension Commission modelling shows under-saving to be particularly common at middle incomes: £9,500-£17,499 (70% under-saving) and £17,500-£24,999 (64%). However, insufficient saving is common at all income levels, with 58% of those on £40,000+ a year failing to save enough to meet their 50% replacement level. That under-saving is less of a problem for incomes below £9,500 p.a. is a quirk of the modelling: full BSP rights are assumed for everyone and this goes most of the way to the necessary replacement level.



The ABI survey data also shows insufficient saving at all income levels with non-saving at low income levels and under-saving at high. The Oliver Wyman modelling gives some idea of the extent of under-saving. This is worst at the income levels of £17,500-25,000 (£5.7bn) and £25,000-35,000 (£8.4bn).

Gender

Figure 8.1 Average Gross Income of Single Pensioners, by Sex and Age: 2002/03



Source: The Pensioners' Incomes Series 2002/03

It is a long recognised fact that female pensioners, especially older female pensioners, tend to have lower incomes than male. *One in Four*, a report for the Fawcett Society and Age Concern, finds that one in four retired women live in poverty, and that female retirees are twice as likely as male to rely on means tested benefits.²³ This is supported by the ABI survey data on saving, with 32% of women non-savers, versus 21% of men, and 14% of women under-saving, versus 20% of men.

There are several reasons why women are more likely to end up with an inadequate pension. Women are less likely to work and more likely to work part-time. Full-time female wages are below average as are part-time wages. Women are more likely to be economically inactive due to caring responsibilities. According to modelling by the PPI this can lower a representative woman's replacement rate to 32% compared to 42% for a representative man.²⁴

Minority ethnic groups

Minority ethnic groups tend to have lower income in retirement, although there are significant differences between different ethnic groups. This is because people from ethnic groups are more likely to be unemployed, more likely to work part-time or be self-employed, and have lower average wages. The PPI modelling shows that a representative individual's replacement rate falls from 42% to 26% due to spells of unemployment, self-employment, and a later start to pension saving. Direct evidence on under-saving by minorities is scarce.

Disability

Disabled people are less likely to be in work, are more likely to have their working life interrupted, and have lower average incomes. The effect is to reduce the

²³ Mordaunt, S., Rake, K., Wanless, H. & Mitchell, R., *One in Four*, 2003, Age Concern: London. http://www.fawcettsociety.org.uk/documents/1infour_000.pdf (31st March 2005).

²⁴ Curry, C., *The under-pensioned*, November 2003, Pensions Policy Institute: London. http://www.pensionspolicyinstitute.org.uk/uploadeddocuments/The_Under-pensioned_27Nov03.pdf (31st March 2005).

replacement rate from 42% to 30% for the PPI's representative individual. Again, there is no direct evidence on how much disabled people contribute to under-saving, and the statistical methods used may mean many are not included in the Pensions Commission's estimates.

Work patterns

Non-standard work patterns are a direct cause of under-saving as well as being typical of women, the disabled, and minority groups. Mothers take more time off than fathers to have children; disability may prevent regular or full-time work; minority groups are more likely to suffer spells of unemployment or be self-employed.

A 10-year change of employment status reduces pension income

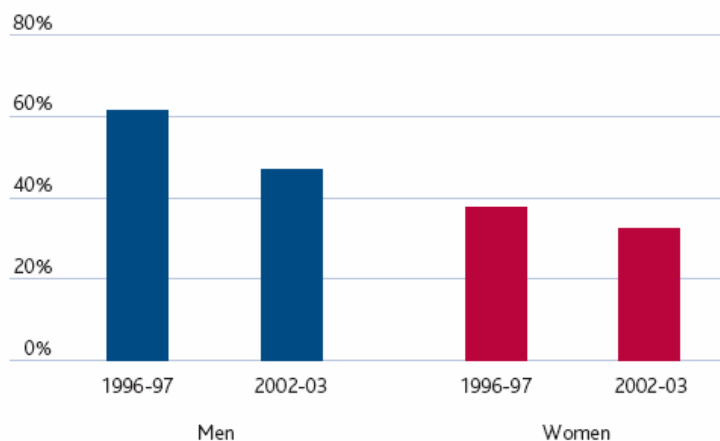
Pension income at age 65 as a proportion of National Average Earnings (NAE), 2003



Source: *The Under-pensioned*, Pensions Policy Institute

Self-employment is important enough as a way of working to form a special case in itself. The self-employed have no organised employer pension to prompt them to save. Their income may be precarious and volatile and they may need what capital they have for their business. Many will rightly or wrongly regard their business as their saving for retirement. As a result, they tend to accrue lower pensions, and the ABI survey identifies 1.4m self-employed non-savers and 0.8m under-savers, giving a total of 2.2m. The percentage of the self-employed enrolled in a pension scheme has been in rapid decline.

Figure 3.38 Percentage of the Self-employed Contributing to Any Private Pension, by sex



Source: FRS, 1996-97 and 2002-03

Source: *First Report of the Pensions Commission*

Summary

The demographics of under-saving are complex and the many factors associated with it interact. The limited data available are not enough to fully untangle them (How many under-savers are women from minorities in part-time jobs?) but in designing a compulsory scheme we need to consider the needs of the following main groups:

- Women (approx 50% of under-savers). The degree of under-saving among working women is worse than among working men, and they are more likely than men to have no pension at all. Several exacerbating factors – lower income, interrupted or part-time work – are more common amongst women. Longer female life expectancy means given pension savings produce lower retirement incomes.
- The self-employed (app. 18-20% of under-savers). The self-employed are nearly twice as likely as employees to have no pension saving at all.
- Non-standard workers. Non- or part-time workers in the past, present, and future are a large percentage of those under-saving. Their number is near impossible to estimate: only those with a current non-standard working pattern can be identified. Those who did not work in the past, and are making insufficient contributions now to compensate cannot be counted, neither can those working abroad, nor those who may retire, for whatever reason, before they reach 65.

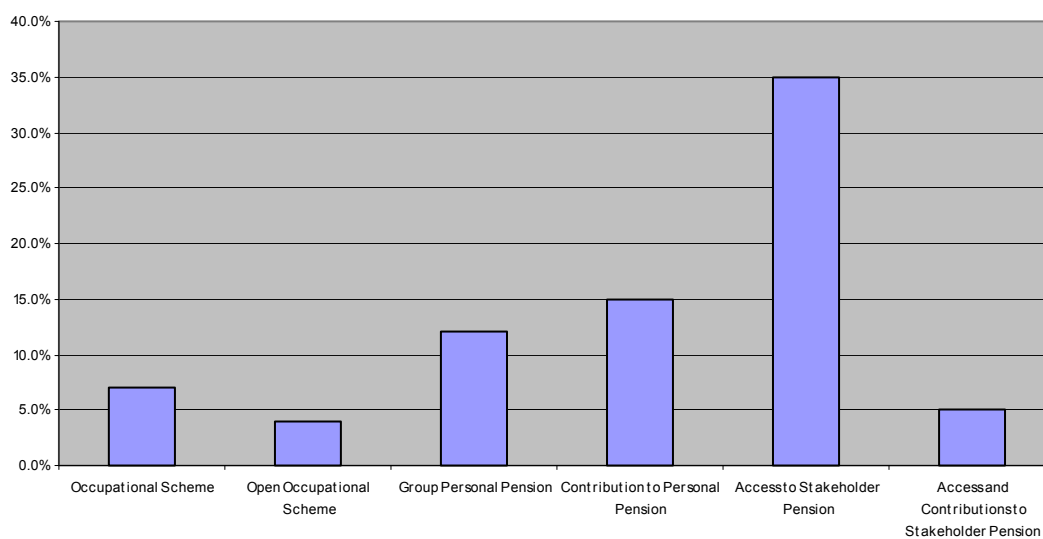
Appendix B: The current pension system in detail

This section describes the British pension system as it stands today, and as it will change to 2050 assuming that current policies remain in place. The main sources are the Pensions Commission, the Government Actuary's Department survey of occupational pensions (hereafter GAD 2003), the Employer's Pension Provision survey (hereafter EPP 2003), the General Household Survey (hereafter GHS 2002), and a report from the Pensions Policy Institute, *The Pensions Landscape*.²⁵ Once again, data problems are acute, especially for personal pensions.

This section discusses each major type of private pension in turn, describes the state pension and benefits system, and then summarises the main forms of provision and their likely trend.

Out of an overall working age population of 34.3m, of whom 25.6m are in work, the Pension Commission finds 14.3m who make some contribution to a private pension and 11.3m who do not. Of those who are making some contribution, the majority are doing so through an employer pension, the broad distribution of which is described below.

Type of Pension Provided by Private Employers, 2003



Source: EPP 2003

²⁵ Pensions Commission – see footnote 1; GAD 2004 – see footnote 10.

Cebulla, A. & Reyes-DeBeaman, S., *Employers' Pension Provision Survey 2003*, Research Report No. 207, March 2004, Department for Work and Pensions: London.

<http://www.dwp.gov.uk/asd/asd5/rports2003-2004/rrep207.asp> (31st March 2004).

Rickards, L. et al, *Living in Britain – General Household Survey 2002*, March 2004, TSO: London.

<http://www.dwp.gov.uk/asd/asd5/rports2003-2004/rrep207.asp> (31st March 2004).

Curry, C. & O'Connell, A., *The Pensions Landscape*, February 2003, Pensions Policy Institute: London. http://www.pensionspolicyinstitute.org.uk/uploadeddocuments/PPI-14_Feb_03-The_Pensions_Landscape.pdf (31st March 2004).

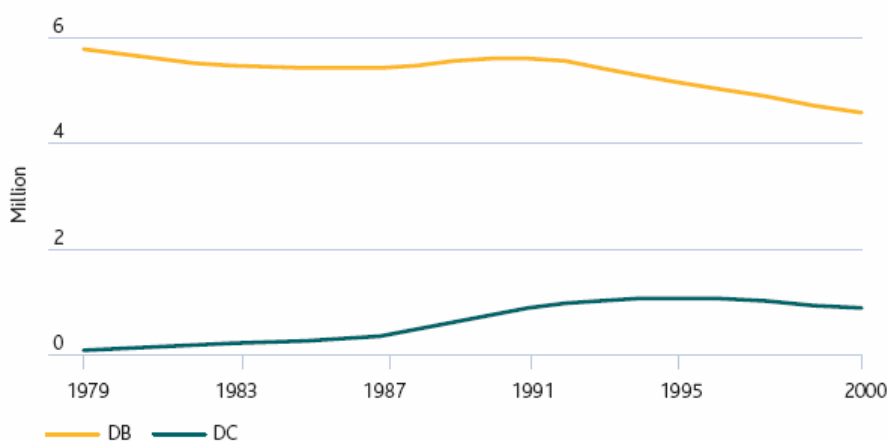
Defined Benefit Pensions

A Defined Benefit (DB) pension is one in which the pension provided is defined by a formula independent of the contributions made. This formula is usually based on salary near retirement, years served, and a fixed accrual rate. Such plans have been the foundation of post-war pension provision in Britain.

The Government Actuaries Department survey of 2000 found 9.1m people with DB pensions, of which 0.5m were in schemes closed to new members, down from around 10m in 1995. Since then, as the Pensions Commission have pointed out, the number of open DB schemes has declined rapidly. Surveys by the National Association of Pension Funds found that 10% of private sector pension schemes closed in 2001, 19% in 2002, and 26% in 2003. This implies that more than 50% of schemes closed in the last three years, though some double counting is likely, and the schemes that closed are likely to be smaller, so the numbers enrolled will not have fallen so much.

A Pensions Commission study of FTSE350 companies found that 60% of active DB members are in closed schemes. The Employer's Pension Provision Survey 2003 suggested a 33% fall in the percentage of employees, in companies above 20 workers in size, currently in open DB schemes. The New Earnings Survey 2003 found that 26% of private sector workers are currently in salary related arrangements but that falls to 14% of new employees. The Pension Commission's modelling estimate is an ultimate fall of 60% in membership from 2000 leaving 1.6-1.8m active private sector members. This seems as good a prediction as any.

Figure 3.25 Active Members of Private Sector Occupational Pension Schemes, millions

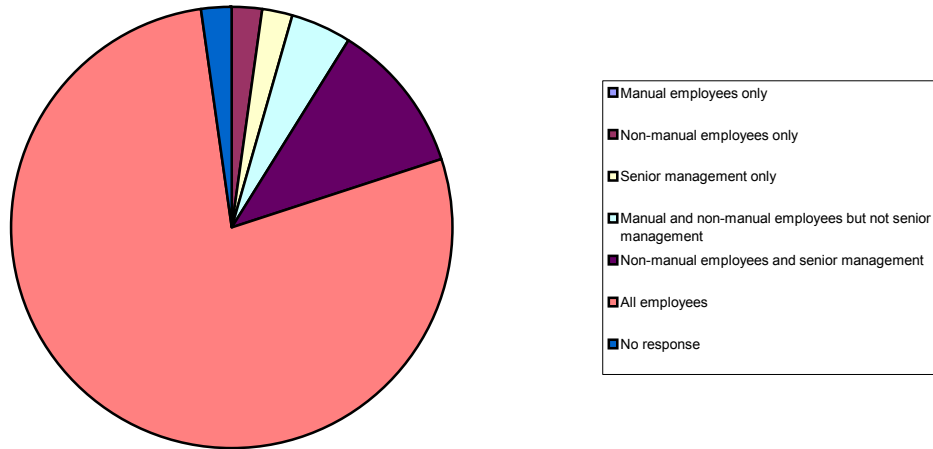


Source: Occupational pension schemes 2000, GAD

Source: *First Report of the Pensions Commission*

Data on the demographics of DB schemes are poor. The 2000 GAD survey found more women (5.1-6m) than men (4.1-5m) in DB schemes, reflecting the slant in DB schemes toward the public sector, and the slant in the public sector toward female employees. The General Household Survey (which does not distinguish between DB and DC pensions) backs this up to some extent, finding that 60% of women working full-time had an occupational pension of some sort in 2002, compared to 55% of men.

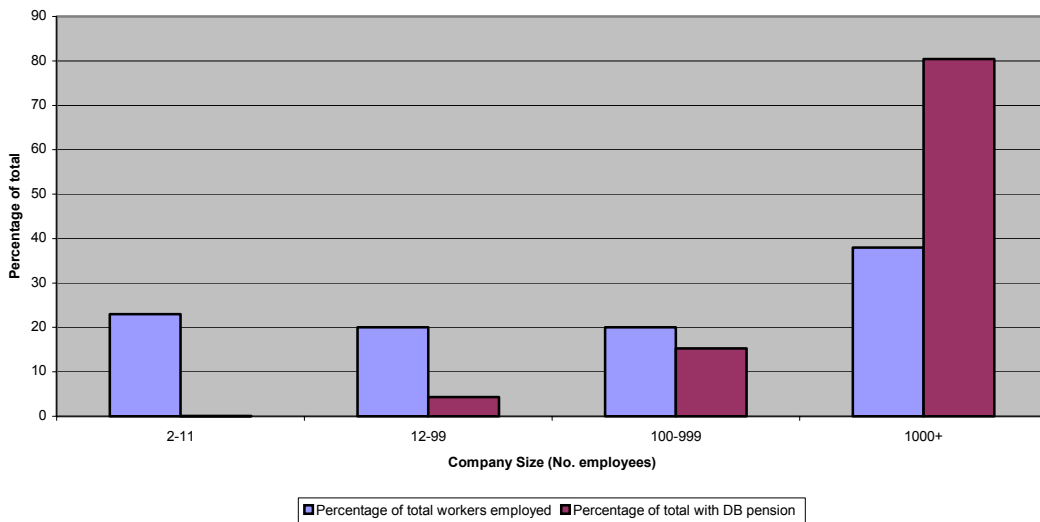
Coverage of private sector DB plans, 2000



Source: GAD, 2003

The GAD survey suggests the majority of DB plans, in both public and private sector, are open to all types of worker. The GHS, however, finds that male managerial and professional workers are 1.6 times more likely to be enrolled in an occupational scheme than routine and manual workers. This probably indicates that firms employing a high percentage of professionals are more likely to have DB plans.

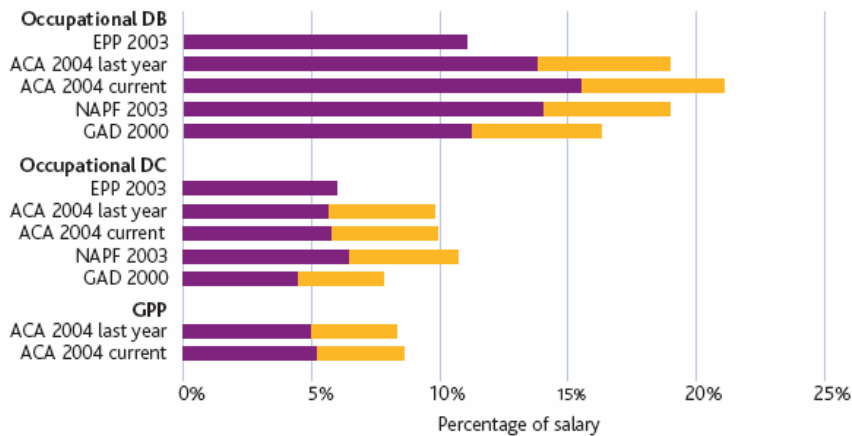
DB Pensions versus company size



Sources: GAD 2000 & Employers' Pension Provision Survey 2003

DB pensions are a feature of larger companies, with 52% of those covered in companies with more than 10,000 employees, and more than 80% in companies of over 1000. Such companies represent less than 40% of total private sector organisations. Data on DB membership by age, income, and ethnic group does not appear to be available.

Figure 3.34 Contribution rates to Employer-sponsored Pension Schemes



Source: *First Report of the Pensions Commission*

Contribution rates to DB schemes are high. The GAD 2000 found an average of 5% employee and 11.2% employer contributions for a total of 16.2%. Public sector schemes were the most generous. Employers who have not closed their scheme seem to have increased contributions since 2000 to keep them viable. The 2003 NAPF survey found average employer contributions of 16% in the private sector with 53% of employers having raised their contribution level.

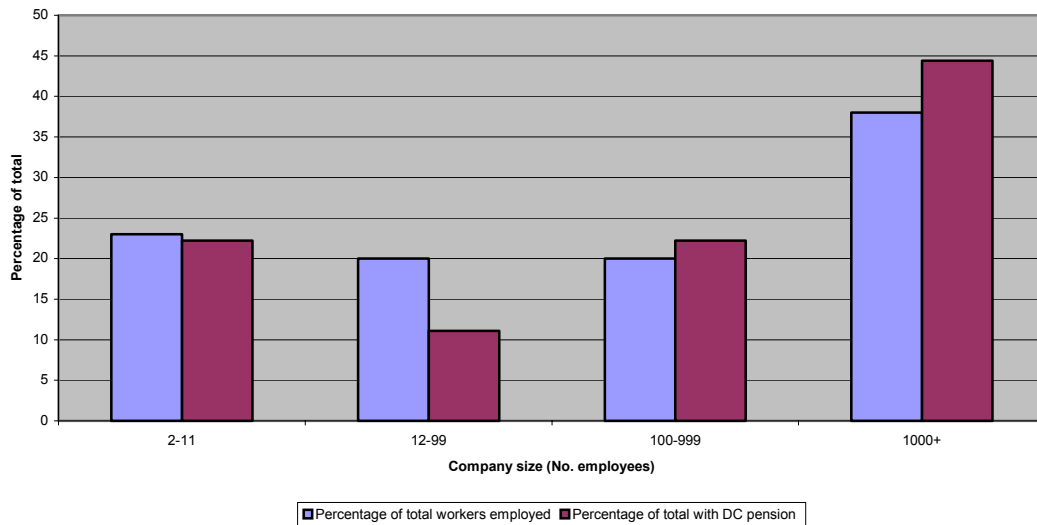
Defined Contribution Pensions

Also known as money purchase, a defined contribution pension is one in which the employer contributes a fixed sum or percentage of salary, and the savings accumulated are used to deliver a pension. Employer DC plans often replace DB plans that are withdrawn.

The 2000 GAD survey found 61,400 employer DC schemes covering 0.9m workers. This figure has risen from almost nothing in 1979 but is down on its peak in the early 1990s. DB schemes closing since 2000 may have been matched by more DC schemes opening but figures to show this do not appear to be available.

Again, breakdowns of those enrolled in DC schemes are scarce. There appear to be more men than women in employer DC schemes: the GAD has 0.5-0.6m men and 0.3-0.4m women in such schemes. This is not necessarily inconsistent with the GHS data on total occupational pension provision but cannot be adequately explained with the available data.

DC pensions versus company size



Source: EPP 2003

Coverage by DC pensions is much closer to the actual distribution of workers by company size although, as with all kinds of pension, they are more common at larger organisations.

Contribution rates to DC schemes are around half of those to DB. The GAD 2000 found contribution rates, excluding schemes with no employer contributions, of 3.3% from employees and 4.5% from employers. Other schemes have found slight differences - the NAPF 2003 finds total contributions in excess of 10%, and the TUC total contributions of 10-11%²⁶ - but the GAD figures seem a reasonable baseline.

Personal Pensions

Personal pensions, established under the Social Security Act 1986, are defined contribution schemes made directly between an individual and a pension company. There is normally no employer involvement or contribution. Personal pensions take various forms:

- Personal pensions – An entirely private pension in which the saver buys units in funds sold by the pension provider. The high charges associated with this type of pension led to the mis-selling scandal of the 1990s.
- Group Personal Pensions (GPP) – A scheme in which an employer contracts with a provider to offer personal pensions to its employees. This differs from an occupational pension in that the money is invested in third party funds rather than a single fund arranged by the employer so costs to the employee are higher. The employer may or may not make contributions.

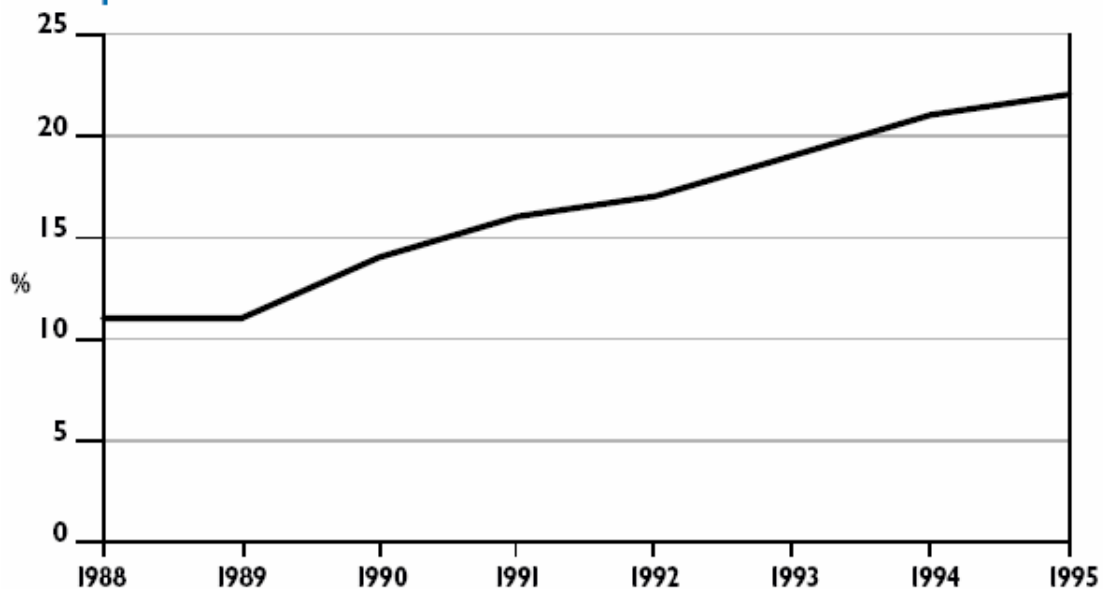
²⁶ 29th Annual Survey of Pension Funds, 2003, NAPF: London.

PensionsWatch 2004, September 2004, TUC: London. <http://www.tuc.org.uk/pensions/tuc-8591-f0.pdf> (31st March 2005).

- Stakeholder pensions – A personal pension or employer scheme but with a 1% cap on charges, no charges for transfers out, and a low minimum contribution.
- Self-invested personal pensions – A personal pension in which the saver makes their own investment decisions within a range of options.

The 2002 GHS found that 19% of men working full-time, 12% of women working full-time, and 9% of women working part-time had some form of personal pension. This is roughly in agreement with a MORI survey that found 11% of adults in employment in December 2003 had a personal pension.²⁷ Personal pensions have been diminishing in importance, with the percentage of workers holding one falling from 18% in 1997 to 11% in 2003, after a period of growth which saw the percentage of total pension assets held in them rising above 20% in the mid-1990s.

Figure 2.3: Personal pensions assets as a proportion of all pensions assets

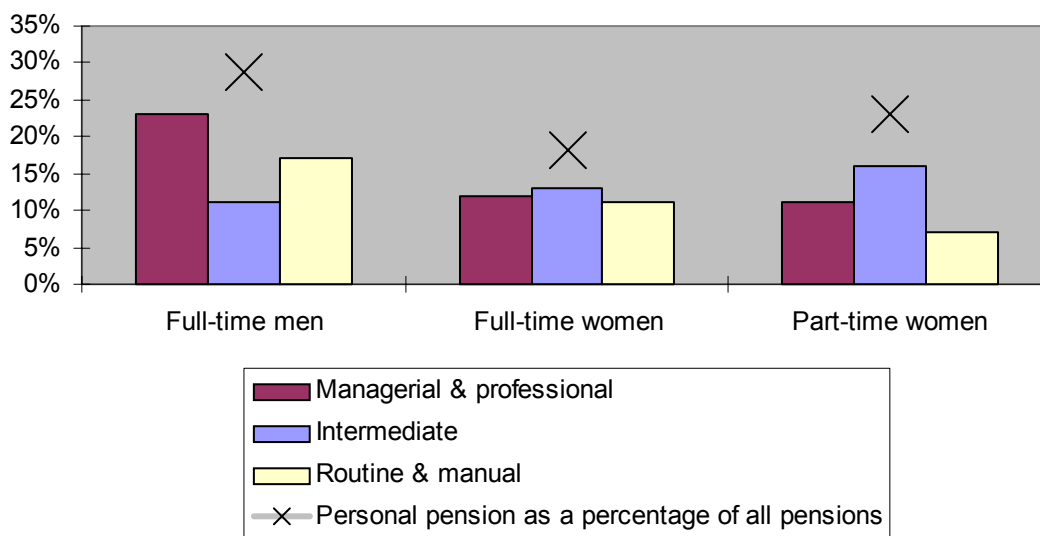


Source: ONS & GAD estimates based on HM Treasury returns.

Source: Sandler review

²⁷ Barker, N. & Healey, M., *Saving Retirement*, 2004, MORI Financial Services: London. <http://www.mori.com/pubinfo/nxb/saving-retirement.pdf> (31st March 2005).

Percentage of employees with a personal pension, 2002

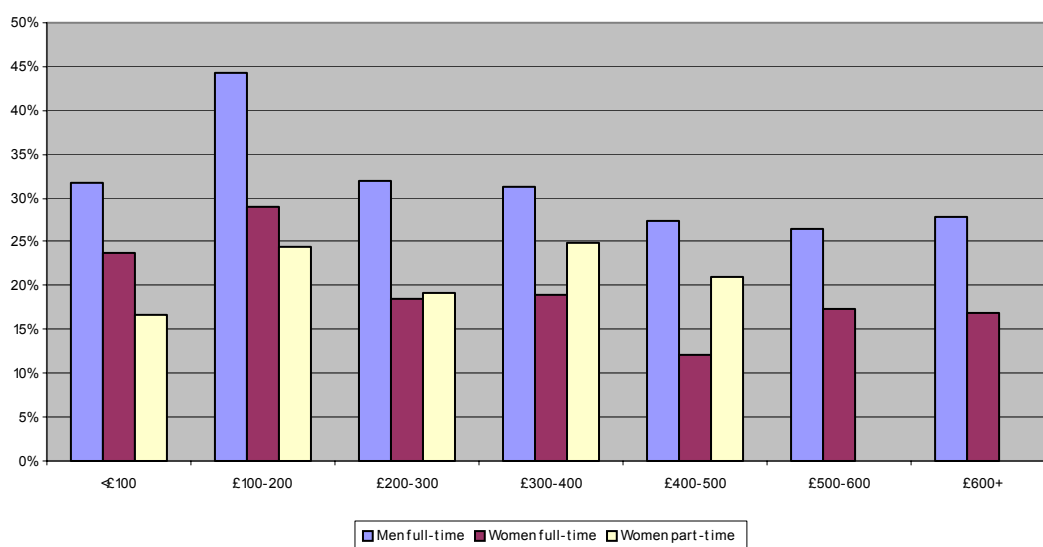


Source: GHS 2002

As with all pensions, the personal type is most common amongst full-time managerial and professional men, but it is also of high relative importance, held by 30% of full-time males with at least one pension. Personal pensions also make up a relatively high proportion of those held by part-time female workers.

There is no clear pattern by occupation. The relatively high proportion held by managerial and professional men may indicate that these are executive schemes for senior businessmen, who do not stay long in a single job, or pensions for wealthy professionals in private practice.

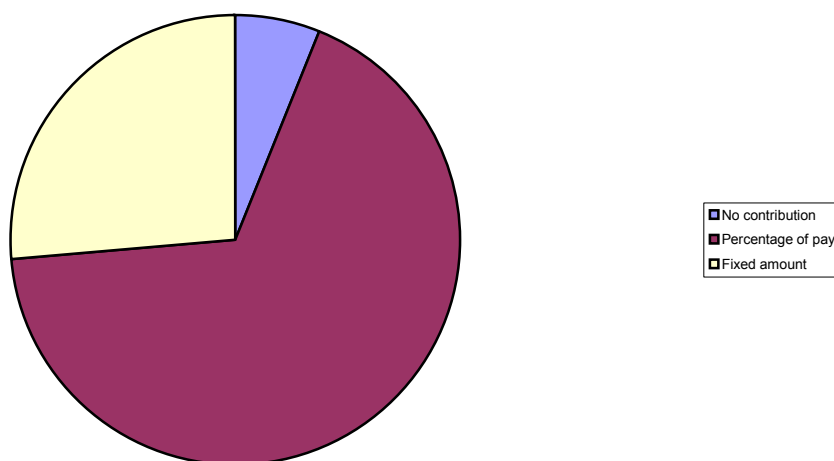
Personal pensions by income, as a percentage of total with a pension



Source: GHS 2002, insufficient responses for women working part-time and earning more than £500 p.w.

In absolute terms, personal pensions are more common at the higher end of the income scale, but relative to other forms of provision, they are slightly more prevalent among the low-paid.

Employer contributions to group personal pensions, by type, average 2001-03



Source: EPP 2003

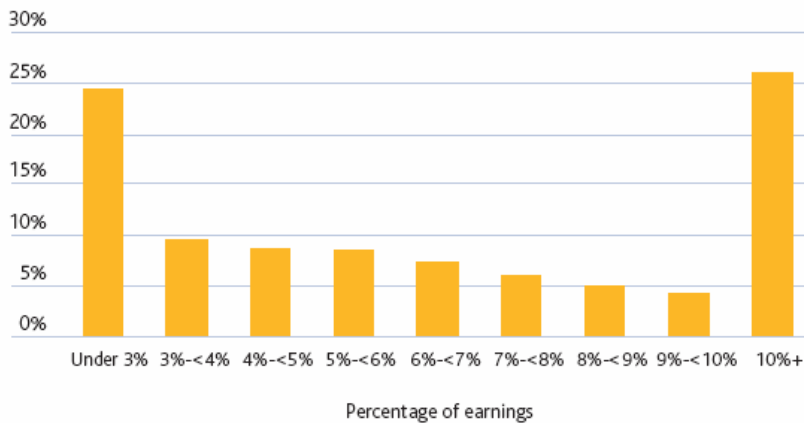
Data on contributions to group personal pensions is available from employer surveys but data on other forms of personal pension is sparse. The large majority of employers running a GPP contribute a percentage of pay (median 5%) and most of the rest pay a fixed amount (median £35 per week).

The EPP also reports that 15% of employers make contributions to the private pensions of their employees. Employers rarely do this for all their employees: 61% of those who make such payments cover less than 25% of their workforce and 34% cover less than half. Employer contributions are split 60:40 between a percentage of pay (median 8%) and a fixed amount (median £23). The absolute number with an approved private pension peaked at 5.75m in 1999/00, since when it has been in a slow decline, in part due to the influence of stakeholder pensions.²⁸

35% of organisations provide access to stakeholder pensions, rising to more than 80% amongst those with 13-49 members of staff. Actual membership of such pensions, however, is far lower, with 42% of organisations that provide stakeholder pensions having no active members, and another 52% having less than quarter of their workforce enrolled. About 61% of organisations that have active stakeholder members make a contribution to their plan. Approximately two-thirds of them contributed a percentage of salary, with the median and modal contribution between 3% and 5%.

²⁸ *Second Tier Pension Provision 1978/79 – 2002/03*, Department for Work and Pensions.

Figure 4.15 Distribution of Employer and Individual Contribution rates to Personal and Stakeholder Pensions



Source: Inland Revenue estimates based on Third Party Information 2001-02 and Survey of Personal Incomes 2000-01.

Note: Percentage of workers (employed/self-employed) with earnings during the year and contributions to personal, Group Personal or Stakeholder Pensions. The Inland Revenue have matched a sample of the Third Party Information (TPI) cases to the Survey of Personal Incomes (SPI) by NI number in order to obtain corresponding earnings. The SPI and TPI data that are matched refer to different years due to different timings of availability. Where both the employer and the individual contribute to an arrangement, their separate contributions are summed. If an individual has two arrangements the contributions from both are summed. This excludes any contracted-out NI rebates.

Source: *First Report of the Pensions Commission*

The Pensions Commission provides some Inland Revenue data on aggregate employer and employee contributions to personal and stakeholder pensions. These confirm the pattern of a median about 5%, with one large group making very high contributions, and another large group making very little.

There is limited information available on the SIPP market, although one recent publication suggests there are now 100,000 plans in force, and the number may be growing by 30% per annum.²⁹

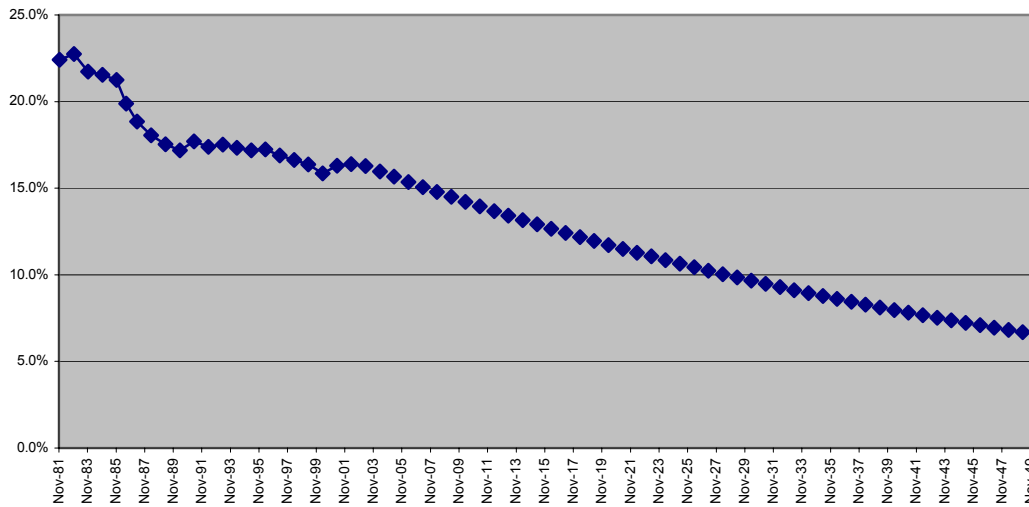
We know of no useful data on employee contributions to personal pensions.

The Basic State Pension

Britain's Basic State Pension (BSP) is a compulsory flat-rate contributory pension run through the tax system. Making National Insurance contributions on earnings above a lower limit (currently £79 per week) builds up "qualifying years"; the number of qualifying years at the state pension age (currently 65 for men, and moving from 60 to 65 for women) determines the level of pension (currently £79.60 per week for a single person with a full contribution record).

²⁹ *Pension changes bring risks*, BBC News Online, 22nd June 2004. <http://news.bbc.co.uk/1/hi/business/3829511.stm> (20/01/05)

Basic State Pension as a Percentage of Average Earnings



Source: DWP and Average Earnings Index. Based on the mean earnings of those in full-time work (the percentage of median earnings is somewhat higher). Projections to 2050 assume earnings growth of 4.5%p.a., inflation of 2.5%p.a., and no change to policy.

The Social Security Act 1980 changed the indexation of the BSP from earnings to the consumer price index. As a result, the value of the BSP has steadily declined as a percentage of average earnings, and is projected to continue to do so into the future.

79% of current pensioners receive the contributory BSP, on which the average payout is £68.34 p.w., suggesting that most pensioners have a good contributions record. A substantial minority of 20%, however, are not receiving the main version, and derive an average income from the BSP of £42-46 p.w.

SERPS and S2P

The State Earnings Related Pension Scheme was introduced in 1978. It is a compulsory contributory pension run through the tax system, but the amount paid out depends on the amount of NI contributions paid, and therefore on earnings.

SERPS became the State Second Pension (S2P) in 2002. This made the system more generous toward those on lower incomes and extended cover to those with caring responsibilities. The current plan is for the S2P to become a flat-rate pension after 2007. The S2P is too new to be paying out a meaningful amount to current pensioners.

As a rough guide, the combined Additional State Pension might pay out 15% of earnings as a pension to someone who averaged £25,000 p.a. while in employment, and had a full contributions record. The distribution of SERPS and S2P is similar to that for the Basic State Pension. A large majority are accumulating some entitlement, but those not contributing enough to receive the BSP will not receive the additional pension either.

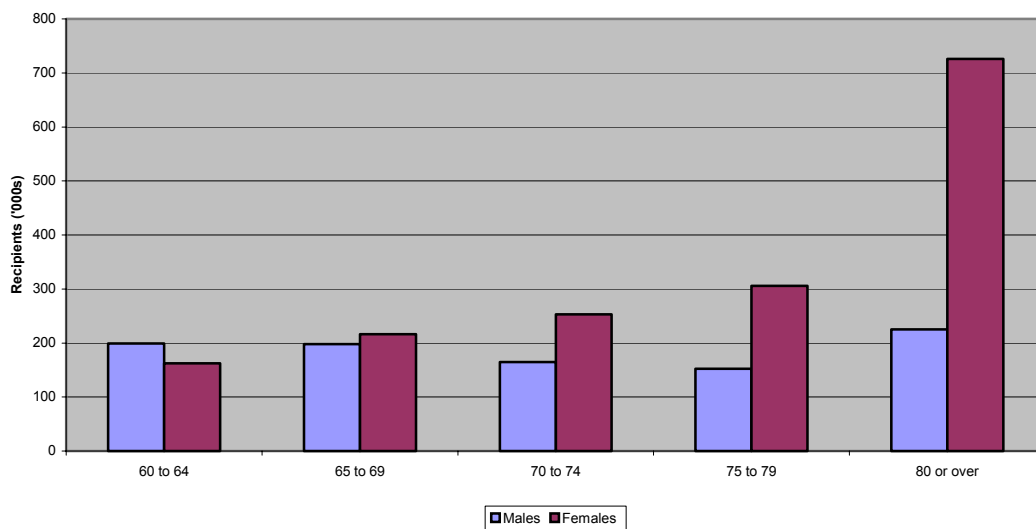
It is possible to ‘contract-out’ of SERPS and the S2P. This essentially means paying less National Insurance contributions in exchange for giving up a S2P entitlement.

These contributions are rebated instead, either into an occupational pension or an approved personal pension. The actual operation of contracting out is complex with different rules applying to different types of pension scheme. The overriding principle is that the contracted-out pension should provide benefits at least equal to the state benefits foregone.

Other State Retirement Benefits

To achieve its goal of alleviating pensioner poverty, the present government has continued to index the BSP to prices, but introduced a Pension Credit indexed to earnings (known as the Minimum Income Guarantee until October 2003). It is means-tested with respect to savings and income and comes in two parts. The first guarantees a single person over 60 a minimum income of £105.45 p.w. in 2004, about £25 more than the BSP, and is known as the Guarantee Credit. The second part, known as the Savings Credit, awards some extra money to those with small savings, so they do not lose £1 of income for each £1 they have saved.

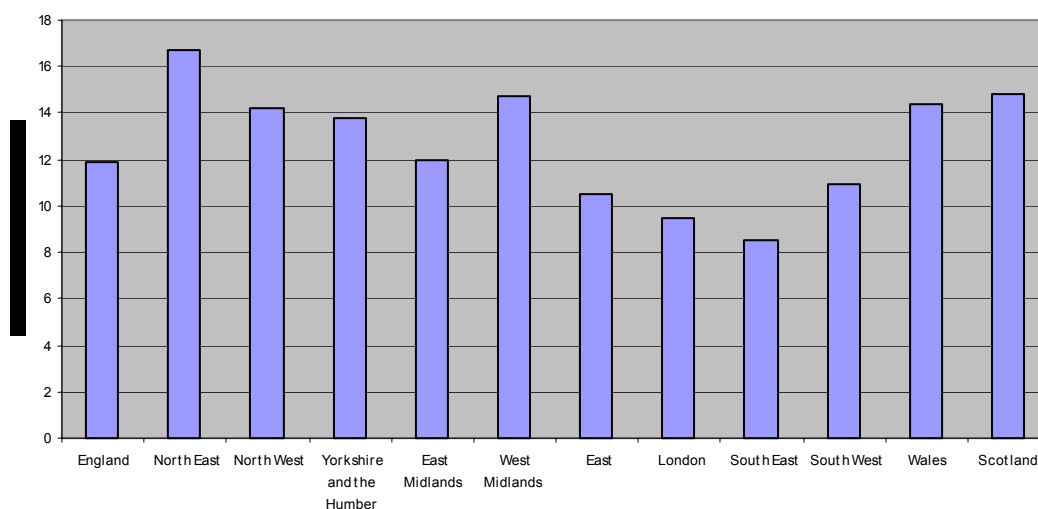
Pension Credit recipients by age, August 2004



Source: Pension Credit Quarterly Statistical Enquiry, August 2004, DWP.

Pension Credit (PC) is a new benefit so statistics on those receiving it are not stable as yet. On the most recent figures (August 2004) there are 2.6m households in receipt of Pension Credit, about 23% of those receiving the BSP, of which half get both Guarantee and Savings Credits, 29% have no savings and so get the Guarantee Credit alone, and 21% have savings producing at least £25 p.w., thus getting Savings Credit alone. Demographically, the majority of recipients are female, especially female pensioners over the age of 80. By region, the Pension Credit tracks the pattern of age and deprivation, with higher payouts in industrial regions and lower in London and the South East.

Pension Credit recipients by region



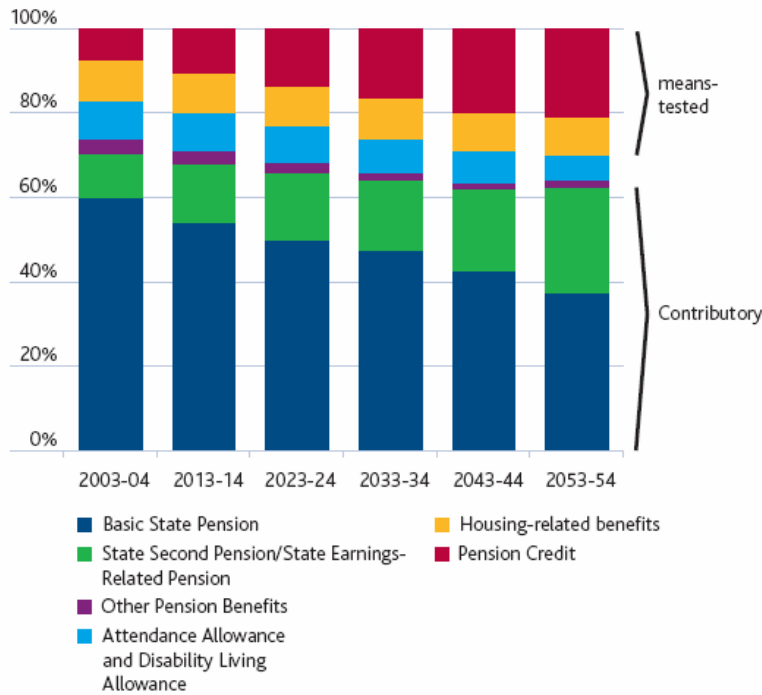
Source: *Pension Credit Quarterly Statistical Enquiry, August 2004, DWP*

The Pension Credit makes a further contribution to the mortgage costs of homeowners; for those renting, eligibility for Guarantee Credit will mean eligibility for full Housing Benefit, which will cover the full cost of renting a suitable property. Being in receipt of Guarantee Credit should also mean eligibility for full Council Tax Benefit.

A major weakness in the system is that there is a single cut-off point – income per week below £105.45 and assets of less than £16,000 (for Housing Benefit) – at which a large range of benefits become available. The value of these benefits is greater than those achieved by compulsory saving (BSP & S2P) for those on low to medium incomes creating a disincentive to any voluntary saving. A further problem with Pension Credit is take-up, with Age Concern arguing in August 2004 that one-third of those eligible were not claiming it.

Because the Pension Credit is linked to earnings while the BSP is linked to inflation, both the number of pensioners receiving PC and its value as a percentage of government support for the elderly will rise over time if current policies remain in place. The Pension Commission chart below shows how Pension Credit will increase as a percentage of total spending at the expense of the BSP.

Figure 3.21 Breakdown of Forecast of State Spending per Pensioner if Current Indexation Plans Continued Indefinitely



Source: Pensions Commission analysis of data from DWP and GAD

Source: *First Report of the Pensions Commission*

Summary

The table below gives a rough indication of the numbers covered by different kinds of pension scheme. Reasons the numbers do not sum to the Pensions Commission total of 14.3m people include: ongoing falls in the number of DB pensions, people holding several kinds of pension, and double counting of personal pensions.

Type of Scheme	Numbers Enrolled	Average Level of Contributions	Annual Charges
Defined Benefit	9.1m (falling to 6.2m medium-term)	16-18%	0.5% (public) 0.75% (corporate) ³⁰
Occupational Defined Contribution	1-2m	8-9%	1%
Group Personal Pension	1m (?)	7-8%	1%-1.25%
Approved Private Pension	5-6m	3-6%	1%-2%
Stakeholder Pension	1m	3-6%	1%

³⁰ Estimates for a median-sized pension fund using US data. Collins, S. "The Expenses of Defined Benefit Pension Funds and Mutual Funds," *Perspective*, No. 9(6), Investment Company Institute, December 2003.

Self-Invested Personal Pension	100,000	N/a	0.5%-2%
-----------------------------------	---------	-----	---------

Wealthier people and more professional workers are more likely to be enrolled in a private pension. The balance between men and women is equal because a large number of women have high quality public sector DB pensions.

The trend is for movement down the ladder, from high contribution DB plans to lower contribution occupational and personal DC pensions. Typically, these products not only receive lower contributions, but have higher annual charges.

In the state system, the trend is for a move from the contributory state pension, toward means-tested benefits for pensioners with the lowest incomes.

Appendix C: International Experience of Compulsion

(1) Australia

Compulsory superannuation in Australia began in 1986 when employers agreed to make a 3% pension contribution in lieu of a productivity pay rise. It acquired its present status in 1992 when the government introduced the Superannuation Guarantee, which makes it illegal for an employer not to make pension contributions.

The first pillar of the Australian system is the Age Pension. This is a means-tested non-contributory retirement pension funded from tax revenue. Some 80% of Australians receive all or part of the pension, it makes up 15% of government spending, and the full amount is equal to 25% of average weekly earnings (currently \$12,384 or £5,087).³¹ The pension age is moving to a gender neutral 65 by 2013. This is supplemented by the compulsory superannuation system, the main features of which are:

Contributions (% of earnings)	Initially 3%, rising in stages to 9% by 2002.
Employer/employee	9%/0% compulsory + voluntary contributions.
Minimum income	\$450 per month
Maximum income	\$9,740 per month (2002/03)
Target replacement rate	60-70% of an individual's pre-retirement income (based on political objective of "meeting expectations in retirement.")
Forecast actual replacement rate	30-40%
Provision for low incomes	Until 2003: 10% tax rebate on contributions up to \$1,000 for those on incomes of <\$27,000 From 2003: Government pays matching contributions of 1.5x up to a maximum of \$1,500 on incomes <\$28,000. Matching rate tapers to zero on incomes between \$28,000 and \$58,000.
Provision for self-employed	No compulsory contributions. 100% income and capital gains tax relief against contributions below \$5,000, plus 75% relief above \$5,000, up to an age based limit.
Minimum pension age	55 on introduction, but now planned to rise to 60 between 2015 and 2020.
Conditions for early access to pension	Unable to meet reasonable and immediate living expenses and in receipt of benefit for >26 weeks. Compassionate grounds including paying for medical treatment, adjustments due to disability etc.

³¹ Rates effective as of March 20th 2005. Sterling equivalent calculated at an exchange rate of £1=\$2.44.

Pension vehicle	<ul style="list-style-type: none"> • Corporate (1,224 funds, 969,000 members, \$59bn assets, declining trend) • Industry (99 funds, 8,194,000 members, \$75bn assets, growing trend) • Public Sector (53 funds, 3,084,000 members, \$129bn assets, stable trend) • Retail (234 funds, 13,895,000 members, \$215bn assets, stable trend) • Small/Personal (296,209 funds, 563,000 members, \$143bn assets, growing trend) <p>Most funds are DC; there are some corporate and public sector DB funds.</p>
Asset allocation	Cash and deposits 8%, Debt 20%, Domestic equity 49%, Property 5%, Overseas 17%, Other 2%.
Maximum pension charges	No maximum. Estimates of actual average charges are 1.3-1.7% (0.4-1.4% corporate/industry funds, 2.0% retail funds).
Government guarantee	No guarantee, but the Age Pension is means-tested, and effectively functions as a minimum guarantee.
Pension taxation	Contributions taxed at 15% (usually less than the marginal income tax rate). Tapered 0-10% additional surcharge on contributions from high earners. Investment returns taxed at 15% but offset by credits against the corporation tax paid by shareholdings. Withdrawals taxed at 15% between upper and lower limits. The upper limit is higher for a fund taken as a pension rather than a lump sum.

Any firm that meets certain regulatory standards can offer superannuation funds. Transfers between funds are possible – various exit and dealing charges apply – although trustees have discretion to deny requests to transfer an active fund (one into which an employer has made a contribution in the last six months). Though employees have always been able to choose the investment vehicle for contributions by previous employers, their current employer has chosen where to invest current contributions. This will change from July 1st 2005, when choice of fund is extended to 4.82m employees, and almost all employers will have to pay contributions as their employees direct them.

Since launch, industry, personal, and self-invested plans have grown at the expense of corporate and public sector funds. The industry has consolidated, with the market share of the ten largest players rising from 56% in 1997 to 65% in 2002.³² There have also been new entrants, however, and the Australian fund market is generally seen as sophisticated and competitive. Superannuation trustees are required to have an adequate risk management plan. Beyond this, regulation over permitted assets is not restrictive.

³² 'Australian Funds Management: Market Structure and Fees,' *Reserve Bank of Australia Bulletin*, February 2003, Reserve Bank of Australia.

The main changes to the system since introduction have been to increase its generosity to the self-employed and low earners, reduce its generosity to the wealthy, and make it less leaky, by raising the age benefits can be accessed to 60, and making a lump-sum less desirable. There was a push in the mid-90s to raise the level of compulsory contributions to 15% but this foundered around 1996 when the Labor Party lost to John Howard's Liberals.

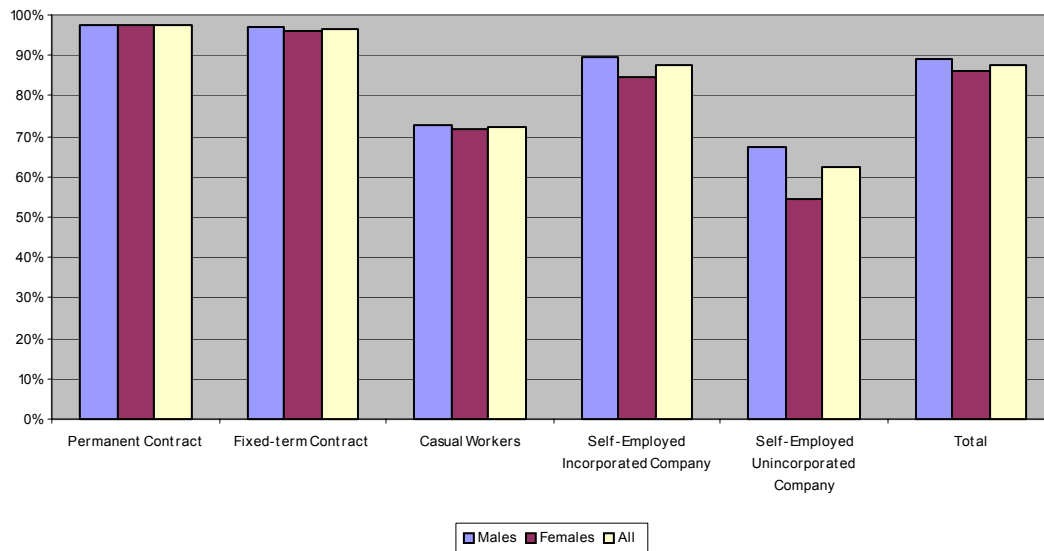
Introduction process

The political process of introducing compulsion was unusual and almost unprecedented. Trade unions pressed for higher pension contributions and, due to Australia's centralised wage bargaining system, they were able to strike a bargain, the so-called Concord agreement, bringing in a 3% pension contribution across a range of industries in return for a pay freeze. This process had political support from a sympathetic government but there was no legislation and the motive force was the unions.

This meant that, when the time came to formalise compulsion in law in 1992, it was already a functioning, accepted system across much of the economy. There was business opposition, but because the unions accepted that contributions would have to be balanced against wage increases, this was overcome, and compulsion now enjoys widespread popular support.

Coverage

Superannuation coverage, April - June 2000



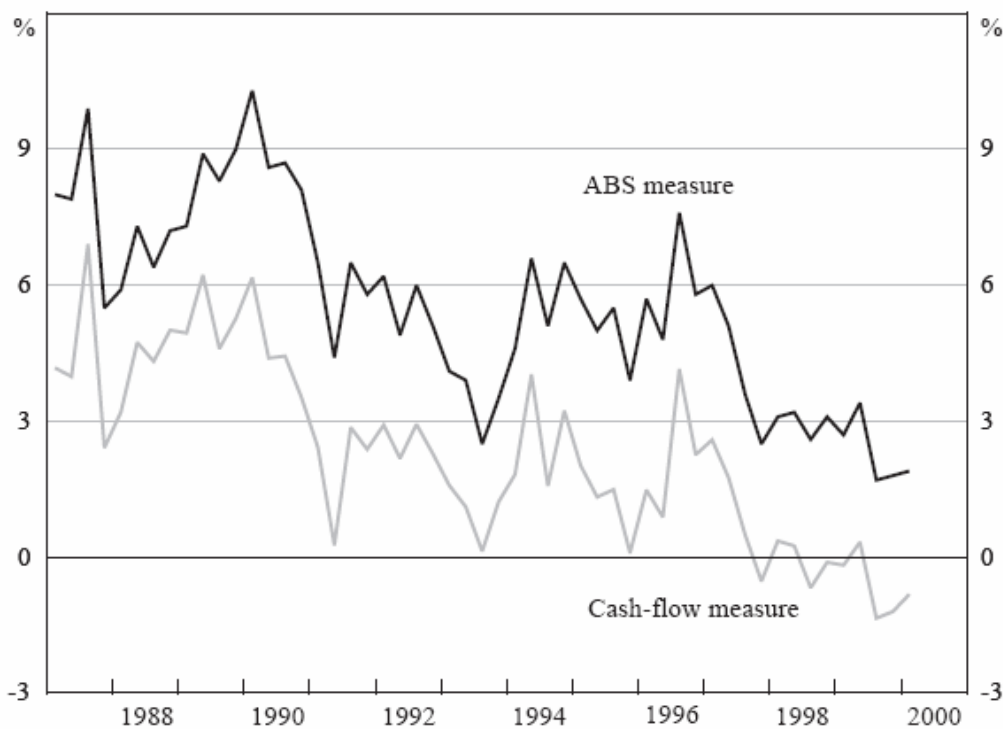
Source:

Superannuation now covers 88% of Australia's working population: those not covered are usually very low paid, very young, or temporary workers. There is also lower coverage among the self-employed, who are not compelled to contribute under most

circumstances, and in some specific occupations, like agriculture, with a large transient workforce. Coverage of male and female employees is roughly equal.

Effects of compulsion

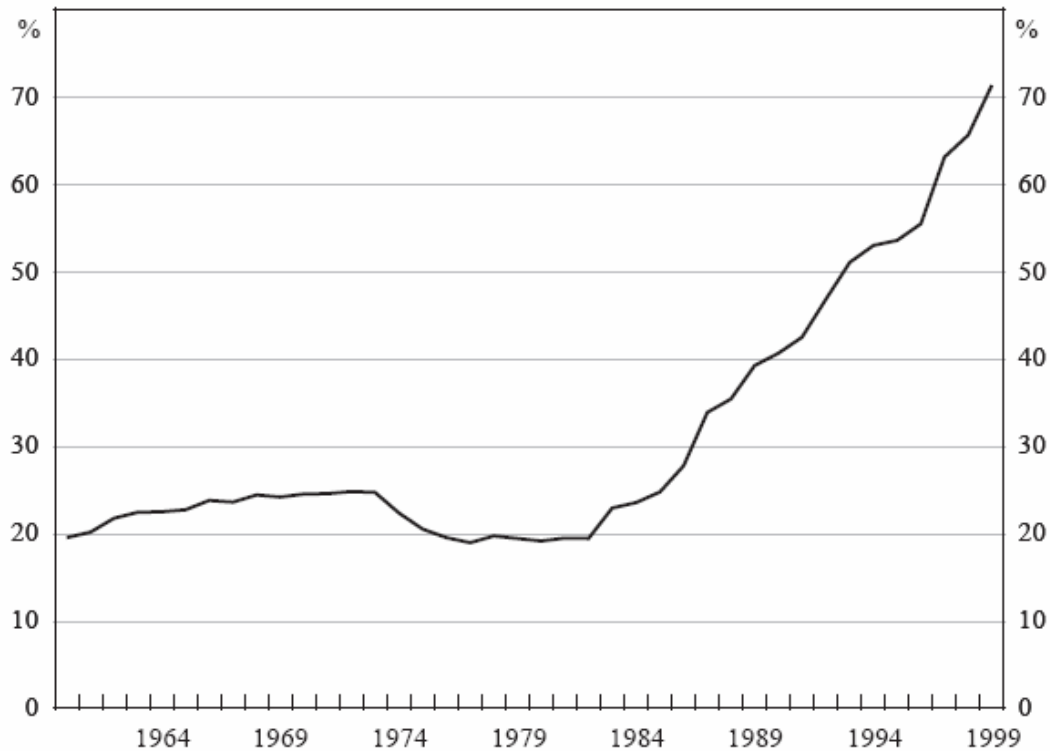
Figure 4: Household Saving Ratio
Net, per cent of disposable income



Source: Conolly & Kohler (2004) – see footnote 29.

Superannuation's effect on the overall savings rate is contentious. Household savings have been in overall decline for nearly two decades: a phenomenon mirrored in the UK and USA. Assets held in superannuation, meanwhile, have risen rapidly. Some critics have used this evidence to argue that superannuation has had no effect on overall saving but merely changed it from one form to another.

Figure 7: Superannuation Assets
Per cent of GDP



Source: Connolly & Kohler (2004) – see footnote 31.

In general this criticism is not borne out by academic studies, which point to three countervailing factors causing savings to fall: financial deregulation, which causes a one-off fall in savings as households bring forward consumption; the wealth effect caused by rapidly rising asset markets in the 1980s and 90s; and certain changes and biases in the measurement of household savings. Most of these studies estimate an offset rate, the percentage reduction in other savings for each dollar of Superannuation, of between 30% and 50%. These studies include:

- Connolly & Kohler (2004) – Offset rate of 38%, equivalent to a 2% rise in household savings, using annual macro data, in a model that corrects for stocks of wealth and financial deregulation.³³ All the studies below are cited in Connolly & Kohler.
- FitzGerald & Harper (1992) & FitzGerald (1993) – Offset rate of 50%, using micro data on liquidity constrained households.
- Corcoran & Richardson (1995) – Offset rate of 17%, using data on the change in voluntary super contributions since 1988.
- Corvick & Higgs (1995) – Offset rate of 37%, using consumption smoothing model on macro data.

³³ Connolly, E. & Kohler, M. (2004), *The Impact of Superannuation on Household Saving*, Research Discussion Paper 2004-01, Reserve Bank of Australia. <http://www.rba.gov.au/rdp/RDP2004-01.pdf> (31st January 2005).

- Morling & Subbaraman (1995) – Offset rate of 75%, using the aggregate relationship between super and other savings, 1960-1994. M&S differs from the other studies in that it uses net savings behaviour, and therefore includes those withdrawing funds.
- Gallagher (1997) – Offset rate of 30-50%, using a model based on data from previous studies.

There has to be a slight caveat on these studies, given that they introduce financial deregulation as the only extra explanatory variable, knowing that it will increase the apparent net savings. The theoretical reasons to do this are sound, however, so it is reasonable to assume that compulsion has had a net positive effect on saving in Australia.

Pension compulsion has not had, and is not expected to have, much impact on the retirement income of Australians. At present, 54% receive the full Age Pension, 28% receive part of it, and 18% have enough income of their own to be ineligible. By 2050, when Super will be fully mature, these percentages are only forecast to change to 33%, 40% and 25%. Recipients lose 40 cents of Age Pension income for every dollar of private income above a given level; the Age Pension is index-linked to be 25% of average earnings.

On present policies, therefore, around half of Australians will see some increase in their retirement income, although this is likely to be moderate at best. This would change if there were fiscal leeway to increase the Age Pension, but the cost of this is still forecast to rise rapidly, and change seems unlikely.

Criticisms

Criticism has been levelled at the Australian system on a number of grounds. One early criticism was that the system encouraged early retirement and economic inactivity. Because of the means-tested Age Pension, many on low or middle incomes receive little more in superannuation than they would if they had not saved at all, creating an incentive to get started on superannuation funds early, and then fall back on the Age Pension. This is being countered by raising the age at which Super can be drawn to 60 and making the lump-sum option less advantageous in terms of tax.

Another criticism is that costs are too high, particularly for the large group with personal pensions, where charges can reach 3%. This will obviously lower the system's ability to deliver a reasonable retirement income. There have been various reforms to superannuation regulation, but the Liberal government since 1996 has placed a high value on pension fund choice so, to date, there has been little action on charges. There has been some criticism of the effect Super has had on older defined benefit schemes but this is generally seen as being outweighed by the increase in coverage.

Summary

Australia is the closest example of a compulsory pension scheme to the UK experience. It is characterised by a 9% compulsory employer contribution between upper and lower limits, a free choice of investment vehicle, and mild tax benefits for

pension saving. The compulsory contribution is too low to achieve comfort in retirement for all, but will boost retirement incomes for some, and relieve the public purse.

The system has succeeded in increasing both the quantity of pension savings and the overall savings rate. Problems have included a tendency for savings to leak, which has been partially addressed, and high charges, which have not.

(2) Chile

Chile introduced the world to compulsory private pensions when its system started in May 1981. Since then, Chilean workers have had to pay a 10% employee contribution, to be held in an individual account. The system also features compulsory disability insurance, effectively privatising another part of the welfare system. This is backed by a minimum income guarantee in retirement (about 25% of average wages) for those who have contributed for at least 20 years, and a lower means tested benefit, for those who have not. The main features of the compulsory system are:

Contributions (% of earnings)	10% of taxable income + admin fees (+ extra charges for disability benefits) + voluntary
Employer/employee	0%/10%
Minimum income	No minimum
Maximum income	Maximum monthly earnings for contribution purposes are approximately US\$2,000.
Target replacement rate	70%
Actual replacement rate	60% ³⁴
Provision for low incomes	No contributions support, but many low paid workers in the informal sector are excluded.
Provision for self-employed	No mandatory contributions but may join schemes.
Minimum pension age	65 years (men), 60 years (women)
Conditions for early access to pensions	If short of pension age by ten years or less, a beneficiary must have enough savings to provide a pension which is at least 50% of average earnings over the last ten years of work, and which is 110% of the minimum pension.
Pension vehicle	Special pension companies, AFPs administer all funds and each is allowed to have up to 5 funds; at present there are six in Chile.
Asset allocation	<ul style="list-style-type: none"> • Domestic financial 29.7% (deposits and bonds 21.5%, mortgage backed securities 7.1%, shares 1.0%); • Government 19.1% (recognition bonds 5.1%, central bank bonds 13.3%, treasury instruments 0.7%); • Domestic corporate 24.4% (investment fund share 2.7%, bonds 6.9%, shares 14.8%); • Overseas 26.9% (equities 24.1%, fixed income 2.7%)
Maximum pension charges	No maximum. Average fees of 0.63% p.a. on assets under management.
Government guarantee	<ul style="list-style-type: none"> • A minimum pension (December 2004 average was US\$93.7 against a minimum wage of US\$158.3). • Annuities guaranteed against provider bankruptcy. • Investment return guarantee*

³⁴ James, E., *How It's Done in Chile*, Washington Post, February 13th 2005.

Pension taxation	No taxation of contributions or capital gains. Benefits, however, are taxed as income.
------------------	--

* Fund providers must guarantee real returns no less than 2% or half of the total (whichever is greater) of the average provider in each twelve month period, i.e if the average fund returns 5%, each provider must pay at least 3%; if the average fund returns 2%, each provider must pay at least 1%. Returns more than 2% above average must be put in a fund to provide for underperformance. If a provider cannot pay, it is declared bankrupt, and the government guarantees the difference.

There has been extensive change since the system was introduced. Most changes have revolved around improving the management of funds and increasing investment choice. Other changes included better provision for early retirement, tighter rules around disability insurance, and restrictions designed to make it harder to transfer funds between managers.

Introduction process

The Chilean reforms were in fact introduced by Decree-Law 3500, which was published in November 1980. The background to introduction was a fragmented pay-as-you-go system that had grown up piecemeal around different groups of workers. Some groups had more political clout and got better benefits; in addition, the system suffered from poor financial management, high levels of evasion, and an ageing population structure. The result was a social security deficit that averaged 28% of government expenditure in the 1970s.

In 1980 Chile was ruled by a military junta, opposed to a collectivist social model, and possessed of the absolute authority to enact what reform it chose. Even without that the new system was an easy sell: the compulsory pension contribution was around 10% less than the payroll tax it replaced. The government subsidised the new system, building up a budget surplus before it started, and offering generous guarantees to people who transferred. These were called ‘recognition bonds’: effectively financial instruments issued by the state that could be deposited in a new private account.

Coverage

Membership of AFP schemes has grown rapidly to reach 7 million in September 2004. The number of active contributors was 3.4 million in September 2004 (although the rate of growth appears to be slowing); overall, AFP now covers 63.8% of the total number of Chileans in employment, up from 21.4% when it began in 1981.

Nonetheless, despite the expansion of the system there are still many who have no coverage whatsoever. Whilst the total number covered by a pension scheme of some sort has risen from 51.6% of employed persons in 1980 to 66.6%, this is still well down on the high point of the old state system, which reached a peak of 86% in the mid 1970s. The main reason is that, whilst it is possible for the self-employed to join an AFP system, there has been limited take-up in practice. In 2001, take-up amongst the self-employed was just 5.2%.

Furthermore, the statistics on coverage hide those contributors who are not saving enough for a reasonable retirement. There is evidence that many Chileans are under-reporting their income in order to reduce the size of their contributions. In addition, the requirement that a person must make 240 monthly contributions to their pension

fund to get the minimum pension guarantee means that, in practice, many workers will be ineligible for state support despite the meagre value of their pension.

Effects of compulsion

It is clear that since the mid 1980s there has been a substantial increase in Chile's savings rate. Whether this can be attributed to mandatory pension saving, however, is unclear, particularly in Chile, where other market-based reforms occurred at the same time. The main empirical studies are:

- Arrau (1996) and Holzmann (1996) find a positive role for compulsion but only in that it increased productivity and developed the capital market
- Crespi & Letelier (1997) find a positive, though minor, impact on saving from compulsory pensions
- Haindl (1995), Morandé (1996) and Corsetti & Schmidt-Hebbel (1997), using private savings functions rather than national accounting, find a positive effect on private saving, though again due mainly to development of the capital market
- Coronado (1997) finds a positive impact in high-income households only.

The overall picture is mixed. There may be some positive impact, but mainly from capital market development, which would not be expected in the UK. On the other hand, Chile's savings rose fast for other reasons, and this may have crowded out increased private saving from compulsion.

Compulsion has substantially improved the retirement income of Chileans. Figures for June 1992 showed that old-age and disability pensions were 43% and 68% higher than under the old system. The first cohorts to go through the system will have exceptionally high pensions thanks to high investment returns (nearly 10%) in the 80s and 90s. Average replacement rates of 80% are cited, and 100% is not impossible. The distribution of higher incomes has been unequal, however, and a large number receive only the minimum pension guarantee.

Criticisms

The Chilean system was initially criticised for high administration costs, blamed on privatisation or competition-inhibiting regulation depending on ideological view. This has improved over time, and costs in the Chilean system are now below the international average, though still above the best British and US defined benefit schemes. A current criticism is that the system has consolidated too far for real competition.

A more serious criticism is lack of fund choice and therefore inability to vary level of risk. In 1981 each provider could offer only one fund, and there were tight regulations on permitted investments, hence the risk profiles were the same. Investors could not adjust risk to suit their circumstances: the young could not risk enough, while older savers could not reduce volatility as they neared retirement. Providers can now offer

five funds, of differing risk profile, but the old problem is not entirely solved and a new one has emerged. Poorer savers, whose pension is likely to be near the minimum guarantee, have an incentive to maximise risk knowing they have nothing to lose.

Frequent transfers were a problem in the 1990s when, in order to stimulate competition, the government made them easier. These were costly, and lowered investment returns. The problem was addressed in 1998 by tighter restrictions: the number of transfers fell from 1.6m to 700,000 in a year.

Coverage is not strong: there are many exemptions, and a large informal and self-employed sector. This is a weakness of the system but was also a problem when collecting social security contributions. The low level of the means-tested pension is perhaps more of an issue.

There has been criticism of the rules on drawing a pension. Pensioners are allowed to take regular monthly payments from their pension, rather than buy an annuity, and thus take longevity risk themselves. Pensioners are also able to take quite large lump sums and to retire quite early.

(3) Sweden

Sweden's pension reform was passed in 1994, implemented in 1998, and started to pay its first benefits in 2001. The reform had several goals, including making the state system fairer, boosting the capital market, and promoting transparent redistribution, but probably the main goal was to deliver financial stability to the pension system. It now has automatic stabilisers such that the system ought to be able to continue indefinitely with current contribution rates.

The new system carves out a small percentage of mandatory social security contributions and directs it to a private defined contribution account. There are now three components:

- earnings and contributions linked, pay-as-you-go, social security pension, supported through a 16% tax on earnings
- defined contribution, funded, private pension, paid for through 2.5% mandatory employee contributions
- means-tested state minimum income guarantee.

The main features of the new private accounts are:

Contributions (% of earnings)	18.5% (16% state system; 2.5% private accounts)
Employer/employee	9.25%/9.25% (inc. social security pension)
Minimum income	SEK 830 (£63) per month (2001) Minimum reporting level for income tax.
Maximum income	SEK 23,563 (£1,782) per month (2001) Maximum pensionable income – social security contributions still levied above this level but do not contribute to pension.
Target replacement rate	65% (traditional target of the old state system; actual replacement rates could be anything from 60-100% depending on income)
Forecast actual replacement rate	Dependant on real wage growth. Likely to be approx. 10% lower than old system when mature.
Provision for low incomes	Government pays contributions for unemployed, carers etc. No reduced contribution rate for low incomes
Provision for self-employed	Pension contributions included in self-employed social security contribution rate of 30%.
Minimum pension age	61 (contributory pension) 65 (guarantee pension)
Conditions for early access to pension	Early access to individual account is not possible; the Swedish state, however, pays generous social security benefits.
Pension vehicle	Individual accounts investing in unit trust structures. Any fund manager registered in Sweden can offer funds provided they meet conditions on reporting and fees: around 500 were available at launch.

Asset allocation	Equity 70.3%; Balanced 8.2%; Debt 2.2%; Life-cycle 19.3% (funds that adjust assets with the age of investors).
Maximum pension charges	Administration and custody carried out by state for flat fee of 0.3%. No cap on private management charges but some must be rebated to the state. Actual average charge 0.73%.
Government guarantee	Main earnings-linked pension is state guaranteed. Government minimum income guarantee. No guarantee on private account contributions.
Pension taxation	Contributions attract income tax relief. No tax on fund income. Pension payments are taxed as income.

The system is still relatively new and has not yet changed from its initial form.

Introduction process

The Swedish pension reform of the 1990s did not involve a move to compulsion where none existed before: in fact, contributions were cut, and some existing contributions were redirected into private accounts. Despite this, the reform was contentious.

The stimulus for reform was the realisation, which loomed in the 1980s, that the pension system was financially unsustainable. An all-party parliamentary commission was established in 1991 and, after hard political bargaining, the principle of individual accounts was accepted in return for a large, ongoing state role. Parties representing 80% of parliamentary strength eventually supported the reform.

The breadth of the reform – introducing private accounts and pension choice – made it possible to conceal the main objective and main achievement: a cut in benefits. The automatic stabilisers built into the new system will almost certainly mean higher retirement ages and lower benefits in the future. This caused a crisis within the Social Democratic Party after the principles of the reform were agreed, and reform was achieved without strong public support.

Introduction has been eased by a long transition period. Pensioners born in 1938 will receive a pension of 4/20ths of what they would under the new system, and 16/20ths what they would under the old. The proportions will change by 1/20th per annum until the new system is fully introduced for those born in 1954.

Coverage

Coverage under the Swedish system is almost universal for workers and widespread for non-workers. Non-workers in receipt of sickness or unemployment benefits have contributions made for them by the state, as do university students, and those with caring responsibilities.

Effects of compulsion

Again, it is wrong to talk of the effects of compulsion as such, because compulsion through the state system has existed since the 1940s. The main features of the Swedish reform are changes to the social security pension: it fixes contributions but makes benefits and retirement ages flexible. The move to individual accounts is incidental by comparison. There is limited evidence on results as the system only began in 2001.

The most important projected result of the new system is financial stability. Pension rights have been indexed to economic growth and life expectancy. Particular demographics may increase costs, but the system is expected to be sustainable with the same contribution rate, 18.5%. Work incentives will also improve. Benefits are linked to income earned in work, rather than the number of years worked, so there are incentives to stay in the workforce and to fully report income. These incentives are increased because the state pension rises for each year retirement is delayed.

One study does suggest that the reform will lead to a net increase in household savings but the truth of this cannot yet be judged.³⁵ No simple comparison of pension adequacy is possible: the new system has different effects on different groups. As a crude approximation, replacement rates will be lower for middle earners retiring at 65, but better for those with disrupted work patterns or who stay in work for longer.

Criticisms

The new system has taken some criticism in Sweden for cutting benefits but the individual accounts are broadly popular.

Some critics have questioned whether benefits really are so firmly linked to contributions, and whether the system really will be so resilient in face of demographic change. They point out that contributions and benefits are still defined separately in law, and though there is a notional link, there might be political pressure to redefine benefits if they began to fall.

One part of the Swedish trade union movement dislikes the strong focus on better pensions in return for longer working lives, arguing that it discriminates against manual workers who tend to retire earlier, and have shorter life expectancy. Employers dislike the low pensionable income cut-off, arguing that it is unfair for employees to make such high contributions when it earns them no further rights.

In general, however, views of the Swedish pension system depend on how the author views the country's high level of social provision.

³⁵ Berg, L. (2000), *Sparandets guldålder*, Merita Nordbanken: Stockholm, cited in Normann, G. & Mitchell, D.J. (2000), *Pension Reform in Sweden: Lessons for American Policymakers*, Background No. 1381, The Heritage Foundation: Washington DC.

(4) Singapore (Central Provident Fund)

Singapore's pension system is part of a larger compulsory savings scheme, the Central Provident Fund (CPF), which covers healthcare, home ownership and social insurance as well. Singaporeans build up individually capitalised accounts from employer and employee contributions; there is no state pension in this 'single pillar', fully funded scheme.

The CPF is not just about savings: the government uses it as an instrument of macroeconomic control, reducing contributions to stimulate consumer spending as necessary. Prior to the economic downturn of the late 1990s the total contribution rate had been 40% and at one point had reached as high as 50%. The retreat from these levels, however, is also, in part, a more permanent policy shift. The government currently targets a long-term contribution rate of between 30% and 36%.

Separate but complementary to the CPF scheme the government also operates the Supplementary Retirement Scheme (SRS) to help people boost their retirement income further. Participants can contribute a varying amount to SRS (subject to a cap). Contributions to SRS are eligible for tax relief, investment returns are accumulated tax-free (with the exception of Singapore dividends), and only 50% of the withdrawals from SRS are taxable at retirement.

Funds are divided between three separate accounts the ordinary account, the special account and the medisave account. The last of these is used to pay for the cost of medical treatment. Meanwhile, the ordinary account, into which the majority of contributions are directed can be used for a variety of purposes including buying property, making certain other forms of investment and for education. Only the special account is used exclusively for the purposes of providing income during old age. As a result, despite the extent of the compulsory savings scheme, the size of the pension-specific element is relatively small. Those under 35 need contribute only 5% of their income to the special account; the proportion rises to 6% for those aged between 35 and 45 and to 7% for those aged between 45 and 55.

The main features of the CPF are:

Contributions (% of earnings)	33% into CPF (30% for those aged 50-55 yrs and declining contributions thereafter). Proportion of taxable earnings going directly into special account: 5% (for those under 35); 6% (for those between 35 and 45); 7% (for those between 45 and 55); and 0% (for those over 55).
Employer/employee	13%/20% (for those under 50 – declining rates thereafter) Employer contribution rate used for macroeconomic management – will vary between 10 – 16%.
Minimum income	SGD50 (US\$31) per month

Maximum income	SGD5,000 (US\$3,100) per month SGD23,760 maximum annual contribution (including voluntary contributions)
Target replacement rate	-
Actual replacement rate	28% for an average worker retiring at 62 (McCarthy et al. 2002)
Provision for low incomes	SGD 50–500 per month = 13% employer contributions only. SGD 500–750 per month = 13% employer contribution plus 60% employee contribution on wages between SGD 500–750.
Provision for self-employed	No mandatory contributions except to the Medisave health insurance scheme. Voluntary participation, however, is encouraged through tax breaks
Minimum pension age	55
Conditions for early access to pensions	Those wishing to draw on their CPF savings must set aside a minimum sum in their special account. This sum will guarantee a minimum income either through the purchase of an annuity or through a programme of planned withdrawals. The minimum sum is currently set at SGD84,500 (US\$52,000) but it will be increased gradually to SGD120,000 (US\$73,500) by 2013.
Pension vehicle	All invested in non-marketable government securities except for funds invested in the CPFIS (about 22% of the total as of December 2004).
Asset allocation	All funds must be invested in government securities. Of funds invested under the CPFIS, 62.2% are in insurance policies, 26.9% are directly invested in stocks, 10.5% are in unit trusts, and 0.4% are in other investments, including gold.
Maximum pension charges	No fees on publicly invested portion: government determined return based on floating short-term interest rates. Medium risk CPFIS unit trusts have an average fee of 1.92%, above a government target of 1%.
Government guarantee	Minimum nominal interest rates of 2.5% on ordinary account and 4.0% on special account (first SGD 84,500 of savings, for retirement and emergencies only).
Pension taxation	No taxation on contributions, fund income, or pension.

Implicit tax if government earns an investment return above 2.5%. In the 1990s returns were often around 10%; in 2000 the implicit tax was 42% of contributions.

One major reform to the CPF has been to allow participants some control over how their assets are invested under the CPF Investment Scheme. This holds out the prospect of returns greater than the short-term interest rate, but fees are unregulated, and investment risk is obviously higher. The CPFIS is run by the big three locally controlled agent banks which are the only ones approved. All savings can be theoretically invested privately, but in practice only 22% of the total is invested in this way.

Introduction Process

The Singaporean CPF system was introduced through legislation passed by the colonial government in 1953 and came into force in 1955. Prior to the CPF scheme the government had played little role in social security provision and the creation of a system relying on individual responsibility can be seen as an attempt to ensure that the British government did not have to support social security in its colonies. It followed on from similar reforms introduced in Africa and Malaya in 1951.

However, despite the consistency of the format, the scope of the scheme has changed considerably. At its inception the CPF was exclusively a pensions system. Yet, as the system progressed, steps were taken to expand its scope, in order to protect the financial security of Singaporeans more broadly. The expansion of savings also fitted in with the government's policy of encouraging investment driven growth. The first steps toward an expansion of the scheme were made under the premiership of Lee Kuan Yew in 1968 when a home ownership scheme was introduced and many further elements have been introduced since then.

During the early years of the CPF system, while the scheme was expanding, contribution rates climbed, reaching a peak of 50% in 1984. However, the economic downturn of 1985-6 prompted a cut in rates in order to prevent a reduction in take home pay. This was followed in the 1990s by a further reduction in contribution rates amidst fears that high employer contributions were adversely affecting Singapore's international competitiveness (Goh Chok Tong, 2003).

Coverage

At the end of 2004, total membership of the CPF scheme was 3.0m, of whom 1.3m were active members (excluding the self-employed). The total population of Singapore is 4.35m and total employment stood at 2.3m in December 2004. A total of 77,953 employers are active contributors to the scheme in 2005.

About three-fifths of the workforce is actively contributing to the CPF. The seemingly large number of non-contributors can be partially explained by the fact that foreign workers, who are excluded from the CPF, constitute a quarter to a third of the Singaporean labour force. Nonetheless, it remains the case that relatively few self-

employed workers make voluntary contributions to the CPF. Furthermore, there is evidence that coverage may be declining, possibly due to increased use of short-term employment contracts (Asher 1995). In the mid 1980s more than two-thirds of the labour force were making payments into the CPF.

Effects of compulsion

The breadth and extent of the Singaporean Central Provident Fund system is designed to offer workers a high level of financial security, whilst at the same time giving them considerable flexibility over such issues as when they retire and how much money they spend on each type of social security need. This is not always achieved.

It is often hard to assess the effect of introducing compulsory savings on the overall savings rate and whether it may deter people from voluntary savings. In Singapore, however, the scale and nature of the CPF scheme means that it has almost certainly helped make Singapore's saving rate the highest in the world. Since 1995 the savings rate has been over 50%. The CPF alone accounted for between 16.3% and 30.4% of gross national savings in 1995 (Asher: 1995) depending on how it is defined.

Only a small portion of the fund, however, must be devoted to pension provision. The result is that, in practice, many Singaporeans have tied up a large part of their savings in property leaving them relatively unprepared for retirement. In 2004 withdrawals for retirement income scheme amounted to just 31% of total withdrawals from the fund; withdrawals for property purchases accounted for 59.8% of the total (CPF 2004).

Combined with the fact that interest on government securities is low this means that, despite the high savings ratio, replacement rates in retirement are relatively modest. McCarthy et al (2002) suggested that for an average person retiring at the age of 62 the replacement rate would be 28%. A study quoted (without citation) by the US embassy in Singapore in its report on the CPF suggested that the replacement rate was between 20% and 40%.

Many Singaporean retirees, especially among the working classes, have their income supplemented by assistance from family members (Asher, 1995; Asher, 2004; Chicago Tribune, 2005). Yet even when all sources of income are taken into account, three quarters of males and nearly 90% of females over the age of 65 survive on under SGD1000 per month (Asher 2005). Given the decline in the mandatory rate of contribution to the CPF, as well as a possible change in social attitudes such that different generation within families become more independent, the situation may deteriorate further going forward.

Criticisms

The benefits of high savings for economic growth are open to doubt. Whilst in the early days of the CPF, savings were frequently ploughed into investment in Singaporean infrastructure it is likely that government investment companies now invest the bulk of their capital abroad. As their accounts are not public it is not possible to ascertain this for certain. However, it is certainly the case that the government has a policy of running budget surpluses suggesting that the money is not needed for public investment (Asher 2005).

It is difficult to know exactly how well the savings in the Central Provident Fund have been invested, due to the lack of transparency of the state investment companies. However, the rate of return offered to members is low, with ordinary accounts generating interest comparable only to short-term bank deposits. The fact that the government alone controls the vast majority of funds may lead to inefficiency due to a lack of competition and the potential for inefficiency is only increased by the lack of accountability of investment. One of the reasons why the CPFIS system was introduced was an attempt to counter this by encouraging the development of private sector fund management companies.

In addition to the problems with government investment, there is also a danger that the CPF scheme has encouraged over-investment in property, with the result of stoking house price inflation.

One obvious advantage of the Singaporean system is that, by requiring workers to provide for their own future, it shields public finances from the stress demographic change puts on PAYG pensions. The corresponding disadvantage, however, is that there is no redistributive element to the CPF whatsoever. Already the government has occasionally used some of its budget surpluses to top-up the CPF, with its cash injections directed particularly towards the most needy. Given the possible growth in the number of retirees on low incomes, it is possible that in the future the government will be forced to introduce a tax-financed minimum pension to ensure a basic standard of living for all.

The high level of mandatory savings, including the high level of contributions from employers has been seen as having a negative impact on the international competitiveness of the Singaporean economy. It is this thinking which has already prompted the government to reduce the level of compulsory contributions, especially from employers (Goh Chok Tong, 2003).

Summary

Overall, the Singaporean CPF system has been successful in encouraging a high level of savings. However, it can be doubted whether savings have been used in the best possible way.

By placing control of the vast majority of savings with unaccountable government fund management companies, the system opens up the possibility of poor management and certainly the setup at present offers low returns to CPF beneficiaries. Furthermore the expansion of the system has meant that what was once a pure pension system has been hijacked by the other elements. The result that is that, astonishingly, despite the fact that Singapore has the highest saving ratio in the world, many Singaporeans are still not well prepared for retirement.

(5) Switzerland (BVS)

The Swiss pension system consists of: (a) a public, pay-as-you-go pension (AVS) designed to provide basic subsistence benefits to all retirees; (b) compulsory contributions to private accounts; and (c) voluntary private savings.

All Swiss residents, including the self-employed, students, dependent family members and benefit recipients must all contribute to the AVS. Employees and employers each contribute 4.2% of earnings; the self-employed contribute 7.8%. Contributions cover 75% of the cost with the remainder coming from general taxation. The final pension is based on contributions but is highly redistributive.

The second-tier, compulsory BVS pension targets a replacement rate (60-75% of average lifetime earnings), rather than define a contribution rate. As a result, actual contribution rates depend on the amount a person has already accrued. Regulation on the funds employers choose is permissive and they have considerable investment freedom. Transfers are only possible out of funds held with previous employers.

Evidence in this section is drawn from a report by the World Bank and data from the Swiss Federal Social Insurance Office.³⁶

Contributions (% of earnings)	System targets minimum level of credits in an account rather than a defined contribution level. In 2004, however, the effective contribution rate was between 7% and 18% of total income.
Employer/employee	Employer's contribution must be at least equal to employee's contribution.
Minimum income	CHF25,320 (US\$21,600)
Maximum income	CHF75,960 (US\$ 65,000)
Target replacement rate	60% to 70% of average lifetime earnings (including state pension)
Actual replacement rate	60% to 75% (but tapers off for those with incomes over CHF75,960 in some schemes)
Provision for low incomes	Means-tested minimum pension guarantee
Provision for self-employed	No compulsion but tax incentives
Minimum pension age	Equal to state pension age Male: 65 years Female: 63 years (set to increase to 64 by 2006)
Conditions for early access to pensions	According to the provisions of the pension fund
Pension vehicle	Funds are chosen by employers and can range from single employer entities (which must however be legally distinct from the

³⁶ Queisser, M. & Vitta, D., *The Swiss Multi-Pillar Pension System: Triumph of Common Sense?*, Policy Research Working Paper No. 2416, August 2000, The World Bank: Washington. http://www-wds.worldbank.org/servlet/WDSContentServer/WDSContentServer/IB/2000/10/07/000094946_00092205342254/Rendered/PDF/multi_page.pdf (31st March 2005).

	firm itself) to multi-employer collective funds (which can operate under various legal forms).
Asset allocation	Equities 21.4%; liquid assets 9.5%; domestic and foreign bonds, loans and mortgages 39.8%; domestic real estate 15.5%; claims on employers 10.2%; other 3.0% (1996 figures)
Maximum pension charges	No maximum. Actual cost = 0.67%. ³⁷
Government guarantee	Funds must guarantee a return of 4%. Guarantee fund in case of an insolvency.
Pension taxation	Contributions are tax deductible. Benefits subject to taxation.

Introduction Process

Switzerland was the first country OECD country to introduce some measure of compulsory contributions to privately managed individual accounts. By the early 1970s the first-tier pay-as-you-go system had become increasingly expensive to maintain. Voluntary occupational pension schemes had already become popular and a compulsory second tier was passed by a referendum in 1972. Due to the economic problems caused by the oil price shocks of the 1970s this was not enacted in legislation until 1985. Acceptance of the scheme was partly inspired by a desire to avoid the alternative suggestion: helping to guarantee adequate retirement income by nationalisation of occupational pension plans to expand the first tier.

Coverage

BVS pension schemes had 3.1m beneficiaries in 1997, but as this double-counts citizens who are members of more than one scheme, the number of individual beneficiaries is probably closer to 2.8m. This accounts for 74% of the labour force.

Effects of Compulsion

The BVS scheme has generated a lot of saving. The system mandates that a high proportion of income must be devoted towards savings for retirement and it catches a high proportion of the population. BVS schemes managed funds with assets of CHF423.1bn in 2003, almost equal to total GDP for that year (CHF433.36).

As ever, it is hard to distinguish how much of the saving is due to compulsion. Even before the introduction of the BVS in 1984, occupational pension schemes had assets worth 65% of GDP. Furthermore, it is notable that many firms actually provide for more generous schemes than the law requires.

The combined AVS and BVS ensure that most Swiss have an adequate retirement pension.

³⁷ According to official statistics from the Federal Bureau of Social Insurance. This probably underestimates true costs substantially, however, as employers absorb a lot of administration costs (World Bank 2000).

Criticisms

The system has been criticised for the high administration costs that result from the unconstrained market for investment funds. Compulsory contributions cannot be invested in personal pensions, however, so this criticism seems overblown compared to the situation in some other countries.

Another complaint frequently aimed at the BVS system is low investment returns. Some studies have attributed the low rate of return to limits on the proportion of assets that can be allocated in any one asset class. It has been argued that these rules have limited flexibility and, in particular, discouraged investment in overseas assets and in equities. The counterargument is that BVS funds have had sufficient investment freedom, but that Swiss pension institutions are naturally conservative. This may have been encouraged by the minimum interest rate rules, which could have induced fund managers to “play safe” by buying low risk assets in order to guarantee they met their obligations.

Summary

The Swiss system features a pay-as-you-go public pension, plus a compulsory private contribution to an occupational account. It has achieved a high degree of coverage, good replacement rates, and kept payroll taxes low.

Demographic change will be especially pronounced in Switzerland and compulsory pensions have not eliminated funding problems in the public system. There are also problems with charge levels and investment performance.

(6) USA (401k)

America does not have compulsory private pensions; 401k plans are covered here as the most successful example of a voluntary private system. Like the UK, America has a three-tier pension structure: a compulsory, contributory, defined-benefit state pension; voluntary employer pensions, either DB or DC; and private savings.

The first tier, Social Security, covers 96% of Americans. The minimum state pension age is 62, with full benefits available from 65, soon to rise to 67. The average replacement rate from Social Security is 42%, but varies from 35% for a high-earner to 56% for those on a lower wage, though rates for all incomes are expected to decline in the future. The actual amount paid depends on the number of years in which contributions were made and the level of those contributions.

After Social Security come various private pensions including many remaining public and private defined benefit funds. In recent years, however, there has been explosive growth in employer DC funds, most of them operating under section 401(k) of the federal income tax code, and an estimated 42 million workers now have one of these plans. Their main features are:

Contributions (% of earnings)	Median contribution rate of 8-9%. ³⁸
Employer/employee	3.3%/6.8% actual split on average The law encourages employers to match 50% of contributions up to 6% of salary.
Minimum income	No set minimum but few low-income jobs have 401k plans.
Maximum income	\$14,000 per annum upper limit for tax relief/\$42,000 per annum total limit (2005)
Target replacement rate	No specific target
Forecast actual replacement rate (401k + social security pension)	Top income quartile – 72-85% (42%) Bottom income quartile – 92%-100%+ (75%) ³⁹ Modelling for 25-29 generation in 2000. (Figures in brackets are for an incomplete contributions record)
Provision for low incomes	Contribution limits for high-paid employees depend on the contributions made by low-paid workers in the same firm. Firms can avoid these limits by making a minimum contribution to all employees (safe harbour provisions).
Provision for self-employed	The self-employed can open 401(k) plans and make contributions from both income and company profit.
Minimum pension age	59 ½

³⁸ Holden, S. & VanDerhei, J., "Contributions Behaviour of 401(k) Plan Participants," *ICI Perspective*, No. 7(4), October 2001. <http://www.ici.org/pdf/per07-04.pdf> (28th February 2005).

³⁹ EBRI, *Can 401(k) Accumulations Generate Significant Income for Future Retirees*, EBRI Issue Brief No. 251, November 2002, Employment Benefit Research Institute: Washington DC. <http://www.ebri.org/ibpdfs/1102ib.pdf> (28th February 2005).

Conditions for early access to pension	<p>Grounds for severe financial hardship withdrawal include:</p> <ul style="list-style-type: none"> • A deposit on a primary residence • College tuition for saver or dependents • Uninsured medical expenses • Prevent eviction or foreclosure on home <p>Under many plans it is possible to borrow from a 401k account though the money must be returned with interest. 18% of plans had loans against them in 2003. For withdrawals on other grounds there is a 10% early redemption charge in addition to income tax.</p>
Pension vehicle	An employer must act as the fund trustee. They will contract to provide a range of mutual funds the employee can invest in. Many employers offer company stock as an investment option.
Asset allocation	Equity 45%, employer stock 16%, balanced 9%, bonds 10%, guaranteed investment contracts 13%, cash 5%.
Maximum pension charges	No maximum. Actual average charges are estimated at 1.4% with significant variation depending on the size of the plan.
Government guarantee	No guarantee on 401(k) plans; the state does guarantee defined benefit pensions.
Pension taxation	Full tax relief on contributions. No tax on fund income. Withdrawals from fund taxed as income with 20% withholding tax.

Introduction process

The growth of 401(k) plans was organic: a basic pensions law, the Employee Retirement Income Security Act was introduced in 1974, and the 401(k) was created under it in 1980, initially as an executive pension plan for a private company. The advantages were plain, and 401(k) plans took off across the private sector: there was never a political debate around them.

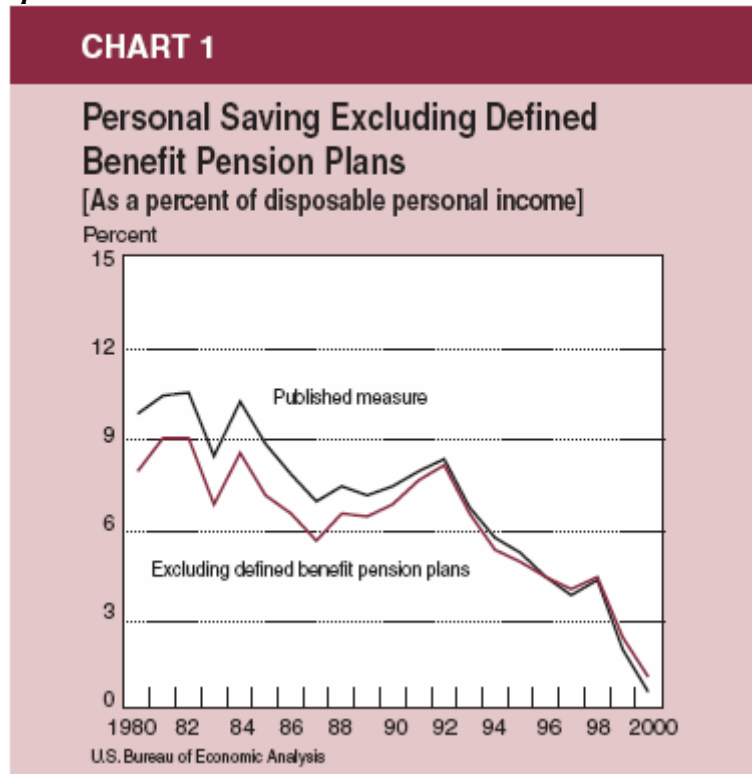
U.S. pension politics more recently has been dominated by projected financial deficits in the Social Security system and an ideological debate about individual choice and control over pension assets. The Bush administration's current pension plan proposes to divert some Social Security contributions into private investment accounts in line with the Swedish and Chilean reforms.

Coverage

Coverage by a U.S. private pension has been stable at around 50% of the workforce since the 1970s; roughly two-thirds of workers are covered at some point in their career. As in the UK, however, coverage is unequal, with only 14% of part-time workers, only 27% of Hispanic workers, and only 6% of those on incomes under \$10,000 having a private pension. Contribution rates are similarly unequal.

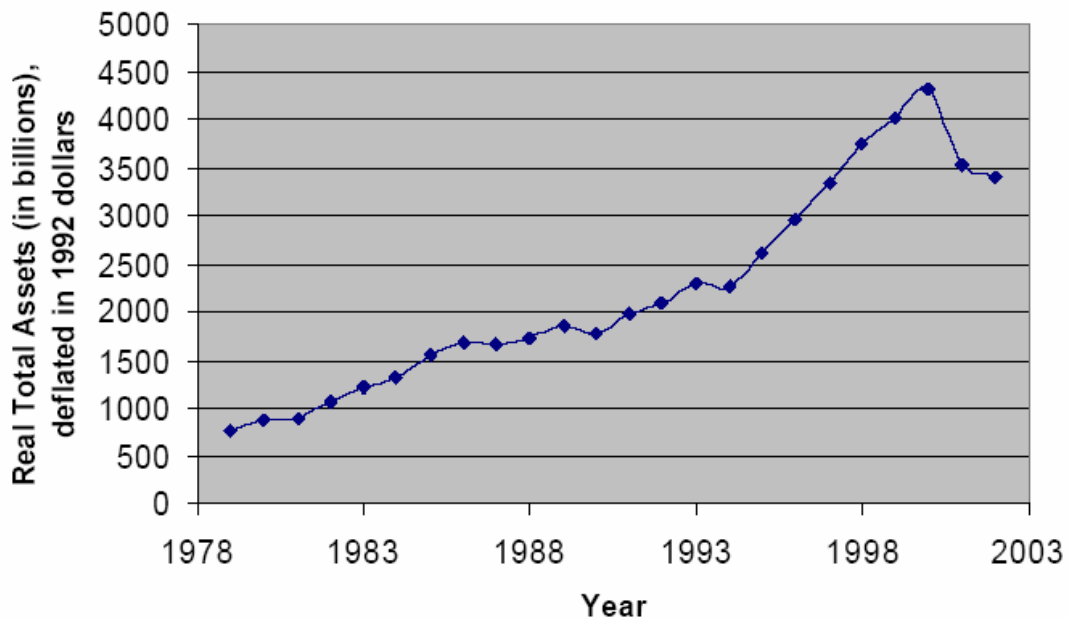
Around 58% of workers are employed by a firm that sponsors a pension plan; of these, only three-quarters actually join the plan. Reasons given for not joining include: age or service limits on participation, a voluntary decision not to participate, or being ineligible due to only working part-time.

Effects of compulsion



American household saving has been in decline for more than two decades, as it has been in the UK, Australia, and several other industrialised countries. Possible causes are the wealth effect from rising stock markets, productivity growth raising expected future income, and financial innovation allowing consumption to be brought forward. Total retirement assets in the U.S. pension system, however, have risen rapidly. The specific contribution of the pensions regime to either of these trends is hard to determine.

Total Real U.S. Pension Plan Assets 1979-2002



Source: Medoff, J.L. & Sellers R.W., Labor's Capital, Business Confidence, and the Market for Loanable Funds, Discussion Paper No. 2042, Harvard Institute of Economic Research.

Studies of 401(k) pensions generally suggest they are producing adequate retirement incomes. There are two provisos to this. First, 401(k) plans seem to result in worse pensions for lower income groups than the DB plans they replace. Second, much current research is distorted by the spectacular stock market returns in the 1980s and 1990s, which have produced strong retirement incomes off relatively low contributions. This may not be sustainable over the next few years.

Criticisms

A major criticism of the 401(k) system is poor pension choices by individuals, who take insufficient or excessive risk, and do not pay enough attention to charges. An extreme example of that, where companies offer their own stock as an investment choice (55% do), 30% of plan assets are invested in it. When Enron's share price collapsed, so did the pensions of many of its employees.

Low paid workers are particularly prone to taking insufficient risk, with almost two-thirds investing in a money market or bond fund; they are also prone to avoiding investment decisions, and employers usually set bonds as the default so they cannot be accused of taking excessive risk.

401(k) plans can be leaky: the early withdrawal and loan provisions are quite generous. This has been a particular problem when a worker leaves a company with only a few thousand dollars in their pension plan. Employers are keen to get rid of these accounts to reduce administration costs, and many have a policy of closing them: the recipient often fails to transfer the resulting check to a new pension. This particular loophole is being closed by denying companies the right to close accounts

above \$5,000 but withdrawals, particularly by those on low incomes, remain a problem.

Coverage is another problem. Employers are not required to offer a 401k plan and many do not. Of those employees who do have access to a plan 25% do not participate. Even those who do participate often fail to pay enough to get their employer's full matching contribution.

Summary

The American system is similar to the UK but retains a large earnings-linked public pension. This combines with relatively widespread private saving to deliver quite high replacement rates to many income groups.

One major vehicle for private savings is the 401(k) account. This is an employer-run DC pension, offering limited investor choice, and supported by generous tax incentives. Matching contributions by employers offer an incentive for individuals to invest; employer administration has kept fees under control.

The trends in the American system, however, are negative. The present Social Security system is unsustainable and either tax will rise or benefits will fall. 401(k) plans have benefited since inception from exceptional investment market performance and this may not continue. The 401(k) approach works less well for the half of the population that lacks a private pension and for lower income savers who do.

(7) International experience – implications for the UK

Other countries that introduced compulsion had very different starting points to the UK. Chile started with minimal private pension provision. Sweden started with a hugely generous state pension. Australia’s unique industrial relations delivered its system almost as a gift.

Contributions (% of earnings)	9-10% typical in privately funded compulsion schemes Overall contribution levels higher in countries with compulsion schemes than without
Employer/employee	Range from 100% employer to 100% employee Who makes the contribution appears to be a political decision – there is little evidence of wider economic consequences.
Minimum income	All systems save Chile have a minimum hurdle for contributions. Generally linked to the tax system or some measure of poverty.
Maximum income	All systems have a maximum income for compulsion. No consensus on level – high in Australia, low in Chile.
Target replacement rate	Target replacement rate usually approximates to comfort in retirement – no compulsion system appears to be based on a minimum retirement income.
Forecast actual replacement rate	Often below comfort in retirement or even a minimum income level. Australia likely to offer only 30-40%; Singapore even less.
Provision for low incomes	Most systems offer a means tested minimum pension. Some systems help those with little or no income to (nominally or actually) fund their pension. Australia offers tapered co-contributions for those on low incomes. Sweden (nominally) funds the pensions of those who are inactive or in receipt of benefits. Singapore tapers the rate of compulsion with increasing income.
Provision for self-employed	Compulsion is generally not applied to the self-employed and this would be the default option for a UK system.
Minimum pension age	Generally in-line with, or somewhat below, the state pension age. Low pension ages have caused pensions to leak and increased reliance on state benefits: this is not an example to copy.
Conditions for early access to pension	Early access is usually possible in case of illness or unemployment. American 401k pensions have the loosest rules, including withdrawal to buy a house, and this is a major cause of leakage. UK rules should be based on preserving pension funds to retirement where possible.

Pension vehicle	<p>Some attempt to limit diversity of provision in most cases, especially Singapore, with a monopoly provider, and Chile, with only six licensed funds. Australia and Switzerland limit diversity by requiring contributions to employer funds. There is a general trend to increase diversity, with Singapore and Australia introducing employee choice, and Chile allowing sub-funds with different risk profiles. Sweden offers fund choice but a single investment administrator.</p> <p>There is no clear evidence from international experience on the benefits of employer funds. The trend to increased choice does not show limiting diversity failed: in Singapore, it replaces an opaque and hyper-conservative government monopoly; in Australia, the trend is ideologically driven.</p>
Asset allocation	All countries impose prudential regulation and limit concentration of investments. There is a bias toward domestic and fixed income investment that has resulted in low returns in Singapore and Switzerland. The UK should aim for international diversification and proper risk management rather than conservatism.
Maximum pension charges	No country imposes a cap on charges. Systems that effectively concentrate investment management and administration produce lower charges without lower gross returns. This should be an objective for a UK system.
Government guarantee	<p>Most countries offer a minimum pension guarantee. Some (Singapore, Switzerland & Chile) also offer a minimum investment return on pension funds though this tends to result in more conservative investment strategies and lower returns. In countries that do not offer a guarantee there does not appear to be a problem of consumers perceiving one to exist.</p> <p>A minimum pension guarantee is the most likely route for the UK though this depends on how the rest of the system for dealing with low incomes is designed.</p>
Pension taxation	<p>Most countries offer tax relief on contributions and investment returns, and then tax pensions as income. The exception is Australia, which used the introduction of compulsion to claw back tax breaks on pensions.</p> <p>Given increasing tax raises necessary contribution rates, the UK would be well advised, at least initially, to maintain existing tax benefits for pensions.</p>

Introduction process

There are no constants in how compulsion has been introduced internationally: all has depended on the circumstances of individual countries. If there is a similarity it is problems in the existing social security system. In Sweden and Chile this meant that compulsory contributions could be entirely offset by lower social security contributions: the actual sums paid did not rise. Chile and Singapore, meanwhile, introduced compulsion under authoritarian governments.

Australia, often cited as the example closest to the UK, was a particular paradox: compulsion was introduced voluntarily, in a bargain between employers and unions, and only later formalised in law. That process probably cannot be repeated in the UK.

Most countries have phased compulsion in by slowly increasing the rate rather than introducing it by cohorts. Another lesson the UK may choose to follow is offsetting some of the increased compulsory saving by cutting social security contributions.

Effects of compulsion

There are many other influences on the savings rate, so unambiguous evidence that compulsion raises saving is not possible, though most academic research suggests that there is a link. The lesson from Australia, however, is not to promise a rise in overall savings, in case it is offset by other factors.

The international experience shows that compulsion, in itself, is not enough to guarantee adequate pension coverage. Australian compulsion will provide inadequate pensions, as compulsion will in Singapore, while, in Chile, pensions will only be adequate for some. The requirements for adequate compulsion are: (a) a high enough contribution rate; (b) low enough charges; and (c) sufficient barriers to leakage from pensions.

Experience elsewhere does suggest that concerns over unwanted side effects, or damage to the financial infrastructure, are unwarranted.

Summary

The main lessons of the international experience for the UK are:

- Compulsion can be effective in raising savings rates and pension coverage, but achieving the latter depends on a high enough contribution rate, low charges, and preventing pension money from leaking before retirement.
- There is no standard approach to assisting low earners. Government contributions, tapered contribution rates and a minimum pension guarantee can all be effective. Compulsion schemes usually exclude the self-employed.
- No country has yet found a truly effective pension vehicle. Charges tend to be lower, however, when investment, administration, or both are reasonably concentrated. Evidence as to whether competition lowers costs is weak.
- Investment rules have tended to encourage inefficiently large holdings of domestic and fixed income assets.
- Compulsion has generally developed rather than damaged domestic financial markets. It does not appear to have caused serious problems of poverty among the generation in work.

Appendix D: Questions for the Working Group

1. Do you agree that ensuring comfort in retirement should be the objective of compulsion? Is the mid-point chosen by the Commission an appropriate benchmark?
2. Is 15% an appropriate target rate to ensure comfort in retirement? Should we adopt a single rate with a floor and ceiling on the income range to which compulsion should apply, or should we adopt 15% as a median rate, with higher and lower percentages applying to different income ranges?
3. Is the Pensions Commission's definition of the pensions shortfall satisfactory for the purposes of developing a model for compulsion?
4. What assumptions should the working group make about the state system that would exist alongside increased compulsory savings?
5. What assumptions should the working group make about the retirement age?
6. How should investments in, returns on, and income drawn from a compulsory pension be taxed?
7. On what basis should the income floor, below which contributions would not be made, be calculated?
8. Is an inadequate projected final pension under a compulsory scheme justification to set a floor below which those on low incomes should make no contributions?
9. If so, on what basis should that decision be made?
10. Does the working group agree that there should be a maximum level of income above which earning should not be subject to compulsion?
11. How should a compulsory scheme respond to potential disincentive to work for those on low incomes?
12. How should the system treat the self-employed? Should they be compelled to contribute at the same level as employees, or at a reduced rate, or not at all? Should other incentives to save be offered?
13. How should the system treat uneven work records?
14. Should contributions come from employers, employees, or both? If both, then what balance should be struck between the two?
15. What vehicle should invest compulsory pension contributions? How would it interact with the existing pension system?

16. What investment system design should be adopted? How would compulsory pension vehicles be regulated within this system?
17. Should compulsory pension savings carry a government guarantee? Will they be perceived to have a guarantee regardless?
18. At what age and in what form should compulsory pension savings become accessible?
19. Are there any circumstances in which savers should be able to access their compulsory pension fund early? What would be the rules for doing this?
20. How would any trade-off between employer contributions and wage increases be managed? Should compulsion be introduced gradually, either through a gradual ratcheting up of rates, or through the application of compulsion only to those in lower age cohorts? Over what timescale should this be introduced?
21. How could compulsion be sold to the public?
22. How will compulsion change overall levels of savings and debt? What effect will this have on the macroeconomy?
23. How will compulsion affect the economy overall?
24. What effect will the system have on intergenerational equity?
25. How would compulsion affect existing pension and savings vehicles? What would be the impact on the industry?
26. What criteria must a compulsion system meet for success? What modelling is needed of compulsion policy options?