Don’t let this crisis go to waste

A simple and affordable way of increasing retirement income

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A NOTE ABOUT NUMBERS

Inevitably this paper includes some numbers to help illustrate particular points. For simplicity, all numbers that are the result of calculations that involve the future are expressed in terms of today's money. Assets are assumed to grow at 2% ahead of earnings, unless otherwise stated, with state benefits growing with earnings. Again, for simplicity, the illustrations assume that people are single and live for 19 years after reaching the State Pension Age (SPA), as per current Department for Work and Pensions modelling.

The State Pension Age and the linkage of the basic State Pension to earnings

To facilitate comparisons, this paper makes no proposals in respect of either changing the SPA, as detailed in the Pensions Act 2007, nor does it discuss the restoration of the State Pension's link to earnings. **Silence on these two crucial issues should not be interpreted as a recommendation to leave them unchanged.**

SUMMARY

- This paper presents eight proposals to make Britain's income-in-retirement landscape sustainable.

- They have been developed in the context of viewing income-in-retirement as a single system with four components: the State Pension, occupational pension schemes, public sector pensions and income derived from personal retirement savings.

- Current expectations of a comfortable and lengthy retirement funded by the state are out of date. Rather, a sustainable and more generous framework is required for our older pensioners and those on lower earnings, founded on the following principles:

  – we should be protected from poverty in old age;

  – we will have to rely less on the state and more on personal savings if we want our retirement income to meet our expectations; and

  – lasting affordability, fairness and simplification are desirable.

Proposal 1: a more generous State Pension for senior citizens

- The State Pension should be substantially increased ten years after the State Pension Age (SPA) to coincide with the onset of "senior citizenship". This increase should be large enough to lift all eligible pensioners above the Guarantee Credit limit and out of poverty.

Proposal 2: end State Second Pension accruals

- State Second Pension (S2P) accruals should cease, consequently ending all contracting out. S2P rights accrued to date would be preserved. In time, S2P would disappear (a huge simplification step) although National Insurance contributions (NICs) would continue to be paid.

- S2P and S2P NIC cashflows would be re-engineered to help finance the additional cost of the larger State Pension for senior citizens. Financing is also assisted by more people contributing full rate NICs (contracting out having ended) and reduced means-tested benefit payments.

- There are also significant savings from delays in cash outflows: contracting-out rebates will end and the State Pension increases for senior citizens will commence ten years after the SPA, whereas previously S2P commenced at the SPA.

Proposal 3: amend the Personal Account

- A new defined contribution-based, state-sponsored, retirement savings scheme is proposed, the "Flexible Retirement Savings Account" (FRSA). This should replace the Government's proposed Personal Account (PA), which is fundamentally flawed. The latter lacks the structural flexibility to accommodate the needs of future pensioners and also invites a potential mis-selling scandal through its interaction with means testing.

- FRSA contributions should total 7% of **gross** earnings, comprised of 3% from the employee with a 1% tax credit, and 3% from the employer (tax deductible, with no requirement to make contributions above, for example, the Upper Earnings Limit). The employee tax rebate rate is therefore 33% for everyone, irrespective of their marginal rate of tax. This could be marketed as “pay £3 and get £1 free”, and provides a significant incentive for 20% threshold tax payers to contribute more than the 3% minimum. The contributions top-up for those on low incomes (below about £10,900) provides an even bigger incentive.

Proposal 4: enhance FRSA contributions of those on low earnings

- Those on low incomes, or with intermittent employment, should have their contributions enhanced by the state, perhaps up to 3% of median earnings. The self-employed should be able to contribute as both employee and employer, with a tax rebate on the combined amount.

- After reaching the State Pension Age, savers would have flexibility as to how they realise their FRSA assets. There should be no obligation to purchase an annuity, (which penalises those with shorter life expectancy, often the less well-off). This paper presents arguments both for and against compelling private (as well as public) sector workers to participate in the FRSA, the alternative being auto-enrolment.

- Confident that the state would sustain them in their later years, FRSA savers would then be free to concentrate their FRSA asset-derived income on ten years of active retirement immediately following the SPA, rather than having to stretch it out until they die, via an annuity. This would substantially boost incomes during that period and send a strong message that opening an FRSA is worthwhile for those even in their 50s. Equally, people would be free to delay realising their FRSA assets, perhaps because they have chosen to work beyond the SPA.

- FRSAs can be expected to accumulate significant assets; for example, a 40 year old on the National Minimum Wage who saves until reaching the SPA could expect assets of over £43,000. This could be used to purchase a ten year annuity that would produce weekly income of £93 (for someone on median earnings, these figures would be over £92,000 and £197, respectively).

- This would be far more generous than the Personal Account. The corresponding lifetime annuities for the same people saving 8% of band earnings within a PA would be £32 and £102 a week.

	FRSA weekly income	Personal Account weekly income
On the Minimum Wage	£93	£32
On Median Earnings	£197	£102

Assumes a 2.5% real rate of return on investment.

- The FRSA is far more likely than the PA to be a suitable retirement savings product not just for low earners, but also for those in their forties and fifties because it delivers income in retirement relatively rapidly. This will particularly benefit those with shorter life expectancy, as they can realise all of their FRSA assets by the time they become senior citizens.

- To encourage FRSA participation further, some access to assets should be permitted prior to reaching the SPA.

- The self-employed, whom the PA ignores, should also be able to contribute employee and employer contributions with tax relief on both contributions.

- A robust model will be required to determine the transition to the FRSA so that the net cost is controlled. It should be designed to exploit the virtuous circle that will emerge. This will take a substantial period of time. Once transition to the new structure is completed, means testing of senior citizens would largely disappear, restoring dignity in retirement.

Proposal 5: FRSA assets to be transferable, on death, free of IHT

- It is proposed that savers should be able to bequeath their unused FRSA assets to third parties free of any inheritance tax (IHT) liability, provided that the assets go into a retirement savings scheme. This would encourage a cascading of wealth down the generations and reinforce the sense of personal ownership of FRSA assets.

Proposal 6: public sector pensions to be cashflow self-sufficient

- Unfunded public sector pensions are unaffordable and inequitable in comparison with private sector employees. The rapidly growing unfunded liability is alarming. The Treasury is making up the annual shortfall as pensions in payment are now increasingly exceeding contributions from employees and employers.

- Every public sector employer should be required to implement a plan to achieve Pay-As-You-Go (PAYG) self-sufficiency in respect of its employees' pensions, within a specific timeframe, thereby ending the Treasury's open-ended exposure to public sector pensions. The plans to achieve such cashflow self-sufficiency should be made public and such transparency, coupled with public sector employers having to pay more NICs (contracting out having ended), will encourage them to exert greater control over the ongoing accumulation of unfunded pension promises. Innocuous accounting entries will increasingly be overshadowed by the reality of cashflow discipline.

Proposal 7: require all public sector employees to pay into an FRSA

- All public sector employees should be compelled to pay into an FRSA, funded, defined contribution scheme. Employees should contribute at least 3% of gross earnings, with employers' contributions being determined by negotiation, set against the backdrop of being required to achieve pensions self-sufficiency.

Proposal 8: clarity on future public sector pension liabilities

- A new chapter in the Financial Statement and Budget Report should provide forecasts of future public sector pensions in payment, and a description of how they will be funded.

- This will introduce greater control over the ongoing accumulation of unfunded public sector pension promises, by introducing greater cashflow discipline and enhancing transparency. The latter will reveal the true cost and value of public sector pensions, a prerequisite for achieving fairness vis-à-vis the private sector.

- Responsibility for the proposed changes to public sector pensions should lie with individual public sector employers. Central government's role should be limited to requiring the employers to become self-sufficient in respect of pensions financing; employers should be left with discretion as to how they achieve this.

- Taken together, these eight proposals are designed to catalyse a culture of retirement saving, particularly among low earners. This would encourage individuals to assume personal responsibility for providing for their retirement income, to the benefit of all.

1. INTRODUCTION

2009 marks the centenary of the introduction of the State Pension by Lloyd George. While this is a cause for celebration, it is no secret that continuing with the current system, of taxing working Peter to pay pensioner Paul, is unsustainable given the demographic and dependency ratio trends.

The UK already has one of the meanest State Pensions in the OECD.[1] This will only get worse as actuarial reality, the declining number of tax-paying workers per pensioner and improving longevity, are creating an unavoidable cashflow shortfall. A decent State Pension, and unfunded public sector pensions, are becoming unaffordable. NICs and tax receipts are increasingly insufficient to meet the pension obligations.

This outlook, dire in itself, is exacerbated by recession and fiscal difficulties. It will not be improved by the Government's proposals for a Personal Account (see Chapter 3). Rather, it is time to find a sustainable alternative.

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1 Throughout this paper, the State Pension is taken to mean the basic State Pension (BSP) and the State Second Pension (S2P) combined, unless otherwise stated.

2. THE NEED FOR RETIREMENT SAVING

The ageing population

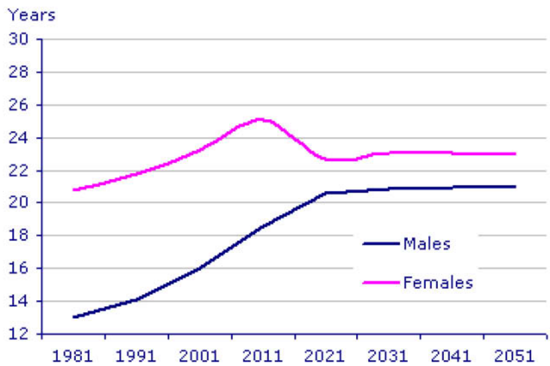
The UK's ageing population is sometimes referred to as the primary reason to promote retirement saving. Part of the concern is that it is becoming harder for today's workers to support a growing pensioner population.

However, two Pensions Acts have done much to address this problem. The Pensions Act 1995 raised the SPA for women from 60 to 65 between 2010 and 2020 while the Pensions Act of 2007 will postpone the State Pension Age (SPA) to 68 for all (in 2046). This latter Act will effectively reclassify those who would have been younger pensioners (aged 65 to 67) as part of the working age group.

Together, these Acts have almost halted the increase in the length of time that people will be in receipt of the State Pension, thereby introducing a degree of control over the affordability of the State Pension. Before the 2007 Act, pensioners were expected to comprise 26.7% of the population in 2046, up from 19.3% today. Now we can expect only a marginal increase (to 20.7%). The average pensioner will, of course, be older.

The increases in the SPA have a significant impact on life expectancy *at* the SPA. For the average person it will almost level off between 2021 and 2051, when the planned increases in SPA match projected increases in life expectancy (see Figure 1). The gap between male and female life expectancy at retirement will narrow (to about two years) as women's SPA aligns with that of men.

Figure 1: Life expectancy at the State Pension Age (SPA)



Office of National Statistics (ONS) Pension Trends series, 15 December 2008.

Support ratios

Table 1 compares today's population with a projection for 2046, the year that the forthcoming changes to the SPA come into full effect.

It is startling to see how, because of these reforms, the working age group remains at 62% of the total population while the pensioner population remains at 20% of the total population.

Table 1: UK working and inactive population[2]

	Under 16			16 to SPA			SPA			Total		
	2009	2046	+/-	2009	2046	+/-	2009	2046	+/-	2009	2046	+/-
Working	0	0	0	490	490	0	21	31	10	511	521	10
Inactive	187	173	-14	130	130	0	172	176	4	489	479	-10
Total	187	173	-14	620	620	0	193	207	14	1000	1000	0

Data per 1,000 population.

Forecasting the proportion of economically active in 2046 is obviously open to debate. But it has been consistent since 1971, fluctuating with the economic cycles, between 77% and 81% of those between 16 and SPA.[3] The 2046 forecast assumes that pensioners will become slightly more economically active, up from 11% to 15% (likely to be much higher had the SPA not been pushed back in the 2007 Pension Act). Based on this demographic data, Table 2 shows some of the key support ratios.

Table 2: Key support ratios

		Before SPA changes		After SPA changes	
Support Ratio	**2009**	**2046**		**2046**	
Pensioner (working age/pensioners)	3.21	2.12	-34.0%	3.00	-6.8%
Total age (workers/pensioners + children)	1.63	1.28	-21.4%	1.63	0.0%
Economic (working/inactives)	1.05	0.98	-10.3%	1.09	4.1%
Total ratio (working/population)	0.51	0.48	-5.9%	0.52	2.0%

2 Government Actuary's Department (GAD), *National Population Projections, 2006-based; Great Britain. Activity rates from ONS, Economic & Labour Market Review,* "Economic Inactivity", February 2009.

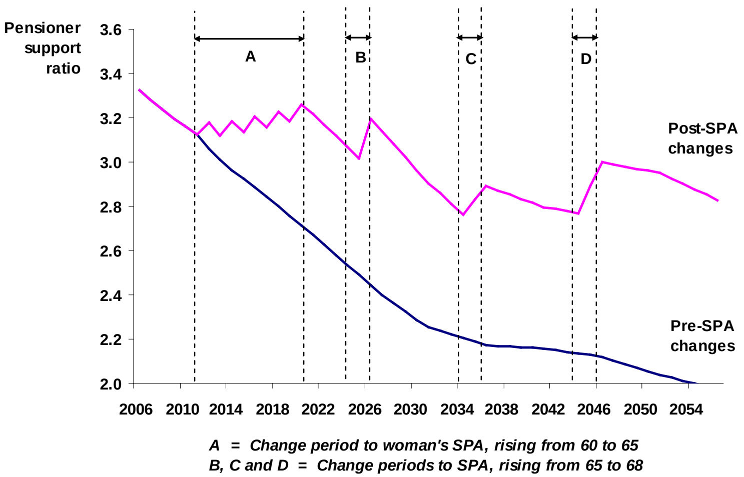
3 Activity rates from ONS, *Economic & Labour Market Review,* "Economic Inactivity", February 2009.

Thus, for example, in 2046 there are expected to be 3 people of working age per pensioner, still less than today's 3.2 but hugely better than the forecast of 2.1 before the SPA changes were made.

But these numbers are not sufficient reason to relax, because, as Figure 2 shows, *after* 2046 all the support ratios revert to their downward trend; the changes to the SPA have merely delayed the process.

As an aside, the picture in the EU is bleaker.[4] By 2060, there will be just two people of working age for every person over 65, instead of the current four. This is expected to place a significant strain on public finances, with spending having to rise by an average of 4.7% of GDP by 2060 to meet higher pension, healthcare and long-term care costs for the elderly. Simultaneously tax revenues will be in decline as the working-age population shrinks.

Figure 2: The pensioner support ratio



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4 The European Commission, *The 2009 Ageing Report,* 2009.

The National Insurance Fund (NI Fund)

The NI Fund was set up in 1948. It receives NI contributions and pays out NI benefits, including the State Pension, operating mostly, but not entirely, on a PAYG basis. During 2009-10, the NI Fund is expected to make payments totalling almost £75 billion, £66.3 billion being the State Pension (£53.5 billion as basic State Pension and £12.8 billion as S2P).[5] Contributions received in excess of benefits paid are retained by the NI Fund; a £2 billion surplus is expected for 2009-10, taking the size of the NI Fund to almost £55 billion.[6]

Given that the NI Fund's asset float (or surplus) is equivalent to more than 80% of the annual State Pension payments, there appears to be a reassuring buffer against future pensions in payment exceeding NI contributions. But the forthcoming return to indexing the basic State Pension (BSP) to earnings rather than prices will both consume the annual surplus and erode the buffer.[7] The additional cost is cumulative: over a ten year period, earning-linkage could add a total of more than £60 billion[8] to the cost of the BSP, and over 20 years, a total of more than £255 billion in additional costs.[9] The alternative is a politically unpalatable increase in NICs.

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5 *Report by the Government Actuary on the drafts of the Social Security Benefits Up-rating Order 2009 and the Social Security (Contributions) (Re-rating) Order 2009,* January 2009. See Glossary for details on the basic State Pension and S2P.

6 GAD eNews, *The National Insurance Fund,* April 2009.

7 The Pensions Act 2007 restores the basic State Pension (BSP) to being indexed to earnings rather than prices, by the end of the next Parliament at the latest (in 2015).

8 The BSP in 2009/10 costs £53.5 billion; add 2% p.a. to this cost.

9 Calculation is based on the assumption that earnings rise 2% p.a. quicker than prices (the cost of the BSP is expected to cost £53.5 billion).

There are other reasons not to be complacent about the current NI Fund surplus. The extent to which longevity could continue to improve is a huge unknown, the pensioner support ratio will deteriorate over the next generation notwithstanding the planned increases in the SPA (which will arrive much later than earnings indexation). Furthermore, from April 2010, the number of qualifying years (of NICs) required for a full BSP reduces to 30 years for men and women (down from 44 years for men and 39 years for women).

An unsustainable strategy

Historically the undeclared strategy to remedy the State Pension affordability issue has been a combination of cutting the basic State Pension in real terms relative to wages (now worth just 16% of average earnings, compared with 26% in 1980[10]), increasing the workforce via immigration and relying on continuing productivity gains (which, over the last 20 years, have outweighed the negative impact of an ageing population). All three strands of this strategy are now under attack.

The Government's decision to restore the BSP to earnings indexation will increase the cost of the BSP from 4.3% to 5.9% of GDP by 2050.[11] With regard to immigration, it is neither possible nor desirable to continue unrestricted immigration. The UK already has the fastest population growth rate in Europe: the 61 million now is forecast to be 73.8 million in 2046.[12] And it is surely unwise to assume that productivity growth will continue at the rate of the last 20 years.

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10 Institute of Actuaries, *100 Years of State Pension*, 2009.

11 DWP, *Saving for retirement: Implications of pensions reforms on financial incentives to save for retirement*, 2009.

12 ONS, 2006-based National Population Projections.

In addition it is assumed that occupational pension schemes will continue to meet the income-in-retirement needs of many. But there is a continuing retreat from assured (i.e. defined benefit (DB), or final salary-based) pension provision by private sector employers.[13] Defined contribution (DC, or money-purchase) schemes are becoming the norm, with the employee, rather than the employer, taking the investment risk and, almost always, with far lower contributions.

But the biggest risk is that the majority of those approaching the (retreating) SPA will not be in work, either because they cannot find it or because they don't want it. It is hard to envisage that there will be millions of new jobs available for those in their sixties when today, across Europe, only 50% of people are still employed at the age of 60.[14] Only a huge change in employer and employee attitudes towards longer working will address this. This is unlikely, although doing away with the employers' obligation to pay NICs in respect of workers over the SPA would help (these workers already don't pay NICs).

We cannot rely on the past strategy to maintain the affordability of a meaningful State Pension and continue to bail us out of demographic reality. It is true that the forecasts for the support ratio do not look too bad, and they are certainly better than many would expect. But they provide false comfort because they do not acknowledge that the strategy is unsustainable. We run the risk that by the time we discover that there is a problem, in the form of widespread pensioner poverty, it will be too late to do anything substantive about it.

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13 See Glossary for a definition of Defined Benefit and Defined Contribution schemes.

14 The European Commission, *The 2009 Ageing Report,* 2009.

In this light, we should recognise that the expectation of a comfortable and lengthy retirement funded by the state is out of date. We live longer than we used to, and should therefore expect both to have to work for longer and to rely more on personal resources for retirement income.

The retirement savings challenge

The need for more retirement savings is therefore great. Yet attitudinal, behavioural, informational and structural barriers seriously inhibit retirement saving.[15] Many people lack the necessary financial understanding to make informed decisions or have difficulty accessing information. Financial myopia – "spend now" – is commonplace, particularly understandable amongst those on low incomes whose behaviour is more influenced by immediate deficiency rather than the prospect of distant, and uncertain, future reward.

In addition, the well-publicised problems of pensions mis-selling have bred popular cynicism, as has the collapse in confidence in the financial sector as a whole.[16] And then there is inertia: we all know that we should plan for our retirement, but apathy and procrastination envelop us, perhaps with a dose of fatalism and futility. Finally, there are structural barriers, notably the sheer complexity of many pensions savings products, the State Pension (e.g. contracting in and out) and the taxation and benefit systems (e.g. different escalation rates for different benefits).

The DWP is aware of these behavioural challenges. It has published a report that specifically considers saving incentives

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15 DWP, *Incentives to save for retirement: understanding, perceptions and behaviour*, 2009.

16 DWP, *Live now, save later? Young people, saving and pensions*, 2007.

and their impact on behaviour and outcomes.[17] However, it implies that the current structure of the Personal Account is ideal. It is not, and from some perspectives it is fundamentally flawed. Also, by its own admission, the DWP report does not take into account important behavioural traits, such as how strongly people value money available now compared to money to come in the future. It also ignores the relative value of money over time; for example, during a period when income is relatively low, each pound is thought of as being worth more than when income is larger.

A bolder vision is needed.

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[17] DWP *Saving for retirement: Implications of pensions reforms on financial incentives to save for retirement*, 2009.

3. THE PERSONAL ACCOUNT'S FUNDAMENTAL FLAWS

The Government's Personal Account is the latest proposal for a state-sponsored retirement saving scheme.[18] Its objective is laudable. It aims to help the 7 million people who are not making provision for retirement that even they would consider adequate.[19] And, as a workplace-based scheme, the PA has the advantage of reaching a broad section of the population as well as allowing for deductions at source. First proposed in late 2005,[20] it is due for implementation in 2012. But as currently structured it is fundamentally flawed.

Inflexibility

The PA's lack of structural flexibility is a serious flaw. It fails to recognise that, for most people, there is a "U" shape to spending in retirement; high in the early years of active retirement, followed by lower outgoings in the more sedentary years, but then picking up with expensive long-term care.

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18 See the Glossary for full details of the Personal Account.

19 DWP, *Security in retirement: towards a new pensions system,* May 2006.

20 Initially as the National Pension Saving Scheme, in the second Turner Report, November 2005.

In addition, pre-retirement access to funds is not permitted. This is a disincentive to save; a more enlightened approach is needed, similar to some of the features within the 401k plan in the US.[21]

The PA structure also fails to acknowledge that, increasingly, people want the flexibility to choose whether to continue working after reaching the State Pension Age. Consequently they may wish to delay the realisation of their retirement-focused savings, and certainly not be compelled to purchase a lifetime annuity. The latter is intended to provide insurance against outliving one's accumulated assets, but commercial annuity rates have to err on the side of caution because of uncertainty about the path of future longevity.[22] Regulatory pressure on life companies to improve their capital ratios is adding to the problem.

As a result, annuity rates are often very unattractive. Furthermore, compelling the purchase of an annuity imposes an injustice upon those who do not meet their life expectancy. Given that, in general, the poor in society live shorter lives than the better off, the annuity requirement effectively requires the poor to subsidy the rich. This is ironic given that the PA is primarily targeted at those on low incomes.

No redress for the iniquities of means testing

It has been estimated that up to 50% of pensioners will still be means tested in 2050;[23] the Pension Act 2007 merely constrains

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21 See the Glossary for details on the 401k plan.

22 Currently, the average Briton lives roughly 19 years after reaching the State Pension Age.

23 Pensions Policy Institute, *An evaluation of the White Paper state pension reform proposals*, July 2006.

future growth from what would otherwise be 70% by 2050.[24] While Pension Credit has helped reduce the number of pensioners in (relative income) poverty by one million since 1997,[25] few would dispute that the spectre of means testing is a disincentive to retirement saving and that it presents a barrier to replacing the dependency culture with one of self-reliance.

Pension Credit comes in two parts. Guarantee Credit tops pensioners' total income up to at least £130 per week (£198.45 for couples) and Savings Credit accrues at 60p for every pound of income derived from savings, between the State Pension and the level of the Guarantee Credit, thereby penalising people who have saved for retirement.[26] Consequently, pensioners receiving Savings Credit are effectively paying 40% tax on it, a significant anomaly given that most pensioners are basic rate tax payers.[27]

To illustrate how Pension Credit interacts with retirement savings, let's compare two 65 year old pensioners, both on a full basic State Pension (£95.25). Pete, with no other income, is eligible for Guarantee Credit of £34.75 per week (taking him up to the £130 limit) from age 65 to death, effectively a gift from the state with a present value, at 65, of £28,330.[28] Lucy, on the other hand, decided at the age of 40 to open a PA which, upon retirement at 65, provided her with an accumulated fund of the

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24 Pensions Commission, *A New Pensions Settlement for the Twenty-First Century: The Second Report of the Pensions Commission*, November 2006.

25 Work and Pensions Select Committee, Fourth Report, July 2006.

26 See Glossary for more details on the Guarantee Credit and the Savings Credit.

27 Increasing the Savings Credit accrual rate to 80p would be sensible.

28 Assuming Pete lives 19 years after reaching the SPA, and 2% p.a. net investment growth.

same £28,330. She used this to buy a lifetime annuity of £34.75 per week, and her Guarantee Credit was reduced pro rata, to nil. The blow is softened by Savings Credit of £20.40, the maximum that she can claim, taking her total weekly income up to £150.40.

Lucy is clearly better off than Pete, but is probably wondering why, as a low earner, her annuity is effectively being taxed at 40%, her 100% Guarantee Credit income being offset by Savings Credit's 60p for every £1 of annuity income. Had her annuity been any bigger, then her Savings Credit would actually have been cut back by 40p in every additional £1, a clear encouragement not to save too much. And, as an aside, had Lucy any other investments in excess of £10,000,[29] they would be deemed to produce income of £1 per week for each £500 of capital (i.e. an expected annual return of 10%), notional income that would also, effectively, be taxed at 40%.

During the 25 years that Lucy was saving in her PA, she would have had to put aside nearly £440[30] of disposable income *every year*, although she may have benefited from her employers' contributions and a tax rebate. But Lucy is unlikely to appreciate that whilst saving she assumed all of the investment risk on her assets, whereas Pete's Guarantee Credit is assured by the Government. That said, Lucy may have got lucky and found herself with a bigger fund than expected, and if not, her misfortune is 40% underwritten by the state. Indeed, Lucy would be well advised to go for a very aggressive investment policy, since her downside risk is to an extent protected; a smaller

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[29] From 2 November 2009, when the Social Security (Deemed Income from Capital) Regulations 2009 S.I No. 1676 come into effect.

[30] To accumulate, at 65, half of £28,330 (the other half is calculated to have come from employer contributions and tax rebate).

annuity for Lucy could well translate into more Guarantee Credit. Similarly, had Lucy earned less whilst working, the contributions into her PA fund would have been smaller, resulting in a smaller annuity and therefore more Guarantee Credit (assuming her total weekly income is less than £130).

It is clear that the relationship between the two components of Pension Credit and income is devilishly complicated. Above all, means testing acts to discourage the low paid, in particular, to save for retirement, the very group that the PA is intended to encourage. Furthermore, there is the potential for a future mis-selling scandal, unless low earners are advised to opt out (or the means-testing architecture is changed).

Finally, it is worth noting that by 2050 spending on Pension Credit is projected to fall from 1.1% to 0.5% of GDP.[31] This is the result of the BSP increasing, thereby lifting people off income-related benefits, and also an increase in the age at which people are eligible for Pension Credit (rising in line with the SPA). Given this, from an affordability perspective, it is important not to overplay the disincentive to retirement saving.

Derisory income in retirement

Let's consider four single men who will be aged 40, 45, 50 and 55 in 2012, all working a 40 hour week on the National Minimum Wage.[32] As low earners, they are very much in the target audience for the PA. Assume that they are all lucky enough to work full time until they reach the State Pension Age (SPA), and

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31 DWP, *Saving for retirement: Implications of pensions reforms on financial incentives to save for retirement*, 2009.

32 £5.73p an hour (£11,918 per year), from 1 October 2008 (uprated with earnings).

from 2012 they each save 4% of band earnings[33] in a PA (doubled care of employer contributions and tax credit). Upon reaching the SPA, each of them buys a lifetime annuity, having liquidated their accumulated assets. Table 3 shows their weekly (pre-tax) income from the annuity, expressed in terms of today's earnings.

Table 3: PA lifetime annuity income for workers on the National Minimum Wage (£ per week)

	Investment growth rates (in real terms)		
Age in 2012	**1.5%**	**2.5%**	**3.5%**
40	£25.9	£32.2	£39.9
45	£18.2	£21.9	£26.3
50	£12.7	£14.9	£17.5
55	£7.1	£8.2	£9.3

Assumptions: 19 years remaining life and, as per the DWP forecasting methodology, the Primary Threshold increasing at 2% p.a. real growth over earnings.

Given how small most of these annuities are, it is understandable why low earners in their 50s, in particular, may conclude that opening a PA in 2012 will not be worthwhile, not least because their disposable income is already likely to be minimal.

The core assumptions that DWP uses to underpin the Government's case for the PA warrant close examination. For example, the DWP uses 3.5% a year for the central long term real rate of investment growth.[34] The UK's post-war trend rate of economic growth has, however, been only about 2.5% a year (the Treasury currently uses 2.75%). So the DWP's assumptions appear

33 By reference to the Primary Threshold and the Upper Earnings Limit for National Insurance contributions (£5,720 and £43,888 respectively for 2009/10). See Glossary for a definition of band earnings.

34 DWP, *Saving for retirement: Implications of pensions reforms on financial incentives to save for retirement, Main Assumptions, Table A.1,* 2009.

overly optimistic. The DWP also uses 2% a year for real wage growth which, at least for the private sector, is also optimistic when one observes the impact that globalisation is having on wage growth of the low paid in other developed economies. Average real hourly wages in the US, for example, have been virtually flat for 30 years, growing a mere 4.4% (over prices) between 1981 and 2006.[35]

Trivial commutation

It is also worth noting that the PA is expected to be subject to the same rules as existing pension schemes for access to funds upon retirement. This includes a curio called the trivial commutation limit, currently £17,500. Individuals with accumulated pension savings of less than this are not required to buy an annuity to provide a regular income; they can take the lot as a taxable lump sum (with 25% tax free). In all of the above examples,[36] the saver would be able to take advantage of trivial commutation. While this does provide an incentive to save up to the trivial commutation limit, it also provides an incentive not to accumulate assets above this level, not least because once the limit is exceeded, none of the pot can be trivially commuted. Furthermore, there is then nothing to prevent people immediately spending all of the lump sum and then falling back on the state by claiming Pension Credit.

Misleading contribution rate

The PA's headline total contribution of 8% is potentially misleading, because many – including the Personal Accounts Delivery Authority (PADA), a quango charged with setting up the PA scheme – might assume that it refers to *gross* earnings. For

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35 CEA, *Economic Report of the President 2006,* 2006.

36 Adopting the DWP's modelling assumption that the commutation limit is up-rated with earnings.

over a year, PADA's website stated that "an 8% contribution for an average earner (approx. £23,700) would be approximately £1,900 per annum, leaving ample headroom for additional contributions". The figure should have been £1,438, as 8% of band earnings, i.e. £23,700 less the Primary Threshold of £5,720.[37]

PADA has now corrected its mistake, but this illustrates how easy it is to misinterpret the PA contribution rate. In reality, PA contributions will never be more than 7% of gross earnings; for someone on median income (about £479 per week[38]) it is 6.2%, and much less for the (low earning) target audience.

In summary, the PA is unsuitable for many low earners. They should be advised not to open one. Its interaction with means testing is also of concern. Given that low earners are the primary target audience, the structure needs to be changed.

That said, the PA has already developed some momentum. PADA already employs more than 130 people (although the scheme does not come into operation until 2012). The proposals here are designed to reform the PA so that the risk of mis-selling is removed while also greatly increasing the income of those in retirement – particularly the low paid.

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37 See Glossary for details of the Primary Threshold.

38 Median weekly pay for full-time employees was £479 in the year to April 2008 (£24,908 p.a.); £521 (men) and £412 (woman). ONS, *The 2008 Annual Survey of Hours and Earnings*, 2009.

4. UNAFFORDABLE AND INEQUITABLE PUBLIC SECTOR PENSIONS

The precise size of the public sector pensions liability (or actuarial deficit) is open to question. But it is colossal, and certainly exceeds the official national debt of £750 billion.

The Government's preliminary estimate of the public sector's unfunded pension liability was £794 billion as at 31 March 2008. This is the present value of what taxpayers owe to public sector workers in the form of future pensions; calculating this number involves the discounting of future cashflows.

Here the debate starts: which rate of discount, or interest rate, should one use to do this? The Government uses the AA-rated corporate bond rate "to keep the public sector schemes in line with internationally accepted practice for private pension schemes";[39] the fact that the latter are funded is disregarded. The corporate bond yield curve is also higher than the Gilts yield curve, leading to a smaller liability than otherwise. Using government bond market rates (i.e. Gilts), Neil Record determined the figure to

39 As required by the Treasury's Financial Reporting Manual.

be £1,100 billion, 78% of the nation's annual economic product.[40] (In addition, the Government is inclined to underestimate life expectancy.)

The size of the problem is bad enough. But it is also growing: according to the Government's own estimates, the liability increased by 50% in three years (it was £530 billion at 31 March 2005).[41] The main cause is falling discount rates, which accounted for nearly £100 billion[42] of the £120 billion increase over 2005-06. Increasing life expectancy added another £9 billion.

It is true that interest rates cannot go much lower; indeed, some day they will rise again and the liability will reduce. But this is a distraction. So too is the precise size of the liability: it should be noted that, to some extent, the level of the liability is theoretical, even nebulous, not least because of the dramatic impact of interest rate changes on the figures. Rather, the two key questions concern affordability and equality. What impact are the public sector pension promises going to have on annual cashflow (impacting the taxpayer)? And what are the consequences of the growing inequality between public and private sector remuneration (including pensions)?

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40 Neil Record, *Public Sector Pensions: the UK's Second National Debt,* Policy Exchange, June 2009.

41 Government Actuaries Department (GAD).

42 HM Treasury, *Long-term Public Finance Report; An Analysis Of Fiscal Sustainability,* March 2008.

Affordability

(a) Annual cashflow

Unlike private sector schemes, public sector pensions are mostly unfunded.[43] In these cases, there is no underlying pool of ring-fenced assets generating income to pay them. Instead, pension payments are met on a pay-as-you-go (PAYG) basis, the cashflow being derived from employer and employee contributions and a growing direct subsidy from the tax payer. As Table 4 shows, in 2008-09 the Treasury is expected to have received contributions of £19.5 billion from public sector employers and employees, and paid out £22.6 billion to public sector pensioners.[44]

The £3.1 billion gap (bridged by general taxation) looks relatively palatable when compared with total public spending of £607.2 billion.[45] But the table shows how contributions are falling behind pensions being paid in the same year, caused partly by increasing longevity. The shortfall is rising, and is expected to continue rising.

Indeed, the 16% increase in the number of public sector employees since 1997, from 5.17 million to 6.02 million,[46] will produce a surge in pension payments in the future. Even worse,

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43 Some schemes, such as those for local government employees and teachers, are at least partly funded out of investments.

44 ONS, *Public Expenditure Statistical Analyses (PESA) 2009 National Statistics release*, May 2009. This covers central government pension schemes; it excludes unfunded local government schemes (including the police and fire-fighters).

45 Total Managed Expenditure, the sum of the Departmental Expenditure Limits and departmental Annually Managed Expenditure resource budgets.

46 ONS Statistical Bulletin, *Public sector employment, Q1 2009*, 2009. The inclusion of Royal Bank of Scotland Group and Lloyds Banking Group in the public sector (in Q4 of 2008) increased public sector employment by 230,000.

this could coincide with a reduction in the public sector workforce, and therefore fewer contributions.

Table 4: the growing PAYG cashflow shortfall

£ billions	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Pensions contributions	£14.3	£15.1	£17.4	£17.9	£19.1	£19.5	£20.0	£20.7
subtract pension payments	£16.1	£16.4	£17.6	£19.1	£21.4	£22.6	£24.2	£25.3
= shortfall	£1.8	£1.3	£0.2	£1.2	£2.3	£3.1	£4.2	£4.6

Data for 2008-09 are estimated outturns; and for 2009-10 and 2010-11 are planned, as at May 2009.

The PAYG approach places no constraint on public sector employers making future pension commitments, and also masks any underestimate of the true cost of their promises.

(b) The accounting

In order to have a feel for the future cashflow (and taxation) implications of the public sector pension commitments, we have to look at the accounting. There are three significant non-cash accounting entries concerning public sector pensions that have implications for future cashflow. They are:

(i) the annual increase in the public sector pensions liability. This includes items such as the value of future pensions accrued by employees during the year and employees adding to their years of service. This is quoted gross: it *excludes* pensions in payment in the same year;

(ii) the reduction in the provisions put aside in prior years. This (roughly) mirrors the cash payments made to pensioners during the year (some relatively small payments were not provided for in earlier years); and

(iii) the unwinding of the discount rate. Each year, as future pension payments come a year closer, the diminishing effect of discounting them reduces, so the present value of the liability actually grows. This figure[47] is loosely equivalent to the amount of interest that the Government would have had to pay if the unfunded public sector pensions schemes had been funded. In 2007-08 the figure was £32.8 billion (Neil Record estimated it to be £45.2 billion using the (lower) Gilts yield curve for discounting).[48]

Note that discount rate changes only affect the theoretical actuarial liability; they have no impact on expected future cashflow and are therefore excluded (unlike assumptions concerning longevity).

Table 5 gives a rough estimate of the annual change in the present value (PV) of the future cash requirement, derived from the three (non-cash) accounting entries that signal a cash requirement in the future. Note that this is cumulative; in the eight years shown here, the PV of accounting items with cashflow implications will have increased by £258 billion.

Table 5: Increase in the PV of the future cash requirement

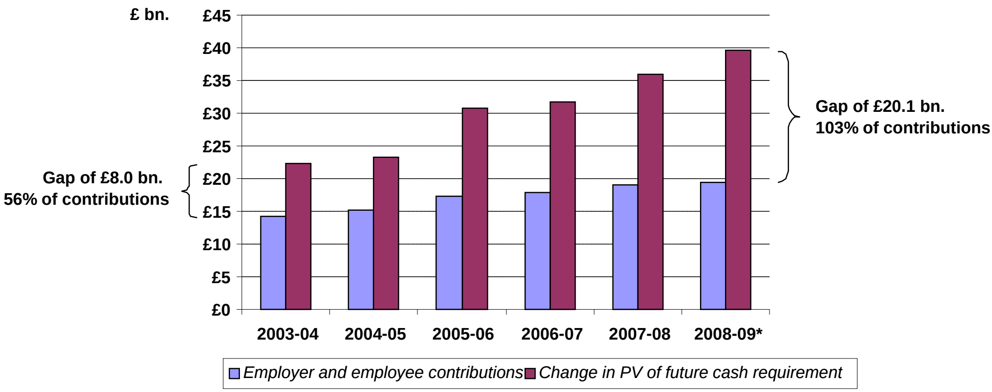
£ billions	**2003-04**	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10**	**2010-11**
Change in gross liability	15.4	15.3	20.9	21.2	24.4	25.5	21.9	22.7
subtract pension provision	15.4	16.2	17.5	18.9	21.3	22.6	24.3	25.1
plus unwinding of discount rate	22.3	24.1	27.4	29.6	32.8	36.7	38.4	40.8
Total	22.3	23.2	30.8	31.8	35.9	39.6	36.0	38.4

47 This is sometimes referred to as "interest on scheme liabilities"; not automatically a Gilt rate.

48 Neil Record, op. cit.

If we compare actual cash contributions with our measure of the annual increases in the PV of the future cash requirement (Figure 3), we see that the trends are diverging; contributions are increasingly being left behind. Over the last six years, the former have increased by 36% (from £14.3 billion to £19.5 billion), while the latter has increased by 78% (from £22.3 billion to £39.6 billion). This is clearly unsustainable.

Figure 3: Cash contributions falling behind the PV of the future cash requirement



(c) An international perspective

Table 6 compares the public pension liability in the UK, US and Canada in GDP equivalent terms.

Table 6: Public sector pension liabilities in GDP terms

	Reported liability	GDP equivalent	"True" liability	GDP equivalent
UK	£886 bn	64%	£1,177 bn	85%
US	£1459 bn	15%	£2,705 bn	28%
Canada	£106 bn	12%	£234 bn	27%

Reported liability uses governments' assumed interest rates.
True liability uses government bond rates as discount rates
British-North American Committee *The need for transparency in public sector pensions*, June 2009.

This illustrates that public sector pensions place Britain at a competitive disadvantage relative to Canada and the US (not to mention the developing world). This will manifest itself either as an increasing tax burden, cuts in public sector spending and investment or, most likely, a combination of both.

Inequality

(a) Pensions apartheid

Public sector employees receive more pension benefits, and at an earlier age, than similarly skilled employees in the private sector, and in recent years this differential has been growing. A lifetime civil servant, employed from the age of 21, could expect to receive a pension of £28,900, thanks to his (unfunded) DB pension scheme (the *implied* employer contribution rate being as high as 35.5% of salary). Conversely, a lifetime private sector worker of the same age could expect a pension of just £11,600, based upon his employer's contribution of, typically, 6% of salary into a DC scheme.[49] This divide has serious adverse implications for the mobility of labour between the public and private sectors.

Company scheme funds are now hugely in deficit; the aggregate shortfall (total assets minus total liabilities) of the UK's 7,400 defined-benefit schemes stood at £173 billion at the end of August 2009,[50] with 85% of the schemes showing a deficit.

Deficits by themselves are not the only concern; it is their volatility that also frightens equity investors. During 2009 alone, the deficit of the FTSE 100 DB schemes has swung wildly – between £17 billion and £80 billion.[51]

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49 These illustrations are taken from PricewaterhouseCoopers (PwC), *The Tortoise and the Hare 2 – a post mortem on their pensions race*, 2009.

50 Pension Protection Fund (PPF), 7800 Index.

51 Hewitt's Pension Risk Tracker.

In a recent survey, 81% of the private sector responses confirmed that they have closed their final salary schemes to new members of staff, whereas the majority of final salary schemes offered by the public sector are still open to new joiners.[52] Of private sector employees, 17% are in DB pension schemes;[53] the comparable figure in the public sector is 76%. The survey also found that 96% of all employers think DB pensions are unsustainable and 88% of private sector employers said the public sector has an unfair advantage in being able to offer quality DB schemes.

One can understand why the private sector is retreating from DB to DC pension provision. The deficits can be huge, and the accounting and regulatory environment imposes risks on employers which are outside of their control and unrelated to their core business. There are now only three FTSE 100 companies (Cadbury, Diageo and Tesco) continuing to offer DB schemes to new staff, payments being based either on an employee's final wage at retirement or their career-average salary.[54] Furthermore, when companies switch to DC they sometimes take the opportunity to reduce their contribution rates. 15% to 20% used to be common; today the average is 5.8% of basic salary[55] (14.2% for DB schemes). It is clear that the collapse of DB pensions in the private sector is occurring against a backdrop of relative generous public sector pension provision.

(b) The pay myth

Historically, the more generous public sector pensions have been justified by public sector pay being lower. Recent data

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52 PricewaterhouseCoopers, *Pensions Survey*, June 2009.

53 Institute for Fiscal Studies, *Reforming Private Pension Enrolment*, June 2009.

54 Lane, Clark and Peacock, *16th Annual Accounting for Pensions 2009 survey,* 2009.

55 Businesslink.gov.UK (Running a Pension Scheme).

debunks this argument. In 2008 the median gross weekly pay of full-time employees in the private sector was £460; the comparable figure in the public sector was £523.[56] The same picture is evident in respect of public sector graduate starter salaries, now ahead of those offered in the private sector. The average salary[57] for a graduate joining the Civil Service in 2007 was £21,885, 3.1% above the private sector average of £21,223.

A labour market unfairly skewed in favour of the public sector, with a pension promise against which the private sector cannot compete, is not in the national interest. It is also unfair on the majority of citizens who are not employed in the public sector. It is forcing private sector employers to offer wages that could render them uncompetitive, and is driving the more mobile industries offshore. Furthermore it restricts job mobility, the pension being a huge disincentive to leaving the public sector.

Conclusion: public sector pensions

Public sector pensions are unsustainable from the perspective of both affordability and equality vis-à-vis the private sector. Annual employer and employee contributions are increasingly falling behind pensions in payment, with the general taxpayer plugging the gap, as are annual increases in the PV of the future cash requirement. The latter point is subtly buried within seemingly innocuous accounting entries such as the unwinding of the discount rate. But huge numbers are involved that in the future may manifest themselves in increasing demands for hard cash.

The theoretical actuarial liability is growing at an alarming rate, albeit largely explained by recent falls in interest rates.

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56 ONS, *The 2008 Annual Survey of Hours and Earnings (ASHE)*, 2009.

57 Hay Group, *First Rung: Graduate Pay Trends,* 2007.

The objective for public sector employers should be pensions self-sufficiency, with contributions at least adequate to cover the same year's pensions in payment (i.e. a PAYG arrangement genuinely hypothecated to public sector pensions). Either contributions will have to rise, or DB, final salary commitments will have to be significantly less generous in the future.

5. A NEW APPROACH IS REQUIRED

The UK needs an income-in-retirement framework that is sustainable (both affordable and equitable), and which does not diminish the economy's competitiveness.

Consequently, retirement saving has to be substantially increased. This will require state-sponsorship of a suitable[58] product that is flexible enough to accommodate future lifestyles, one which offers incentives that overcome inertia, encourages personal responsibility and will catalyse a retirement savings culture. The PA does not meet these criteria. It needs to be amended, not least in order to prevent accusations of mis-selling.

At the same time, the State Pension needs to be simplified, not least to improve clarity of decision-making in respect of saving for retirement. And the pensions apartheid between the private and public sectors must be addressed.

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[58] See the Glossary for the definition of suitability as used by the pensions industry.

Tinker?

There are numerous ways to encourage retirement saving by amending the PA. Changing the rate at which benefits are withdrawn as income increases (the "taper rate"), disregarding a slice of pension income in benefit calculations ("income disregard"), increasing the amount of capital which can be held without it affecting benefit entitlement ("capital disregard"), increasing the trivial commutation limit and combinations thereof are all options. The DWP has analysed a number of these potential tweaks and concluded that their impact is mixed.[59] Most complicate the "incentives to save" message. None makes a large difference to the average payback and most increase the proportion of pensioners eligible for income-related benefits, reversing the direction of the DWP's intended reforms.

Act radically?

A more radical approach is to completely reform the means-tested benefits and State Pension architecture, in order to reduce their interaction with retirement savings and attune the State Pension to people's needs. Dramatically reducing means-tested benefits, for example, would make saving more likely, but would also lead to an unacceptable increase in pensioner poverty. This could be reduced significantly if the basic State Pension (BSP) were made universal, but this would cost £6.9 billion[60] in today's terms. Raising the BSP to the level of Guarantee Credit would cost £8.3 billion per year by 2017–18, and increasing a universal BSP to this level would cost at least £20 billion per year. All these would be unaffordable, at the best of times.

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59 DWP, Saving for retirement: Implications of pensions reforms on financial incentives to save for retirement, 2009.

60 IFS, *Pensioner poverty over the next decade: what role for tax and benefit reform?,* 2007.

Furthermore, restructuring the BSP, or means-tested benefits, in isolation does not address the PA's flaws. A more innovative approach is required.

The State Pension, a significant portion of public sector pensions and, to a lesser extent state-sponsored retirement saving (through Treasury-provided incentives) are all competing for the same, finite, Treasury and NI Fund resources. They are so entangled that the PA cannot be designed in isolation.

Finally, any proposals must be long lasting. The pensions framework requires a revolution, not evolution, but currently attention is distracted by the immediacy of the financial crisis. But such is the depth of the crisis that, ironically, it provides us with a golden opportunity to grasp some pension nettles, including confronting the fiendishly complex State Second Pension (S2P).

6. PROPOSALS FOR INCREASING INCOME IN RETIREMENT

The following five proposals are designed to address the majority of the income-in-retirement issues (with the exception of public sector pensions; these are addressed in Chapter 12).

Proposal 1: a more generous State Pension for senior citizens
Ten years after the State Pension Age, the basic State Pension should be increased to a level that will produce an income just above the current Guarantee Credit threshold.[61] Consequently all those who qualify for the full basic State Pension at the SPA (those with 30 years of NICs) will become ineligible for Guarantee Credit ten years after the SPA. This would be similar to introducing a new senior citizens' pension, but rather than treating it as a separate component of the state's post-SPA income provision, it is subsumed within the basic State Pension.

Proposal 2: end State Second Pension accruals
S2P accruals should cease, consequently ending all contracting out of private sector and public sector final salary schemes[62], and with it the need for complex contracting out rules (and

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[61] Currently £130 per week.

[62] The Pensions Act 2007 already provides for the abolition of contracting out of S2P for DC schemes.

advice to understand them). S2P rights accrued to date should, of course, be preserved and National Insurance contributions (NICs) will continue to be paid at the contracted-in rate.

In time, the complex S2P will disappear (a huge simplification step). In the interim, ceasing S2P accruals will provide an incentive to calculate, codify and then simplify the shambolic state of the existing records.

Proposal 3: amend the Personal Account

An alternative structure to the flawed Personal Account (PA) should be introduced, the Flexible Retirement Savings Account (FRSA). Contributions should total 7% of gross earnings, comprised 3% from the employee (paid net) with a 1% tax credit, and 3% from the employer (tax deductible). The employee tax rebate rate is therefore 25% for everyone (pay £3 and get £1 free), irrespective of their marginal rate of tax, providing an additional incentive to all basic rate tax payers which, of course, includes the low-earning target audience. Employers should not be required to make contributions above, for example, the Upper Earnings Limit.

The FRSA is designed to accommodate different post-SPA lifestyles and to motivate retirement saving. FRSA savers will be allowed to concentrate the realisation of their FRSA into a finite (ten year) period of more active retirement, providing “bridging” income between the SPA and the onset of senior citizenship. Alternatively, people should be free to delay realising their FRSA assets, perhaps because they have chosen to work beyond the SPA. There should be no requirement to purchase a lifetime annuity.

Just like the PA, the FRSA will be a defined contribution retirement savings scheme, created in the name of the individual to confirm a true sense of ownership. Unlike the PA, it is designed to supplement the State Pension for a finite period (rather than open-ended, until death), between the SPA and the onset of the more generous State Pension ten years thereafter.

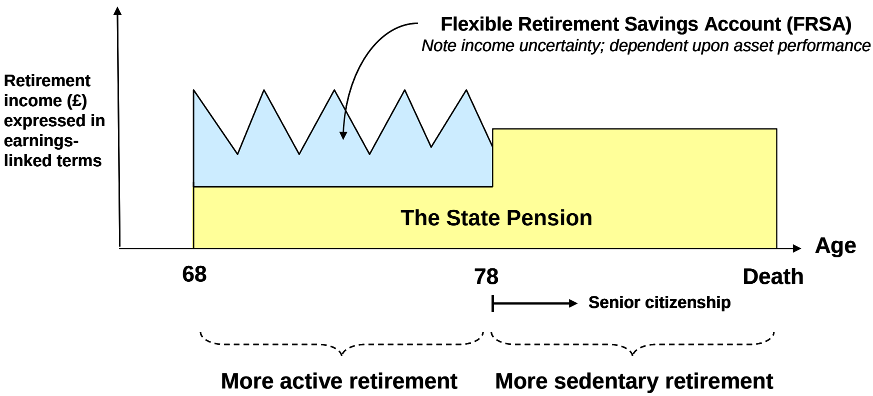
Proposal 4: enhance FRSA contributions of those on low earnings
The low paid should have their FRSA contributions topped up by the state, perhaps to a total of 3% of median earnings. Their asset pools are then likely to produce a post-SPA income that will materially help them to be self-reliant in later life, rather than falling back on the state for Pension Credit. In effect, this is pre-funding of means testing. The self-employed should also be able to contribute as both employee and employer, with a tax rebate on the combined amount.

Proposal 5: FRSA assets to be transferable, on death, free of IHT
FRSA savers should be permitted to bequeath their unused FRSA assets to third parties free of inheritance tax (IHT) liability, provided that the assets remain within a retirement savings scheme. This would encourage a cascading of wealth down the generations and reinforce the sense of personal ownership of FRSA assets.

The rise in home ownership has illustrated the strength of motivation to accumulate assets that can be passed on to children. The ability to pass FRSA assets on to children will be a further incentive to open an FRSA.

The new income-in-retirement framework, once transition is complete, is illustrated in Figure 4 (excluding all other sources of pension and retirement savings income).

Figure 4: The proposed FRSA and State Pension framework



It is increasingly questionable whether progressively raising the SPA for men and women to 68 by 2046 goes far enough, from an affordability perspective. Indeed, Lord Turner himself, since the publication of his second report which proposed the SPA increase, has revised his opinion.[63] In a recent interview, he said: "if I was to change anything now, I would suggest we go faster in increasing the State Pension Age".[64]

Linking the State Pension to earnings rather than prices raises an even bigger affordability challenge.

63 Pensions Commission, *A New Pension Settlement for the Twenty-First Century*, November 2005.

64 "Peston and the Money Men", BBC Radio 4, 7 September 2009.

7. FRSA STRUCTURE

FRSA contributions

The PA's contribution structure is expressed as a percentage of National Insurance band earnings;[65] 4% from the employee, 3% from the employer (the compulsory minimum) and (roughly) a 1% tax credit. Many believe that 8% of band earnings is not enough. For example, New Zealand's equivalent of the PA, KiwiSaver, allows employees to contribute up to 8% of their gross salary. And when compared to occupational schemes, the PA's 3% employer contribution (2.25% of gross income for the median earner) looks almost derisory, being less than half of the typically employer's contribution to DC schemes, 5.8% of basic salary,[66] and less than a fifth in respect of DB schemes (typically 14.2% of basic salary).[67]

Referencing contributions to NI band earnings is an unnecessary complication and meaningless to most people.[68]

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65 By reference to the Primary Threshold and the Upper Earnings Limit; £5,720 and £43,888 respectively for 2009/10, up-rated annually in line with average earnings.

66 Businesslink.gov.UK (Running a Pension Scheme).

67 See Glossary for more details on the KiwiSaver scheme.

68 See Chapter 3 for how PADA, initially, failed to understand the contribution structure.

Simplicity suggests that FRSA contributions should therefore be based on gross earnings, which has the added advantage of a lower perceived cost (than a band earnings basis), to both employer and employee.

Most people could be expected to stop their FRSA contributions when they reach the SPA, but if they choose to continue contributing beyond the SPA, their employers would no longer be compelled to do so, as a modest incentive to encourage the employment of older workers.

There are two important contribution-related features proposed for the FRSA that are not part of the PA, concerning the very low paid and the self-employed.

The low paid

Those on very low incomes, or with intermittent employment (including carers and, of course, many woman), are unlikely to accumulate significant assets in their FRSA. Consequently, when they reach the SPA they may well fall back onto the state via Pension Credit. It therefore makes sense for the state to enhance the total FRSA contributions of the low paid (including the employer contribution and tax rebate) to 3% of median earnings, say, equivalent to £762 per annum. Consequently anyone (today) earning less than £10,888[69] per year would have their contributions topped up.

Topping up low earners' FRSA contributions is the equivalent of pre-funding what will otherwise be, for many of the low paid, means-tested benefit payments in the future. This does mean that one generation will be paying twice over for means testing, but the cost can be contained by spreading it over a lengthy transition period (see Section 8).

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69 £762 = (7% x £10,888).

The self-employed

The PA prejudices the self-employed because they miss out on the 3% employer contribution; the suggestion for the FRSA is that the self-employed should be able to contribute to their FRSA as both employee and employer, with a tax credit on the combined amount.

There is also the question of migrant workers who work in the UK sporadically. Depending upon their nationality, they should perhaps be allowed to open an FRSA although, given their focus on immediate cashflow, it is unclear how many would choose to do to. That aside, there is a risk that this would create administrative complexities such as a large number of tiny unclaimed asset pools.

FRSA assets

Savers should be free to invest as they see fit, paying for advice if they so wish. This would give the Independent Financial Adviser (IFA) community an opportunity to provide advice in respect of asset selection and help propagate the "saving makes sense" message, thereby broadening FRSA take-up.

That said, many people are bewildered by choice, let alone making financial decisions, so it is essential that an advice-free default option is available to them. It should be managed in the private sector with fund management contracts being awarded on a competitive basis by an independent board, at arms length from ministers.

The default option could take the form of three large With-Profits funds, with all their attendant risk sharing features, using life-cycle principles so that asset allocation reflects the demographic distribution of the participants in aggregate. The three funds could be separated into younger, middle aged and those nearing the SPA, adopting different asset allocations to reflect the savers' proximity to the SPA. DWP modelling uses 80% equities and 20% fixed income (bonds and gilts) early in life, and then reduces risk as retirement approaches by moving to 100% fixed income over the final ten years. Alternatively there could be three default funds, say, each focused on a different asset composition to reflect different lifestyles after the SPA. However the default funds are structured, in time they could become the equivalent of a UK Sovereign Wealth Fund.

The question of risk allocation within each asset class would, no doubt, occupy legions of analysts. The only suggestion to be made here is that diversifying away from UK risk may be a good idea.

Using the FRSA assets

Savers, once they reach the SPA, should be free to decide when and how to realise or draw down their FRSA assets. They should be at liberty, for example, to determine the trade off between working longer and drawing FRSA-derived income and focusing their FRSA-derived income into periods when their need is greatest. Some people will want to remain in full- or part-time employment after passing the SPA and have no immediate need for additional income; others may want to start receiving FRSA-derived income immediately.

This ideal is dampened by the need to protect the state from individuals embarking upon an FRSA asset liquidation binge and then claiming Pension Credit. Some sort of controls would be required for the FRSA, and four alternative approaches are considered here.

(i) An annual draw down cap

Each year after passing the SPA, savers could be allowed to realise an increasing percentage of the value of their FRSA asset pool, starting with 10% in the first year, and all of the remaining assets in the year before becoming a senior citizen.

Consider the example of someone with an FRSA asset pool valued at £50,000 when he reaches SPA. Under this proposal he could realise up to £5,000 in his first year after the SPA. Alternatively he may choose to delay drawdown, perhaps by three years because he is still working. In the remaining seven years, he can draw down up to £7,143[70] each year, provided he doesn't run out of assets.

This is a simple way of controlling asset access, but comes burdened with the hassle of requiring an annual asset valuation (and asset composition may have changed in the interim year). It does, however, allow the asset realisation cap to be annually adjusted so that it more closely reflects the assets' prevailing market value.

(ii) Compulsory annuity purchase.

At the SPA, the asset pool is sold and an annuity is purchased for a period of at least ten years (longer if the saver so chooses.) This has the merit of simplicity but eliminates the flexibility required for making individual choices.

(iii) Auto-annuitisation

The lifestyle choice issue could be addressed by introducing "auto-annuitisation" at the SPA. A ten year annuity would have to be purchased for the period between the SPA and the onset of the higher State Pension but there would be an option to opt out, a feature that would protect both the state and those with a propensity for financial dithering. It does, however, require particularly clear communication between the saver and their FRSA administrator.

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70 That is £50,000 divided by 7 years.

(iv) Virtual annuitisation

When savers reach the SPA, their FRSA assets could be valued and the result divided by ten. If Pension Credit is subsequently claimed, this number (annually uprated by prices) is then deemed to be the saver's FRSA-derived annual income for means-testing purposes. The downside risks associated with future FRSA asset performance are left with the saver, reinforcing his on-going responsibility to monitor his assets, but the *quid pro quo* is that he also retains the asset performance upside. There is no obligation to actually purchase the annuity.

If one were to rate the suitability of these four alternatives, the measurement criteria would include simplicity, practicality, flexibility to take account of asset market price changes, freedom of choice, protecting the state and a structure that encourages people to open an FRSA in the first place, the benefits of so doing being tangible and simple to understand. It is likely that option (i), the annual draw down cap, would score highest as it would provide individuals with more flexibility than the PA, leaving them with the personal responsibility that accompanies freedom of choice, whilst also protecting the state.

Pre-SPA access to assets

The PA structure does not acknowledge that tying up funds until reaching the SPA is likely to be a deterrent to participation, particularly for the low-paid. Some imaginative thinking is required, and there is plenty to learn from other countries.

In the US, the 401k plan, for example, permits cash to be withdrawn in the form of loans for specific purposes, including the purchase of the primary residence, college tuition fees, medical expenses and home repairs. This flexibility is identified as one of the main reasons for the plan's high participation rate: more than 77% of eligible workers are enrolled, although the distinctive US cultural attitude that the state is not seen as a "fall-back" option may also play a part. New Zealand's KiwiSaver allows savers to make a one-time withdrawal of their funds for a deposit on their first home.

A degree of (pre-SRA) access to FRSA assets should be permitted, but inevitably some rules will be required to mitigate the risk of abuse. Loans usage could, for example, be restricted alone the lines of the 401k plan. However, it should be recognised that the more rules there are, the more expensive they are to administer, and people inevitable find ways around them (and the 401k experience indicates that there are issues in this regard).

One approach is to place no restrictions on loan usage but to require an asset value minimum threshold, after deducting any FRSA top-ups received from the state, before assets can be accessed. Loan size could be limited to a percentage of total FRSA assets (50%?), which reduces after the age of 45, say, down to 25% at the SPA. If there is a loan outstanding thereafter, the account holder would be ineligible for both means-tested benefits and taking advantage of the trivial commutation limit until the loan is repaid in full.

Administration

The FRSA should not require any expensive and risky public sector IT project. FRSA administration should harness the processes and systems that are already in place for administering personal and contracted out pensions, supported by the current National Insurance systems (which can accommodate those with multiple employments and employers). The internet should be the primary communication route, with the administration online and fully automated, not least to keep costs down. A call centre would also be required, not least to support those without internet access.

There are two key aspects to consider; collecting cash contributions and account management, with simple communication between the two for reconciliation purposes.

(i) Collecting cash

Monthly FRSA contributions could be collected in the same manner as income tax, NICs, student loan and other payroll deductions, with an annual declaration of FRSA contributions added to the P60/P14 return. Ideally, records of contributions and the fund(s) to which those contributions had been allocated could be retained within the NI system. In addition, arrangements would have to be put in place to make it easy for the self-employed to make contributions.

(ii) Account management

This should perform a hub role connected to service providers, including banks in respect of cash holdings and fund managers for the execution of asset purchases and disposals, and valuations. Savers should be able to view their FRSA portfolios and execute transactions online.

As for the default fund, the administration costs clearly need to be kept down; 30 basis points per annum (0.3%) was initially aired for the PA, much to the anxiety of the financial services industry. Large open-ended funds (such as With Profit funds) would cut out a lot of the personal administration burden and reduce leakage via fees and charges. 30 basis points (or less) should be feasible given economies of scale and the simplicity of the proposals.

8. AFFORDABILITY

Transition

Affordability is inextricably linked with the manner in which transition is structured to achieve full implementation of these proposals; the latter has to accommodate the former. Full implementation is achieved when:

(i) the FRSA top-ups are paid irrespective of the age of the worker (initially it may make sense to focus them on a particular age group); and

(ii) the increase in the State Pension for senior citizens reaches a level above the Guarantee Credit threshold.

Planning the transition period is not easy. From the Government's perspective, the budget will be pulled in opposite directions; there will be additional costs and savings. The viability of these proposals relies on keeping these in balance, at the least. And, inevitably, transition will require a substantial period of time.

Costs and savings

Additional costs for the State will be incurred by the larger State Pension for senior citizens, and by the topping up of FRSA contributions of the low paid.

The savings will come via a combination of the gradual elimination of all S2P payments (accruals having ceased), more people contributing full rate NICs (contracting out having ended) and reduced means-tested benefit payments, resulting from three different aspects of the proposals:

(i) enhancing the FRSA contributions of the low paid, up to a total of perhaps 3% of median earnings, will enable many low earners to purchase ten year annuities when they reach the SPA that will provide sufficient income, when combined with the State Pension, to lift them out of means testing. In effect, means testing is being shifting from retirement to pre-retirement, in a relatively simple manner;

(ii) compressing FRSA asset realisation into a ten year period, rather than until death, will boost incomes for many savers which, when combined with the State Pension, will lift them out of means testing in the period between SPA and senior citizenship; and

(iii) the increase in the State Pension, ten years after SPA, is sized so that it produces an income just above the level of full Guarantee Credit. Consequently, means testing of senior citizens largely disappears, once transition to the new structure is completed.

There are also significant delays in cash outflows from the state as contracting out rebates will end and the increase in the State Pension will commence ten years after the SPA, whereas previously S2P commenced at the SPA.

A virtuous circle

During transition, a virtuous circle should evolve. As means-tested benefit payments decline, more cash will be available to the Treasury to accelerate transition. This can be done either by increasing FRSA contribution top-ups (by broadening the eligibility age range or increasing payments towards 3% of median earnings) or upping the State Pension towards its final destination for senior citizens, just above the Guarantee Credit limit. This in turn will lead to more retirement income being generated, further cutting means-tested benefit payments.

Controlling transition – modelling

A robust model will be required to design the optimal transition path towards full implementation, to harness the virtuous circle to full effect and then monitor the transition path relative to affordability. It will also be a useful tool for indicating the degree of flexibility required within the transition structure; some of the model's input variables (see the Appendix) will invariably not turn out to be as originally parameterised.

The model will need to be sensitive to the volatility of the British economy. It should also play a major part in identifying how to optimise the effectiveness of the transition path, as the prevailing affordability weakens or improves, once it strays outside of a pre-specified "band width" around a central path. Cashflow shortfalls, indicating when the transition has run ahead of affordability, will have to be anticipated and addressed by slowing transition down. Alternatively, should transitional spending fall behind affordability, perhaps because higher than expected FRSA-derived annuity incomes are reducing Pension Credit costs, then the excess cashflow could be deployed to accelerate transition.

Accelerating or slowing down transition can be achieved in numerous different ways, but the main control levers are:

(i) the size of the FRSA top-up, the ultimate objective being 3% of median earnings;

(ii) the size of the State Pension for senior citizens, the ultimate objective being a level just above Guarantee Credit; and

(iii) the rate at which FRSA top-ups and the State Pension for senior citizens are broadened across the eligible populations.

The latter could be divided into five year cohorts with, for example, top-ups initially focused on the youngest (aged 20-25, say) to provide them with an opportunity to get onto the savings ladder early and the eldest (60+, say) who are closest to the SPA, with the increased State Pension focused on those aged over 90. A few years later, top-ups could advance to also include those aged 26-30, with eligibility for the increased State Pension also being widened to those aged 85-90, and so on.

9. FAIRNESS

Redistribution is an integral part of the S2P regime because accrued rights to future S2P income are capped at the Upper Accrual Point[71] whereas employees are required to pay (various rates of) NICs on all earnings above the Earnings Threshold.[72] The S2P/NICs framework is therefore skewed so that high earners pay relatively more. Although the end of S2P accruals is proposed, the rights accrued to date will take at least a generation to be paid; by ending all contracting out, all high earners, rather than only those who are still contracted in, will be participating in the subsidy of low earners' accrued rights. This also ensures that the whole workforce is more involved in contributing towards the financing of the increased senior citizens' State Pension and the FRSA top-ups paid to low earners. Furthermore, with NICs rebates having ended and more people therefore paying NICs, the Treasury's NICs income will increase, making these proposals more affordable.

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71 From 6 April 2009 accruals are based on earnings between the Lower Earnings Limit and the Upper Accrual Point, fixed at £40,040.

72 Where earnings exceed the Upper Earnings Limit, NICs are paid at 1%.

Ideally, there should be a single unified rate of NICs payable by all, perhaps based on the current contracted-in rate. This will lead to some restructuring of existing DB schemes, but some occupational schemes have already been contracting back in because contracting out rebate terms are now poor in market terms.

The PA proposals are not as fair as those suggested here. In particular, the PA requirement to purchase a lifetime annuity penalises those who die relatively young because they are typically priced assuming that everyone lives into their 80s (albeit that the use of postcodes hints at a refinement in actuarial principles). Consequently, those who die early are subsidising those who live to be relatively old, and the latter are more likely to be relatively wealthy. The FRSA addresses this inequality by ending the annuity purchase obligation.

10. SUITABILITY

Many FRSA savers, when they reach the SPA, will have significant accumulated assets. The key decision to be made may concern the trade off between working a few extra years and saving more, or starting to realise FRSA assets immediately. Many in the latter group will probably opt to purchase a ten year annuity to bridge the period between SPA and the onset of the enhanced pension. This concentrates the proceeds of FRSA asset draw down into a shorter period than the PA.

The impact on weekly income is dramatic. In the earlier example (see Table 3), under the three investment growth scenarios (1.5%, 2.5% and 3.5%), weekly (pre-tax) income would be increased by 78%, 71% and 65% respectively. The FRSA's ten year annuities provide a much more meaningful income than the PA-derived lifetime annuities.

Table 7 shows the FRSA asset pot sizes for four men; it assumes that in 2012 they start to save aged 40, 45, 50 and 55 until reaching the SPA (27, 21, 16 and 10 years later, respectively), based upon total contributions of 7% of gross earnings.

Table 7: FRSA asset pot sizes

	Investment growth rates (in real terms)		
Age in 2012	**1.5%**	**2.5%**	**3.5%**
National Minimum Wage (£11,918 p.a. from 1 October 2008)			
40	£37,836	£43,192	£49,527
45	£26,512	£29,387	£32,657
50	£18,518	£20,030	£21,692
55	£10,428	£10,592	£11,507
Median earnings (estimated at £25,406 for 2008-09)			
40	£80,654	£92,071	£105,576
45	£56,514	£62,644	£69,613
50	£39,474	£42,697	£46,241
55	£22,229	£23,347	£24,529

Assuming total contributions of 7% of gross income p.a., with the National Minimum Wage and median earnings being uprated at 2% p.a. in real terms

Table 8 compares the ten year annuities, expressed in terms of today's earnings, that one could expect to buy[73] after the FRSA and PA asset pots have been realised for cash, respectively. Note that, for those on the Minimum Wage, the FRSA is expected to produce an income well over two and a half times that of the PA, and for those on median earnings, nearly twice as much.

[73] Data ignores transaction costs.

Table 8: Comparison of weekly income

	Investment growth rates (in real terms)					
	FRSA			Personal Account		
Age in 2012	**1.5%**	**2.5%**	**3.5%**	**1.5%**	**2.5%**	**3.5%**
National Minimum Wage						
40	£78	£93	£111	£26	£32	£40
45	£55	£63	£73	£18	£22	£26
50	£38	£43	£49	£13	£15	£18
55	£21	£24	£26	£7	£8	£9
Median Earnings						
40	£166	£197	£236	£82	£102	£127
45	£116	£134	£156	£58	£70	£84
50	£81	£92	£103	£40	£47	£56
55	£46	£50	£55	£23	£26	£29

Table 9: FRSA-derived income as a percentage of PA-derived income

	Investment growth rates (in real terms)		
	1.5%	**2.5%**	**3.5%**
National Minimum Wage	300%	288%	277%
Median Earnings	201%	193%	186%

The higher income generated by the FRSA in comparison to the PA is to be expected: these FRSA-derived incomes are spread over ten years, whereas the PA's income is lifetime-based (i.e. from SPA until death).

But what is really significant is that the FRSA is far more likely than the PA to be an intrinsically suitable retirement savings product, not just for low earners, but also for those in their forties and fifties because it delivers income in retirement relatively rapidly. This will particularly benefit those with shorter life expectancy, as they can realise all of their FRSA assets within the 10 years following retirement. This degree of freedom, and personal responsibility, is not offered by the PA as, under that scheme, the saver has to realise his assets over a much longer timeframe.

Higher annuity income will also help overcome the disillusionment with retirement saving which has, partly, been fuelled by small asset pools being converted into lifetime annuities that produce a tiny annual income (a problem exacerbated by the administration costs of small funds being high in percentage terms).

11. SELLING THE FRSA

The pensions industry has a tarnished reputation. Equitable Life, pensions and endowment mortgage mis-selling, non-performance of With Profits funds and misaligned commission structures have undermined public confidence. In addition, for most people, pensions are fundamentally boring and mind-numbingly complex. On top of that, the industry faces onerous and expensive regulation.

Recent Government initiatives have failed to capture the public interest. Stakeholder pensions, for example, were introduced in April 2001 with a similar target audience as the FRSA (and PA): those on low incomes without access to occupational schemes. They are not compulsory for those in employment, and have failed to significantly capture the public interest. Their low fees[74] have deterred the financial services industry from offering advice to those who need it most (the low-paid) and have given the industry little incentive to market the product. Then, just as some marketing did get underway, the Pension Credit and its attendant means-testing deterrent was introduced, aimed at the same low earning audience.

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[74] Capped at 1.5% for the first 10 years and 1% thereafter.

The challenge

It is hard to communicate financial information effectively. The majority of Britons (52%), for example, do not realise that there are tax incentives attached to stakeholder pensions. This figure rises to 65% of under 34-year-olds, and 70% of workers under 24.[75] Furthermore, changing people's behaviour is not as simple as offering them money. In 2007-08 up to £10.5 billion in income-related benefits[76] went unclaimed, 23% of all entitlement money. In spite of considerable efforts by the DWP (the Pensions Service make 13,000 face-to-face visits to retired people every week), in 2007-08 one in three eligible pensioners did not claim Pension Credit (saving the Government up to £2.5 billion). The number of pensioners receiving Pension Credit has stuck at 2.7 million for the last three years, 500,000 below the 2008 target. Sadly it is often the most vulnerable who are not taking up their entitlement.

Ultimately, the FRSA will have to pass the pub test. It has to be attractive and simple enough for people to want to talk about it across the bar, i.e. to sell itself rather than to rely solely on marketing or, indeed, compulsion.

It should also be recognised that at least some employers may be reluctant to encourage take-up of the FRSA as they will be obliged to make contributions themselves. The temptation to fob off employees by slipping a bit more into the wage packet is understandable, but ultimately it would not be in anyone's best interests.

Considerable behavioural change is required if the FRSA is to be successful. Saving for retirement requires a sacrifice in

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75 B&CE Benefit Schemes.

76 Income Support, Pension Credit, Jobseekers Allowance, and housing and council tax benefits (DWP).

consumption today in return for some distant, uncertain future benefit. Yet we seem hooked on immediate gratification with behaviour being primary influenced by immediate deficiency.

How can we counter this?

To compel or not to compel?

Arguments in favour of compulsion

Compulsory, or forced, occupational retirement saving is not new. Chile adopted such a policy in 1981, and Australia's "Superannuation Guarantee" (SG) was introduced in 1992. SG plans are mostly DC-based, but some employers do assume the investment risks and offer a DB-based scheme. The SG is intended to become the greater part of an employee's retirement income; there is no politically-inspired attempt to hide the adverse implications for the state-provided old age pension.

Today, Australian employers contribute 9% of earnings.[77] It is being proposed that this should increase to 12% via "soft compulsion", with the message attached that lifetime contributions nearer to 15% are required if one wants to retire comfortably without relying on the age pension.[78] Employees are not currently compelled to contribute, but many do so, not least because low-income workers[79] are helped by the government matching every A$1 of their personal contributions with a co-contribution of A$1.50, up to an annual maximum of A$1,500.

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77 Based on Ordinary Time Earnings. Employer SG contributions are not required for employees who earn less than A$450 per month (c.£222).

78 Institute of Actuaries of Australia, *Australia's future tax system*, March 2009.

79 Annual income of less than A$28,000 (c. £13,800).

The SG provides participation benchmarks to which to aspire; it extends across the earnings distribution and includes part-time workers. Over 90%[80] of all workers now have some employer-provided superannuation (over 97% and 89% in the public and private sectors, respectively), data that is envied by governments around the world (both developed and developing economies). On the downside, there is evidence to suggest that the Australian compulsory scheme has, over time, led to lower salaries.

Compulsion is a way of tackling retirement savings inertia head-on. It avoids the risk of employers "persuading" or colluding with their employees to opt out, perhaps in return for a small wage increase. It also avoids the need for an opt out bureaucracy and will generate, in aggregate, a bigger pool of retirement saving than auto-enrolment. Ultimately this would save the Treasury some money via a smaller Pension Credit cost (offset by FRSA top-ups).

"Thou shalt" does not win hearts and minds, and contradicts the "assume personal responsibility" message, but it does produce the desired result.

Auto-enrolment (with the ability to opt out)

Despite its advantages, compulsion is always likely to be politically unpopular as it involves an immediate drop in income to all those not currently enrolled in a pension scheme. In addition, to many it contradicts libertarian instincts. Individuals should be encouraged (through education), rather than be told, to assume responsibility for their own retirement income.

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80 Social And Economic Dimensions Of An Aging Population (SEDAP), *Retirement Saving in Australia*, 2007.

Automatic enrolment with a difficult opt-out avoids the political damage of advocating compulsion.[81] It harnesses inertia (i.e. people don't bother to opt out), preserves freedom of choice, counters the "additional tax" challenge from business, reduces the risk of the Government being attacked if asset performance turns out to be poor, and perhaps reduces the temptation for employers to "dumb down" their occupational scheme contributions, and deflects the accusation that FRSAs are part of an unspoken plan to reduce the basic State Pension over the long term.

Furthermore, the FRSA should attract extensive participation on the basis of its own merits, and auto-enrolment is a way of putting that to the test. A take-up rate of anything above 75% should be considered a success; switching occupational schemes from voluntary to automatic enrolment has seen take-up increase from an average around 55% to near 80%. And if take-up is poor (less than 60%, say), then rather than imposing compulsion, perhaps the message that the FRSA is failing to be attractive enough in its own right should be accepted and the structure, but not the underlying principles, revisited.

Compulsion has one crucial advantage over auto-enrolment; it is reversible. If, in the future, the financing of the pensioner population is not the problem we fear today, we can end compulsion. Introducing compulsion in ten years time, perhaps as an act of last minute desperation, could be too late.

Ultimately, however, the decision on whether contributions should be compulsory is political. The debate is finely balanced.

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81 New Zealand's KiwiSaver uses auto-enrolment.

Should the FRSA be means tested?

Income derived from FRSA assets should be excluded from means testing. This has the merit of simplicity and would differentiate the FRSA, albeit perhaps unfairly, from other retirement savings products. If FRSA participation were made compulsory, means testing would of course be inappropriate.

Interaction with occupational pension schemes

Income derived from occupational schemes does fall into the means testing arena, but we do not want to provide employers with a good reason to persuade employees to leave the company scheme, perhaps leading to scheme closure, which would not be in the employees' interests. Consequently FRSAs should be integrated within occupational schemes, forming the base (and disregarded for means testing purposes), with the sponsor building the rest of his scheme on top.

Indeed, re-characterising occupational schemes as FRSAs has the added attraction of tackling portability issues, such as when changing jobs. The concern is that companies will be tempted to reduce their in-house scheme contributions to the FRSA minimum, treating it as a benchmark. Employees and unions will of course be sensitive to this, not least because in-house schemes are increasingly presented as an integral part of the overall remuneration package. Given this, employers should be wary of risking their workforce relationship, although they may, in future, offer smaller wage rises than otherwise.

But ultimately, the success or failure of the FRSA will not revolve around how companies react, because employees with access to corporate schemes are not the primary target audience. It is the response of part-time workers and the SME[82] workforce,

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[82] Of the 4.3 million businesses in the UK, 99.9% are SMEs and 99.3% have fewer than 50 employees. DTI, *SME Statistics for the UK*, 2006.

59% of the nations' jobs and largely without in-house savings schemes, that matters most.

Interaction with personal pension products

The introduction of the FRSA will need the support of the financial services industry. It will not help if it is met by a chorus of "not yet another product". In industry parlance, the product has to be viewed as an "acceptable alternative" and, ideally, a "winner".

There is a variety of pensions products, including personal pensions (Stakeholder and Self Invested Personal Pensions, SIPPs) and group personal pensions, sometime accompanied by arcane terms and conditions. Choice is great when you know what you want, but in this arena, very few of the FRSA low-earning target audience, in particular, know what they want. Choice introduces complexity, which leads to confusion and therefore the need for advice. But, in general, people do not like to pay for it. The typical response is then to procrastinate, or make an instant decision not to pay for advice, which in this context probably means not saving.

If savers want "bells and whistles" there are plenty of other products on offer. The FRSA will not have any directly competing products and should be viewed as a product for everyone, with a common tax credit irrespective of the saver's threshold rate of tax.

Interaction with Individual Savings Accounts (ISAs)

ISAs are the Government's primary vehicle for tax-advantaged adult saving, outside of pensions. They are clearly successful: £37.5 billion was subscribed to 14.2 million accounts in 2008-09 alone.[83] A total of over £299 billion has been subscribed since

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[83] ONS, HMRC, *ISAs*, Table 9.4, July 2009.

ISAs first appeared in 1999, supported by an estimated £2.1 billion per year in tax relief.

While not strictly a retirement savings product, many people treat their ISA as a core part of their retirement savings, attracted by its simplicity, the ready access to assets, the tax-free capital gains status and, for higher rate taxpayers, a saving of 22.5% on dividend income (the 10% dividend tax credit is not recoverable).

ISAs clearly appeal across all income groups. Indeed, the data suggest that the FRSA's low-earning target market are already major ISA subscribers. In 2006-07, 9.8 million of the 12.8 million subscribers (77%) had income of less than £20,000 a year.[84]

The FRSA's lack of a tax-free capital gains feature is therefore not likely to be a deterrent to low earners, but a degree of pre-SPA access to funds is expected to be important. 7.9 million of the 9.8 million sub-£20,000 income subscribers were Cash ISA subscribers. It is probable that ISA subscriptions would fall once the FRSA is introduced, not least because workers are likely to be attracted to the FRSA by the employer contributions and the tax credit in respect of their own contributions.

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84 ONS, HMRC, *ISAs*, Table 9.7, June 2009.

12. PROPOSALS IN RESPECT OF THE PUBLIC SECTOR

The ambition for public sector pensions is a fully funded income-in-retirement system for all employees, backed by real assets rather than a vague promise that taxation raised from the next generation will be sufficient to look after today's workers once they retire.

This is, however, an unrealistic ideal because one cannot expect today's workforce to pay twice during transition. Their tax payments would have to pay for pensions in payment and fund the asset pool from which their own pensions would be paid in the future. Fully funding the public sector pensions commitments would require the accumulation of over £1,000 billion of assets; this is not feasible.

There is another aspect to consider; public sector bodies, like the British Government, are effectively corporations without end; to some extent, a cashflow-based PAYG approach can be permanently accommodated. Conversely, private sector-sponsored pension schemes are required to have mechanisms in place, notably a funding obligation, to protect employees in event of company liquidation.

Pragmatism suggests that the best approach to facilitating income-in-retirement for public sector employees is a mixture of PAYG and funded schemes. Relying solely or largely on one source in the face of different kinds of risk is imprudent.

The primary objective behind the following proposals is to establish a hypothecated PAYG public sector pensions framework – one that requires no cash from the Treasury to plug a cashflow gap between pensions in payment and employee and employer contributions.

A second objective is to at least halt, and ideally reverse, the growth in the unfunded liability arising from factors other than interest rates. It is recognised that while interest rates will rise at some time in the future, diminishing the liability, there are other factors that may increase the liability, including improving longevity, growth in the size of the workforce and rising pay.

Proposal 6: public sector pensions to be cashflow self-sufficient
Every public sector employer should be required to put in place a self-sufficient PAYG employee pensions framework, within a specific timeframe (two years?). Subsequently the Treasury should not be required to make good any cash shortfalls between pensions in payment and employer and employee contributions. This will end the Treasury's open-ended exposure to public sector pensions. The plans to achieve such cashflow self-sufficiency should be made public.

Proposal 7: require all public sector employees to pay into an FRSA
All public sector employees should be compelled to pay into an FRSA, funded, defined contribution scheme. Employees should contribute at least 3% of gross earnings, with employers' contributions being determined by negotiation, set against the

backdrop of being required to achieve pensions self-sufficiency.

Proposal 8: clarity on future public sector pension liabilities
There should be a new chapter in the Budget Report which includes forecasts of future public sector pensions in payment and a description of how they will be financed.

These proposals would introduce greater control over the ongoing accumulation of unfunded public sector pension promises, by enhancing transparency and introducing greater cashflow discipline. The latter will be reinforced by employers' having to pay more NICs, contracting out having ended (see Section 6). Innocuous accounting entries will increasingly be overshadowed by the stark reality of cashflow discipline.

Substantially improved transparency, a prerequisite for achieving fairness vis-à-vis private sector pensions, will reveal the true cost and value of public sector pensions, facilitating comparison between total public and private sector remuneration packages, and more meaningful negotiations between employers and employees in respect of contribution rates.

Self-sufficiency
There are several different aspects of pensions self-sufficiency that public sector employers may focus on. The crucial one, concerning annual cashflow, is a clear objective behind these proposals; it effectively means public sector pensions hypothecation so that the Treasury is not required to make good any cash shortfalls.

A second aspect that public sector employers should be encouraged to forecast, and publicise, is the annual growth in the present value of the future cashflow requirement, derived from non-cash accounting entries (predominately the unwinding of the discount rate). This will help provide early warning of any future cashflow pressure, so that appropriate measures can be taken early. Prudent public sector employers may wish to ensure that annual contributions cover any growth in these accounting entries (effectively a small step towards a funded scheme) or limit any increases to the growth rate of the economy, for example; akin to establishing a kind of balance-as-you-go (BAYG) framework.

A more comprehensive BAYG framework would limit any growth in the pensions liability to the economic growth rate, say. This is, however, an unrealistic objective, not least because of the liabilities' volatility; in recent years we have seen annual increases of over £100 billion.

Achieving self-sufficiency

Public sector employees are likely, of course, to resist any change to the generous pension arrangements to which most are now entitled. However, public sector employers do have some tools available to them when negotiating with the relevant unions. These include:

(i) ending defined benefit (DB) accruals, or at least adjusting accrual rates down from, for example, 1/60th to 1/80th of final salary for each year of service (or 1/80th to 1/100th). In recent years most of the private sector has concluded that transferring their employees' pensions wholly into a defined contribution (DC) arena (preserving accrued DB rights, of course) is the only sustainable way forward. While developing their plans to establish on-going cashflow self-sufficiency, public sector employers may come to a similar conclusion;

(ii) adjusting the level of employee and employer contributions. If DB accruals were to be ended, for example, the need for contributions to meet pensions in payment will diminish as the legacy DB commitments run off, leaving more scope for increasing the FRSA contributions

(iii) delaying the pensionable age. This would reduce the number of years that pensions are in payment *and* increase the number of contributors;

(iv) changing benefits so that they are based upon career average, rather than final salary;

(v) reducing lump sum accrual rates. Lump sums, typically accrued at 3/80ths for each service year, represent some 15%[85] of the present value of the pension package when an employee reaches pensionable age. An alternative approach could be to scrap the DB-based lump sum and replace it with employer contributions into the DC-based FRSA;

(vi) tightening governance issues, such as early retirement due to ill health, where some rates are abnormally high: 68% of all retirements in the fire service, 49% in the police and 39% in local government.[86]

(vii) reducing the workforce.

Responsibility for implementation

Addressing public sector pensions is politically challenging. These proposals firmly place the responsibility with individual public sector employers for ensuring that they are self-sufficient in respect of pensions financing, and that public sector pensions are sustainable. The role of central government is limited to requiring the employers to develop and implement

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85 Assuming 40 years service accrued at 1/80th and 20 years in retirement

86 Neil Record, op.cit.

plans, against a deadline, as to how they are going to meet the pension cashflow demands of future years. Empowerment has to accompany responsibility; it is important that the employers have a sense of ownership, and substantial discretion as to how they achieve pensions self-sufficiency.

This approach still requires central government to exhibit considerable political will, but should help it avoid appearing excessively draconian. In essence, the employers should assume the managerial role, negotiating future pension rights, with central government providing the over-arching strategy.

13. CONCLUSIONS

The UK's income-in-retirement landscape, as it stands, is not sustainable. The strains in pensions schemes, both private and public, threaten to turn the financial crisis of the past two years into a social crisis lasting decades.

The introduction of the proposed Flexible Retirement Savings Account (FRSA), with compulsory public sector participation, an increased State Pension for senior citizens, the ending of S2P accruals (and, therefore, contracting out) and the obligation of public sector employers to achieve self-sufficiency, are all central to forming an affordable, equitable and simpler income-in-retirement framework.

FRSA asset-derived income will provide a meaningful income and, with an increased State Pension for senior citizens (i.e. those more than ten years older than the SPA), dignity in retirement. Unlike the Government's PA, which invites a major mis-selling scandal unless people are advised to opt out (or the rules for means testing are changed), the FRSA is an inherently suitable and flexible product and represents a major step towards establishing a culture of saving for retirement.

It should be recognised that great efforts will be needed to overcome financial myopia. Success would herald a tacit acceptance that we will have to rely more on personal savings, rather than (unfunded) state promises, for our retirement income. The FRSA could be one step towards confronting the inter-generational inequality whereby today's workforce pays for today's pensioners, rather than contributing to their own retirement savings.

Political leadership will be required to achieve this long-term vision. Inevitability there will be winners and losers, and admitting the reality of our unsustainable pensions architecture will be politically difficult.

Given this, the financial crisis should be recognised as an opportunity that is far too good to waste. The public is likely to reward those politicians who have the courage to confront the institutionalised irrationality of our unsustainable retirement income framework. We now have a unique opportunity to change it to ensure that it is more equitable and sustainable.

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The numbers in Sections 2, 3 and 10 were checked by Hewitt Associates Benefits Research department.

APPENDIX

FRSA MODELLING – KEY VARIABLES

(i) The State Pension Age (SPA) and the UK's projected population, distributed by age;

(ii) the timing of the increase of the State Pension for senior citizens, which could either be the SPA plus a fixed period, such as ten years, or simply fixed at a specific age, 75, say;

(iii) the indexation basis of the State Pension; the model should be able to look at the affordability implications of both prices- and earnings-linkage (and be prepared to be really frightened by the latter);

(iv) Pension Credit (with the ability to model the consequences of changes, such as increasing Savings Credit to 80p);

(v) a range of mortality curves;

(vi) different transition paths for FRSA top-ups; how much to pay (is 3% of median earnings a sensible objective?) to which (5 year) cohort of the eligible population and when to introduce the payments? Should we start with the youngest, those nearing the SPA, or spread top-ups thinly across age groups, gradually increasing over time?;

(vii) different transition paths for the increase in the State Pension of senior citizens to be paid to each (five year) cohort of the eligible population. Should we start with those aged 90+, 85-90, then 80-85, etc, and how (in terms of time) should the State Pension for senior citizens be increased to a level just above Guarantee Credit?; and

(viii) a slew of economic forecasts; interest rates (for discounting purposes), investment growth rates, median earnings, etc, fed by an economic scenario generator.

GLOSSARY

401k plan	401k plans are the successful American form of stakeholder-type defined contribution retirement savings scheme. They allow earnings to be “deferred” and put into an Individual Retirement Account (IRA) and savings may be drawn down from age 59.5 onwards (or on earlier retirement) and are taxable as income on withdrawal. The plans are open to all companies and the self-employed, but not government bodies. Over 77% of eligible workers participate and 95% of plans involved some form of company contribution. The average 401k participant saves between 5% and 7% of pre-tax salary. The key features of 401k schemes are: • Draw down is allowed from age 59.5 or upon retirement if earlier. There are no limits on the rate of drawdown but by age 70.5 an annuity must be taken or a percentage of funds (based on life expectancy) must be withdrawn each year. 10% penalties are applied to withdrawals before 59.5. • Company contributions at the discretion of the employer but are limited to $15,000 (2006). Employers offer 401k plans as a way of attracting employees.

	• The over 50's may make additional catch up contributions of $5,000 p.a. (pre-tax). • Pre-tax contributions are taxed on withdrawal. • Equality amongst executives and other staff. If executives want good schemes for themselves, they have to offer similar terms to all employees. For example, executives' contributions cannot be more that 2% above the average percentage contribution of low paid workers. • Most schemes are set up on the basis that employees can choose from a selection of mutual funds. The trustees determine investment strategy in respect of schemes set up under trustee arrangements. • If the participant dies before distribution commences, the benefits are distributed to the beneficiary either over a five year period or over the expected lifetime of the beneficiary (depending on the plan rules). The beneficiary pays tax on the withdrawals.
Band earnings	In respect of contributions to the Personal Account, this refers to National Insurance band earnings between the Primary Threshold and the Upper Earnings Limit (£5,720 and £43,888, respectively, for 2009/10).
Basic State Pension (BSP)	The basic (or "old age") State Pension is a government-administered flat-rate pension based on the number of qualifying years gained through National Insurance contributions (NICs), paid throughout working life. It is a basic flat-rate pension funded on a pay-as-you-go basis, which aims to provide a pension of approximately 20% of national average earnings. The BSP is increased each year in line with the Retail Prices Index (RPI). The Pensions Act 2007 restores it to being indexed to earnings, by the end of the next Parliament at the latest (in 2015).

	To receive the full basic State Pension, men and women need 44 and 39 qualifying years, respectively. After 6 April 2010, this reduces to 30 qualifying years for men and woman. For 2009-2010, the weekly full basic State Pension is £95.25 (singles) and £152.30 (couples).
Defined Benefit (DB) occupational pension schemes	DB, or final salary, pension schemes entitle employee members to pension benefits defined by a formula linked to their length of pensionable service and salary when they leave the scheme. Employees are typically provided with 1/60 of final salary for each year of service up to a maximum of 40/60, i.e. two thirds of final salary. At retirement a tax-free lump sum may be taken at the expense of a reduced pension. DB pension promises are unrelated to the contributions made to the underlying fund. Many schemes now face large deficits as liabilities have outgrown the funds' assets. Consequently, many sponsors, struggling to meet their statutory funding requirement and deterred by the increase in company accounts volatility (care of accounting standard FRS 17), are closing their DB schemes in favour of DC schemes.
Defined Contribution (DC) occupational pension schemes	DC, or money-purchase, schemes are pension schemes into which an employer pays a regular contribution, fixed as an amount or percentage of the employee's pay. The employee may also make contributions into the scheme. Contributions are invested to provide employee retirement benefits, with investment risk and investment rewards assumed by each employee/retiree, and not by the sponsor/employer. Employers increasingly favour DC schemes over DB schemes because they cost less to run and result in a predictable cash outflow. The "cost" of a DC scheme is readily calculated, but the benefits are dependent upon the amount of contributions and investment performance. Consequently, participants bear the risk of outliving their assets. This risk can be mitigated by using accumulated savings to

	purchase an annuity upon retirement (a legal requirement before reaching 75), to provide a regular income until death. Although DC scheme participants typically have control over investment decisions, the sponsor retains a significant degree of fiduciary responsibility over investment of plan assets, including the selection of investment options and administrative providers.
Guarantee Credit	This guarantees anyone over 60 an income of at least £130 per week if single, £198.45 for couples. Thus, a single person with weekly income of £90 would receive Guarantee Credit of £40. "Income" is defined as including basic State Pension and State Second Pension payments, some state benefits, private pensions and earnings, but excludes Disability Living Allowance, child tax credit, child benefit, etc. Guarantee Credit is uprated in line with earnings.
KiwiSaver	KiwiSaver is New Zealand's work-based state-sponsored retirement savings scheme. Using auto-enrolment, it allows employees to contribute up to 8% of their gross salary and all accounts are kick-started by the Government with a contribution of NZ$1000 (c£390), locked in until retirement, in recognition that once a savings account is activated, people are more likely to catch the habit and save more. Savers can make a one-time withdrawal of their funds for a deposit on their first home, and those with at least three years standing can receive government help with the deposit; NZ$1000 for each year's membership in KiwiSaver, up to a maximum of NZ$5000. This feature encourages workers to embrace KiwiSaver and take the first steps to building a long-term savings habit. It also demonstrates that the Government is cognisance of a strong trait; home ownership and long-term financial security (into retirement) are closely related in many peoples' minds.

National Insurance Contributions (NICs)	NICs, collected through the pay-as-you-earn (PAYE) income tax collection system, are paid into the National Insurance Fund (NIF) by most employers, employees, self-employed, and some unemployed people. The amount paid depends upon earnings and employment and marital status. NICs, via the NIF, finance a range of benefits, including state pensions (but not the means-tested pension credit), incapacity benefit, widows' benefits, maternity allowance, guardian's allowance, jobseeker's allowance and the Christmas bonus. Part of the contributions is not paid into the NIF but goes towards the cost of the National Health Service.
Pension Credit	A state benefit targeted at pensioners, comprising Guarantee Credit and Savings Credit.
Personal Account (PA)	The Personal Account (PA) it is intended to encourage employees without access to work-based pension schemes to save for retirement; the target audience is clearly the low paid and those in intermittent work. There will be auto enrolment but workers will be able to opt-out if they choose not to participate, i.e. "soft" compulsion. Employees will pay contributions of 4% on their National Insurance band earnings, with employers required to contribute 3%, plus roughly 1% from the Government through normal tax relief. Contributions are limited to £3,600 per year (based on 2005 earning levels), up-rated by earnings year on year. There will be a choice of investment funds, including social, environmental and ethical investments, as well as branded funds, as well as a (lifestyle smoothing) default fund for those not wishing to make an investment choice. The maximum administration charge likely to be capped at 0.3% of the fund under management. There has been much debate around this issue, not least because the low take-up of Stakeholder pensions is partly blamed on the lack of incentive for the financial services industry to push the product.

	When savers reach the State Pension Age they are required to purchase a lifetime annuity with their account proceeds, having assumed the investment risk in the interim, (akin to a defined contribution ("DC"), or money purchase, scheme). There is a general ban on transferring rights into and out of the scheme. PAs will regulated in much the same way as existing trust-based DC schemes.
Primary Threshold	Also referred to as the "earnings threshold", an amount set each year by the government which triggers liability for an employee and his or her employer to pay National Insurance contributions (NICs). In the tax year 2009/10, the Primary Threshold is set at £110 each week (£5,720 p.a.).
Savings Credit	Savings Credit is intended to reward people who have saved for their retirement. Entitlement to Savings Credit requires a single person to have weekly income of between £96.00 and £181.00 (£153.40 and £266.00 for couples). Pensioners over 65 receive a credit of 60p for each £1 derived from a source other than the State Pension. Savings Credit is limited to £20.40 per week, determined as 60p x (the Guarantee Credit ceiling of £130.00 - £96.00) for singles, £27.03 for couples. Beyond this, and Savings Credit is withdrawn at the rate of 40p in the £1. Thus when income reaches £181.00 no Savings Credit is payable (calculated as £130.00 + £20.40 / 0.4)).
State Second Pension (S2P) (as defined by Scottish Life)	S2P is the successor to SERPS and was effective from 6 April 2002. It is based on an earnings-related system similar to SERPS but with different accrual rates. As well as providing an additional state pension for the employed, S2P for the first time gives an additional state pension based on earnings of £13,900 (2009/10) to: • those with earnings above £4,940 but below £13,900;

	• carers with no earnings or earnings below £4,940 for any year that they: o receive child benefit for a child under six, or o are looking after an ill or disabled person in circumstances which qualify for Home Responsibilities Protection, or o have an entitlement to Invalid Care Allowance (even if the benefit is not claimed because of entitlement to another greater benefit); and • those who are entitled to long term incapacity benefit or severe disablement allowance, provided that they have worked for and paid Class 1 NI contributions for at least one tenth of their working life since 6 April 1978. S2P is not available to those earning less than £4,940, the unemployed, students, those caring for children older than six and the self-employed. Accrual rates Initially there were three S2P bands of accrual to ensure that the principle aim of government was met (that low and non-earners received a greater benefit from S2P than its predecessor, SERPS). The bands based on the 2009/10 tax year are as follows: • Band 1 - covers earnings from the Lower Earnings Limit LEL, £4,940) up to the Low Earnings Threshold (LET, £13,900). Benefit accrues at a rate of 40% (twice what SERPS provided). As previously mentioned those earning less than the LET are treated as though they had earned the LET. • Band 2 - earnings between the LET (£13,900) and the Secondary Earnings Threshold (SET, £31,800). The accrual rate is 10% for earnings

within this band (half what SERPS provided).

- Band 3 - covers earnings from the SET (£31,800) to the Upper Accrual Point (UAP) (£40,040). Benefit in this band accrues at 20% (the same as SERPS).

These bands apply to everyone with a SPA on or after 6 April 2009. Individuals reaching SPA before 6 April 2009 had enhanced accrual (as previously mentioned) under SERPS. These transitional arrangements were extended to S2P by increasing the accrual rate in each band. An additional 1%, 0.25% and 0.5% of earnings is added to each band respectively for each year that SPA is earlier than 6 April 2009.

So, if your SPA is before 6 April 2009 you will not receive less under S2P than you would have done under SERPS.

Pensions Act 2007 and National Insurance Contributions Act 2008 changes

The Pensions Act 2007 put in place legislation to reform the State Second Pension so that it would become a flat-rate top-up to the Basic State Pension by 2030. The National Insurance Act brought these reforms forward and a decision was made to start these changes in 2009 when the UAP was established. The upper accrual point will be cash fixed from the point it is introduced. This will mean that from 6 April 2009 employers and employees with occupational pension schemes contracted-out of State Second Pension will receive contracted-out rebates on earnings between the lower earnings limit and the upper accrual point. Employers and employees will pay National Insurance contributions at 12.8% and 11% respectively on earnings between the upper accrual point and upper earnings limit (UEL). The UEL is £43,888 for the 2009/10 tax year.

	Starting in 2010, band 2 (10% band) and band 3 (20% band) will be merged so that all earnings between the LET and the UAP will accrue additional pension at a rate of 10%. From an unspecified future date, the band 1 (40% band) will be replaced by a weekly flat-rate accrual of £1.50 (£78 p.a.). The 10% accrual component will be withdrawn around 2030, leaving a wholly flat-rate benefit.
State Pension Age (SPA)	The State Pension Age (SPA) is 65 for men and 60 for women. However, the SPA for women is changing; it will gradually rise from 60 to 65 from 2010 to 2020. The SPA for both men and women is to increase from 65 to 68 between 2024 and 2046, with each change phased in over two consecutive years in each decade. The first increase, from 65 to 66, will be phased in between April 2024 and April 2026; the second, from 66 to 67, will be phased in between April 2034 and April 2036; and the third, from 67 to 68, between April 2044 and April 2046.
Suitable (retail investment product)	The FSA's Consultation Paper 09/18 of June 2009, *Distribution of retail investments: Delivering the RDR (Retail Distribution Review)* refers to the word "suitable" to such an extent that, at least informally, the word has become a proxy for minimising the risk of mis-selling of retail investment products by Independent Financial Advisers (IFAs). To the extent that an IFA can demonstrate that a given product is "suitable" for his (retail) client, there is an implication that he has acted in best interests of the client and, *inter alia*, has performed a comprehensive and fair analysis of the market on behalf of that client, that the client is operating in accordance with his financial means and investment objectives, that the recommended product best meets the client's needs and risk profile, and that unbiased advice has been given.

Upper Earnings Limit (UEL)	The UEL is an amount set by the government each year for the purposes of calculating National Insurance contributions (NICs) payable by employers and employees. In the tax year 2009/10, the UEL is set at £844 a week (£43,888 p.a.). An employee must pay NICs at rate of 11% of earnings between the Primary Threshold and the UEL, plus 1% of earnings above the UEL. His or her employer must pay NICs at rate of 12.8% of the employee's earnings above the primary threshold. Note that from April 2009 the Upper Accrual Point (UAP) replaces the UEL for the purpose of calculating (and capping) entitlement to S2P. The UAP has been frozen in cash terms, i.e. fixed at £770 a week, £40,040 p.a. (the level of the UEL for 2008-09) and it will remain at that level, leading to an erosion of earnings-related S2P accrual. By 2030, S2P will become a flat-rate top-up to the Basic State Pension.

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These proposals would encourage a culture of retirement saving, and would entail individuals assuming greater personal responsibility for providing for their retirement income, to the benefit of all.

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