

The financial future

Lord Adair Turner, Chairman of the Pensions Commission, offers an overview of their Final Report...

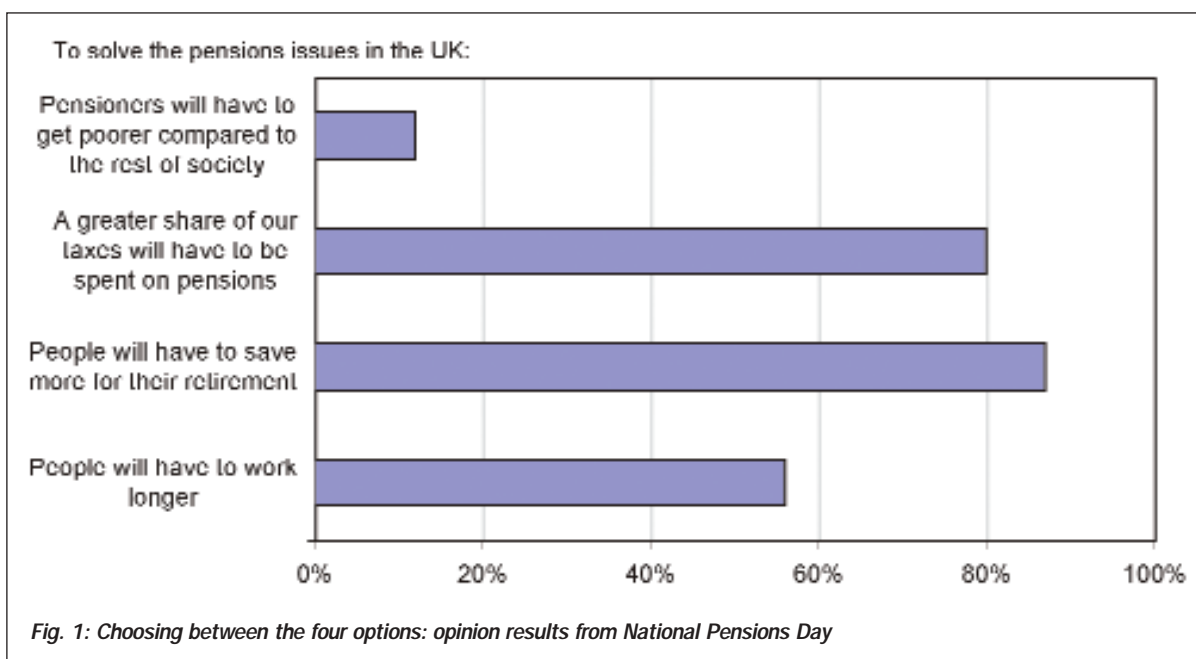
The Pensions Commission's third and final report weighs in at 45 pages, about a 20th of the size of the previous reports. That reflects the nature of this final report. It does not present any major new analysis conducted since the Second Report last November, nor deal with any entirely new subjects not covered in that report. Rather, it responds to specific issues that have arisen in public debate over the Second Report's conclusions. And since it responds to responses, it is necessarily skewed towards those issues where there has been the most intense debate.

Since the Second Report, the limited new information coming available about trends in pension provision has confirmed the picture of a system of voluntary private pension saving, which is in underlying decline. Latest estimates based on the Family Resources Survey show that the percentage of the private sector work force that has no current private pension provision in addition to that provided or mandated by the State has grown from 51% to 56% between 2002 and 2004, a figure up from 44% in 1996. Latest figures from the Employer Pension Provision survey similarly confirm a steady retreat of employers from voluntary pension provision. These trends explain the wide consensus that the existing voluntary system

of private pension provision combined with the existing State system is not fit for purpose.

Faced with that reality the Pensions Commission's Second Report proposed an integrated package with four key elements:

- Reforms of the State system to make it more generous and less means tested than it would otherwise be, but with those reforms made affordable by a gradual long-term rise in the State pension age;
- The application at national level of automatic enrolment, with employees not already in good pension schemes automatically enrolled by their employers into pension saving, but with the right to opt out;
- A modest level of contingent employer compulsion, with employers required to make contributions of 3% of relevant earnings, where the employee chooses to stay enrolled; and
- The creation of a new National Pension Savings Scheme, designed to ensure that all individuals can enjoy the opportunity to save at the low costs currently enjoyed only by higher earners or by employees of large companies or of the public sector.



Those four elements form an integrated package. This final report reiterates the importance of each of the elements, and comments on some of the detailed issues that have been debated over the last four months.

On the first issue, State pension reform, there has not been much detailed debate since Christmas. This reflects the fact that the Government will not make its own proposals until the White Paper due later this spring, but also that there is very wide consensus that the overall thrust of the Pensions Commission's proposals is appropriate. Indeed, criticism of the Pensions Commission's proposals has come almost entirely from experts and interest groups who believe we should have proposed more radical measures to reduce means testing, even at the expense of much higher public expenditure increases than we proposed.

'The Government now faces the difficult challenge of deciding how far and how fast it can move towards the reform of the State pension system we proposed, in the light of other claims on public expenditure.'

We continue to believe that the package we proposed strikes a reasonable balance between the need to prevent the future spread of means testing, the distributional impacts of more generous across-the-board pensions, and public expenditure constraints. Further work on the cost of our proposals has not suggested any major revision to the figures presented in the Second Report, and the cost of our proposals in 2050 is not significantly higher than the Long-term Public Expenditure Projection published at the time of December's Pre-Budget Report, which is the best estimate of expenditure on unchanged indexation arrangements. But the fact that the figures are similar does not mean that there is no additional cost involved – in both, there is an increase in public expenditure on pensions of something like 1.5% of GDP between now and 2050, and it is essential that there is public debate over whether that long-term increase is acceptable.

The Government now faces the difficult challenge of deciding how far and how fast it can move towards the reform of the State pension system we proposed, in the light of other claims on public expenditure. As we said in the Second Report, it may be possible to vary from the specific proposals we made there, while still heading in the required direction. But the direction is essential for the integrity of the overall package. If the State pension system is not reformed in a way that limits the spread of means testing, the success of the proposed new system of private pension saving will be undermined.

At the core of that new system of private pension saving is automatic enrolment. This is the element of the overall package on which there has been the greatest consensus. All of the

interest groups that have proposed variants to the National Pension Saving Scheme – the ABI, the NAPF, CBI – have been united in supporting the principle of auto-enrolment. Any criticism of this principle has come almost exclusively from those who believe that we should have proposed full compulsion, rather than from supporters of pure voluntarism. This reflects the extensive consensus – to which I referred earlier – that a voluntary system will not work. And the principle of auto-enrolment seems to go with the grain of people's attitude towards the appropriate role of the State – most people want to be strongly encouraged and enabled to save, but not actually compelled. At the National Pensions Day, on 18th March, support for the principle of automatic enrolment was very strong.

Contingent compulsion on employers, when the employee chooses to stay enrolled, has, however, been more contentious, with several, though not all, business groups – the CBI, the BCC, the FSB, but not the EEF – arguing against it. Their concern has been the cost to business, and in particular to small business – a cost that we specifically recognised in our Second Report, where we estimated that, while the overall impact on labour cost of our proposal might be of the order of 0.6%, for the smallest companies, it could be a full 1%.

This cost impact is a concern, but the minimum matching contribution is essential for the architecture of the whole package we have proposed.

It means that, for the individual, pension saving can attract a one-for-one match – 4% from the employee, 1% from tax relief, 3% from the employer. Without this matching, we believe that participation rates will be significantly lower.

And it is needed to ensure that returns on savings are attractive despite the remaining element of means testing within the State system – means testing that could not be fully eliminated without levels of public expenditure well beyond those we proposed, and that no government is likely to consider affordable.

We therefore continue to urge that the focus of attention should be on measures that mitigate the cost impact on small business of the matching employer contribution. One appropriate source of additional government revenue that could fund a support package is that created by the declining level of contracted out rebates, which will result from our proposals for the State Second Pension. We did not illustrate the impact of this in the Second Report costings: in fact, government cash flow could be increased by about £0.8bn by 2015 and by £1.9bn in 2020 (in today's real terms) as a result of the proposed freezing in cash terms of the upper limit for S2P accrual. A still higher cash flow benefit would result if contracting out from defined contribution schemes was abolished.

Let me turn finally to the fourth dimension of the package we proposed – the creation of a National Pension Savings Scheme.

This aims to ensure that employees who do not already enjoy low cost savings opportunities through their employers can do so through a national scheme, with the State acting as a bulk buyer of account administration services and of fund management services. The most detailed debates over the last four months have been around this proposal and the alternatives put forward by different experts and interest groups.

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I will not go in detail through the various pros and cons of the different proposals made, but highlight the following points:

First, it is important to understand the common ground. Each of the two major alternatives proposed – the ABI's Partnership Pensions, and the NAPF Super Trust model – share with the Pensions Commission's proposal the principle of automatic enrolment, and the objective of radically reducing operating costs by eliminating the need for regulated individual advice. A year ago, many people might have proposed auto-enrolling employees into stakeholder accounts with Annual Management Charges of 1.3%; the debate now is where, within a range of about 0.3% to 0.6%, the costs should settle.

Second, the argument is not between choice and no choice, competition and no competition, but between different forms of choice and competition. In both the NPSS and the ABI scheme, individuals choose their asset allocation; in the NAPF scheme, their employers choose a Super Trust, which then makes discretionary asset allocation decisions. In the NAPF and ABI schemes, meanwhile, employers or an automatic allocation mechanism – 'the carousel' – select between different alternative account administrators, different insurance companies or Super Trusts. In the NPSS model, the central system can choose between different operational service providers in a competitive bidding process.

The issue, therefore, is which model of choice and competition is most likely to produce the best combination of low cost and benefits of value to members. As set out in this report, we continue to believe that an NPSS type model will likely be the best for three reasons:

- First, it is likely to prove in the long term the lowest cost solution, and to provide just as powerful incentives as the alternatives for costs to be driven down towards the minimum theoretically possible;
- Second, the risk to government arising from member disappointments over investment returns is no greater in the NPSS model than in the alternatives; indeed, arguably, it is less; and

- Third, the NPSS creates no greater a risk than the alternatives of the 'levelling down' of pension provision to a minimum standard. That risk is created by the common features of all three models – by automatic enrolment and by the definition of a minimum matching employer contribution – not by features specific to the NPSS. But we believe that this levelling down risk is less than the risk of doing nothing, which could result, over time, in levelling down to zero pension provision in many small and medium-sized companies.

Where the alternative models might have advantages, however, is that they build on existing infrastructure – IT systems, call centres and communication mechanisms already in place – so that operational set-up risks may be reduced. Government will need to make the trade off between such set-up risks and the likely significant long-term advantages of the NPSS approach.

Overall, therefore, we continue to believe that pension reform needs to combine the four elements we proposed in November:

- State pension reform to prevent the further spread of means testing
- Automatic enrolment
- A minimum matching employer contribution, and
- Low costs delivered through a National Pensions Savings Scheme

Let me finish by stating one other point made in the Second Report: the need to build a consensus around a system whose features and evolution are understandable and relatively stable over time. Other countries, the US or Sweden, show that it is possible to achieve that. In the past, the UK has not managed to. But without reasonable stability and predictability – a system in which people know what the State will do for them and what they have to build for themselves on top of that State provision – we will not address the problems of pension adequacy that the Pensions Commission, three years ago, was asked to investigate.

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