

# Executive Summary

## Introduction

This document is a summary of the First Report of the Pensions Commission. The Commission is an independent body which was established by the Government following the pensions Green Paper in December 2002. Its remit, set out in the Green Paper is, in summary:

*"to keep under review the regime for UK private pensions and long-term savings, and to make recommendations to the Secretary of State for Work and Pensions on whether there is a case for moving beyond the current voluntarist approach."*

This report presents the findings of an analysis of the UK pensions and retirement savings system. It describes in detail the present situation, the trends in place, and the challenges which need to be met. It does not make specific recommendations on pensions policy: these will be set out in our Second Report, planned for Autumn 2005, and will follow a consultation process. It does, however make recommendations relating specifically to improvements in official data sources: these are discussed in Appendix A and listed at the end of the main report.

The key conclusions from our eight analytical chapters are set out below, along with a summary of Chapter 9, which describes the consultation process.

## Chapter 1: The demographic challenge and unavoidable choices

Life expectancy is increasing rapidly and will continue to do so. This is good news. But combined with a forecast low birth rate this will produce a near doubling in the percentage of the population aged 65 years and over between now and 2050, with further increase thereafter. The baby boom has delayed the effect of underlying long-term trends, but will now produce 30 years of very rapid increase in the dependency ratio. We must now make adjustments to public policy and/or individual behaviour which ideally should have been started in the last 20-30 years.

Faced with the increasing proportion of the population aged over 65, society and individuals must choose between four options. Either:

- (i) pensioners will become poorer relative to the rest of society; or
- (ii) taxes/National Insurance contributions devoted to pensions must rise; or
- (iii) savings must rise; or
- (iv) average retirement ages must rise.

But the first option (poorer pensioners) appears unattractive; and there are significant barriers to solving the problem through any one of the other three options alone. Some mix of higher taxes/National Insurance contributions, higher savings and later average retirement is required.

## **Chapter 2: Average retirement ages: Past and possible future trends**

Our response to the demographic challenge should include a rise in the average age of retirement. Healthy ageing for many people makes this possible; and an increase in employment rates among older people is now occurring. But the increase needed to make later retirement a sufficient solution alone looks very large; and significant inequalities in life expectancy and health across socio-economic groups may limit the scope for across the board increases. Increases either in taxes/National Insurance contributions and/or in private savings will therefore also be needed to meet the demographic challenge.

## **Chapter 3: The UK pensions system: Position and trends**

The UK pensions system appeared in the past to work well because one of the least generous state pension systems in the developed world was complemented by the most developed system of voluntary private funded pensions. This rosy picture always hid multiple inadequacies relating to specific groups of people, but on average the system worked, with the percentage of GDP transferred to pensioners comparable to other countries. But the state plans to provide decreasing support for many people in order to control expenditure in the face of an ageing population and the private system is not developing to offset the state's retreating role. Instead it is in significant decline.

The underlying trend in private sector employer pension contributions has been downwards since the early 1980s, and the total level of funded pension saving is significantly less than official estimates have suggested. But irrational equity markets and delayed appreciation of life expectancy increases enabled many Defined Benefit (DB) schemes to avoid necessary adjustments until the late 1990s. As the fool's paradise has come to an end, schemes have been closed to new members, and a shift to less generous Defined Contribution (DC) schemes has followed. The underlying level of funded pension saving is falling rather than rising to meet the demographic challenge, pension right accrual is becoming still more unequal, and risk is being shifted to individuals sometimes ill-equipped to deal with it.

#### **Chapter 4: Looking forward: Pension adequacy if trends unchanged**

Given present trends many people will face "inadequate" pensions in retirement, unless they have large non-pension assets or are intending to retire much later than current retirees.

Current government plans and private savings levels imply that total pension income flowing to normal age retirees will rise from today's 9.1% of GDP to a mid-point estimate of 10.8% by 2050, and that there will be no significant shift in the balance of provision from state to private sources. This level of transfer in turn implies either poorer pensioners relative to average earnings or significantly higher average retirement ages.

The burden of adjustment will however be very unequally distributed. We estimate that at least 75% of all DC scheme members have contribution rates below the level likely to be required to provide adequate pensions. Our estimates suggest that around 9 million people may be under-saving, some by a small amount, some severely. But the significant minority of people in still open private sector DB schemes will enjoy more than adequate pensions and most public sector employees will be well provided for, as will some higher paid employees in Senior Executive schemes. The present level of pension right accrual is both deficient in total and increasingly unequal.

The implications of this for pensioner income will be more serious in 20-25 years time than in the next 10. And over that long time span many adjustments, for instance to savings rates and retirement ages, may naturally occur. A muddle-through option does therefore exist. But it is highly likely that the muddle-through option will produce outcomes both less socially equitable and less economically efficient than we could achieve with a consciously planned response to the problems we face.

## Chapter 5: Non-pension savings and housing

In addition to occupational and personal pension funds worth £1,300 billion and unfunded public sector pension rights worth about £500 billion, the personal sector owns about £1,150 billion of non-pension financial assets, some of which could also provide resources for retirement income. But the ownership of these assets is very unequally distributed, and for the majority of people they can only provide a modest contribution to their standard of living in retirement.

Housing assets are more significant both because they are much bigger (£2,250 billion net of mortgage debt) and their ownership is more equally distributed. While the liquidation of housing assets during retirement will likely remain limited in scope, the inheritance of housing assets by people who already own a house may play an increasing role in retirement provision for many people. But house ownership does not provide a sufficient solution to the problem of pension provision given (i) uncertainty over future house prices; (ii) other potential claims on housing wealth such as long-term care; and (iii) the fact that housing wealth is not significantly higher among those with least pension rights.

Business assets, meanwhile, are important stores of wealth and potential sources of retirement provision, but for only a small minority of people. The fact that pension saving among the self-employed is not increasing therefore remains concerning.

## Chapter 6: Barriers to a voluntarist solution

The present level of pension right accrual, private and state combined, will leave many with inadequate pensions. And there are likely to be limits to solving the problem solely via increased retirement ages. If state system plans are taken as given, a higher level of private saving is required.

There are however big barriers to the success of a voluntary pension saving system, some inherent to any pension system, some specific to the UK. Most people do not make rational decisions about long-term savings without encouragement and advice. But the cost of advice, and of regulating to ensure that it is good advice, in itself significantly reduces the return on saving, particularly for low earners. Reductions in Yield arising from providers' charges can absorb 20-30% of an individual's pension saving, even though they have fallen to a level where provision to lower income groups is unprofitable. This poses a fundamental question: in principle can a voluntary market for pensions work for low income, low premium customers?

But both the behavioural barriers to savings and the costs of provision have been made worse by the bewildering complexity of the UK pension system, state and private combined. This complexity reflects the impact of multiple decisions made over the last several decades, each of which appeared to make sense at the time, but the cumulative effect of which has been to create confusion and mistrust. Means-testing within the state system both increases complexity and reduces, and in some cases reverses, the incentives to save via pensions which the tax system creates. The scope of this means-testing would grow over time if current indexation approaches were continued indefinitely.

Unless new government initiatives can make a major difference to behaviours it is unlikely that the present voluntary private system combined with the present state system will solve the problem of inadequate pension savings.

### **Chapter 7. Revitalised voluntarism, changes to the state system, or increased compulsion?**

To achieve adequacy there are three possible ways forward:

- (i) a major revitalisation of the voluntary system and/or;
- (ii) significant changes to the state system; and/or
- (iii) an increased level of compulsory private pension saving beyond that already implicit within the UK system.

This chapter considers possible change along these three dimensions, and the issues to be considered in choosing between them. Its purpose is solely to stimulate debate and to highlight the difficulties, as well as the advantages, of any way forward. Analysis of these issues, discussed only in outline here, will be the key focus of the Pensions Commission between now and the publication of the Second Report in Autumn 2005

## **Chapter 8. Women and pensions**

Women pensioners in the UK today are significantly poorer than men. This reflects both labour market features (lower employment rates, lower average earnings, and more part-time work) and specific features of the UK's state pension system. These state system features have in the past entailed most women gaining pension income through their husband, and reflected assumptions about family structure which have ceased to be valid. An effective pension system for the future must be one in which the vast majority of women accrue pension entitlements, both state and private, in their own right.

Some progress towards that aim is now occurring, with some labour market trends favourable to women, and some changes in the state system which benefit women. But important issues remain relating to overall equality in the workforce, to state system design, and to low levels of pension provision and take-up in some service sectors in which women's employment is concentrated.

## **Chapter 9. Issues and consultation process**

In its deliberations over the next year, the Commission would like to hear the views of interested and informed parties, and to get their reactions to this First descriptive report. It would be helpful if in setting out those reactions, organisations or individuals could separately and explicitly identify:

- (i) Any areas where they believe that we have the facts wrong or where we overlooked available sources of information.
- (ii) Whether they believe the judgements we have had to make about future trends are over-optimistic or over-pessimistic.
- (iii) What the organisation or individual believes should be the appropriate responsibility of the state in ensuring adequate pension provision.

Specific issues on which we would welcome views are mentioned at various points in the report, and are then pulled together in Chapter 9.

The Commission would like to receive written submission on these issues by end-January 2005. The arrangements for making submissions are set out at the end of Chapter 9.