



**Charles Cowling**

**Pension Reckoning**

Paying for private and public  
pensions

**POLITEIA**

A FORUM FOR SOCIAL AND ECONOMIC THINKING

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Pension Reckoning  
Paying for Private and Public Pensions

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POLITEIA  
2010

First published in 2010  
by  
Politeia  
22 Queen Anne's Gate  
London SW1H 9AA  
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Policy Series No. 71

ISBN 978-0-9564662-3-5

Cover design by John Marenbon

**Politeia gratefully acknowledges support for this publication from**



The Foundation for Social and Economic Thinking

Printed in Great Britain by:  
**Abacus Printing Company Ltd.**  
Gloucester House  
34-38 Gloucester Way  
London EC1R 0BN

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He is a co-author of the Sessional Paper, *Funding Defined Benefit Pension Schemes*, for the Institute and Faculty of Actuaries in 2004. He is a Fellow of the Institute of Actuaries and served as member of the Council of the Institute of Actuaries from 2003 through to 2009 and as Chairman of the Pensions Executive Committee of the Actuarial Profession between April 2008 and July 2010.

*'Turn him to any cause of policy,  
The Gordian Knot of it he will unloose'*

Shakespeare, *Henry V*

As it was for Henry V, whose reputation was partly built on success in breaking down apparently intractable problems, so it will be for the new government. Amongst the many problems faced, few will appear as intractable as that of paying for UK pensions. The problem has been made all the more complex by the successive attempts of ministers and regulators to modify the foundations, though with little success so far. As the problems of UK pensions have become more complex, so too have they become more acute and more significant. The time may now be right to cut this Gordian Knot.

# Introduction

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Over the last decade one of the problems with which Westminster has grappled for over a century has become a central focus for policy: How should the UK pay for retirement? When, in 2002, the Pensions Commission was appointed, its remit was to keep under review the adequacy of private pension saving in the UK and advise on changes needed. It was also to consider whether policy could continue to rely on a voluntary approach. Its *First Report* (October 2004) suggested the options for the country were either relative poverty for pensioners unless taxes, National Insurance contributions for pensions and savings were to rise, or the retirement age should rise.<sup>1</sup>

The problem of paying for retirement is not new or peculiar to the UK. The World Bank's detailed research report of the 1990s, *Averting the Old Age Crisis*, urged that 'all countries should begin planning now'.<sup>2</sup> However, that report was published in 1994 and sadly we are little closer now to addressing the problems of pension provision in the UK.

The wider pensions picture must be considered against a number of societal changes, which include:

- People are all living longer - a lot longer
- Pensions have become much more expensive
- Tax incentives for pension saving have been eroded
- The private sector is weighed down by legacy pension debts
- The public sector has a mountain of unfunded pension debt

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<sup>1</sup> Pensions Commission, *First Report*, 2004. The report suggests the following possibilities:

- Pensioners will become poorer relative to the rest of society
- or taxes/National Insurance contributions devoted to pensions must rise
- or the savings rate must rise
- or average retirement ages must rise'

<sup>2</sup> World Bank, *Averting the Old Age Crisis*, Oxford, 1994. The Report explained that 'Systems providing financial security for the old are under increasing strain throughout the world. Rapid demographic transitions caused by rising life expectancy and declining fertility mean that the proportion of old people in the general population is growing rapidly. Extended families and other traditional ways of supporting the old are weakening. Meanwhile, formal systems, such as government-backed pensions, have proved both unsustainable and very difficult to reform. In some developing countries, these systems are nearing collapse. In others, governments preparing to establish formal systems risk repeating expensive mistakes. The result is a looming old age crisis that threatens not only the old but also their children and grandchildren, who must shoulder, directly or indirectly, much of the increasingly heavy burden of providing for the aged.'

## *Pension Reckoning*

- Regulators are demanding increased protection for pensions
- Employment practices are changing
- Defined Benefit (DB) Pension Schemes are rapidly disappearing in the private sector
- We are not saving enough for our retirement
- Current pension provision is a complicated mixture of State and Private
- The National Employment Savings Trust (NEST) is complicated and will provide only minimal benefits
- Politicians do not seem prepared to introduce major pension reform

Both the UK's Pensions Commission and the World Bank highlighted the severity of the problem and the difficulties that any solution must address. Both concluded that pension provision needs to be a careful balance of state and private provision, and both concluded that urgent action is needed. This paper supports those conclusions, in particular that urgent action is now needed, and suggests a possible way forward.

# I

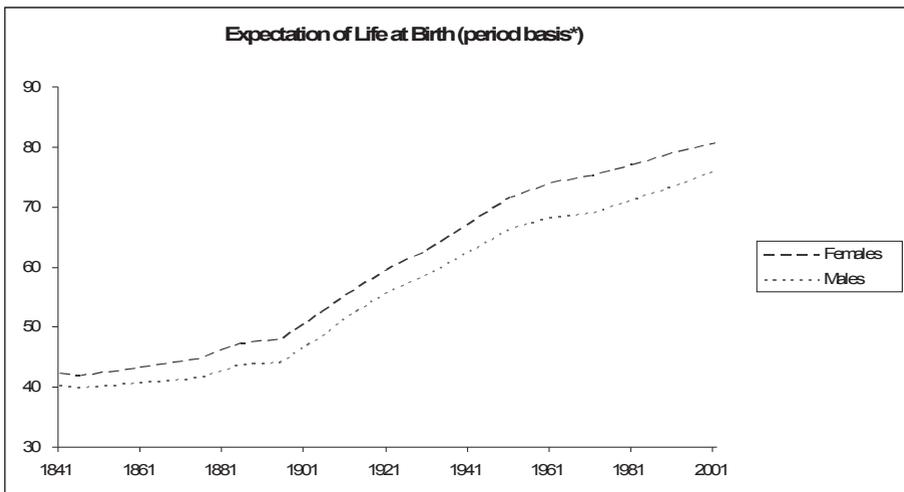
## The Position Today

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Behind the problem of pensions in the UK lie a number of demographic and societal trends, many of which can only be welcomed, but all of which bring some cost. People are living longer but retirement age is not fixed in relation to life expectancy. At the same time some of the advantages which the UK enjoyed over other similar countries in terms of pension provision until the 1980s have disappeared, often hastened by misguided pension policy. The burden of cost to both public and private sectors is high, but often hidden.

### People are all living longer - a great deal longer

Average life expectancy in the UK has been increasing at the rate of up to 2 years every decade, or put another way, 5 hours every day. Indeed, increasing life expectancy has been a feature of our society for at least 200 years. The following graph shows the increase in period life expectancy at birth in England and Wales since 1841 from the tables produced by the Government Actuary.



Source: [http://www.statistics.gov.uk/downloads/theme\\_population/Eols-ELT.xls](http://www.statistics.gov.uk/downloads/theme_population/Eols-ELT.xls)

\* The period basis of calculating life expectancy uses the mortality rates at all ages for the calendar year under consideration. Hence the calculated values do not show the likely experience of a particular generation, but form a convenient summary measure of the overall effects of changes in mortality.





## *Pension Reckoning*

This increasing cost of pensions flows through, in particular, to DB or final salary pension schemes. It has not been unusual to see a pension scheme which in the 1980s had, for the company, an ongoing cost then of perhaps 15 per cent of payroll, see the same cost rise to over 30 per cent of payroll today (before the cost of financing any deficit).

### **Tax incentives for pension saving have been eroded**

Tax incentives to save for a pension have been severely cut back over many years by a number of changes:

- |                       |   |  |
|-----------------------|---|--|
| Finance Act 1986      | - | Introduced taxation of excessive pension scheme surplus  |
| Finance Act 1989      | - | Introduced caps on pensions for high earners   |
| 1993 and 1997 Budgets | - | Abolition of tax relief on equity dividends for pension schemes                                |
| Finance Act 2004      | - | Introduced a new regime of pension taxation with new annual and lifetime limits and allowances |
| 2009 Budget           | - | Significant new restrictions on tax relief on pension contributions for high earners           |

The many attacks on high earner pensions in particular have had the effect of significantly changing attitudes towards pension schemes in company board rooms. Whilst senior management were also benefiting from generous company pension arrangements they strongly resisted proposals to change pension provision for employees generally - even as the burden of pension schemes on companies became ever greater. As senior management have increasingly been taxed out of pension schemes, so their desire to fight for the maintenance of good pension provision for other employees has waned.

A further feature of the latest tax changes for high earners is that they are excessively complicated. So much so that it will be impossible for employers to work out whether (from April 2011) it makes sense to include high earners in pension arrangements or not. As a result many commentators have suggested that employers would be advised to withdraw all employees earning over £130,000 per annum from their group pension provision. This will have an inevitable consequence on all employee pension provision.

### The private sector is weighed down by legacy pension debts

The latest quarterly report from Pension Capital Strategies (PCS) on the FTSE 100 and their pension schemes shows total disclosed pension liabilities of £410 billion (on the IAS19 calculation basis) with an estimated total deficit at 31 March 2010 of £66 billion. There are 9 FTSE 100 companies with total disclosed pension liabilities greater than their equity market value, whilst for British Airways and BT, total disclosed pension liabilities are more than treble the company's equity market value.

The FTSE 100 companies with the largest pension scheme liabilities (all those over £10 billion) are as follows:

		<b>Total Pension Liabilities £m</b>	<b>Equity Market Value* £m</b>
1	Royal Dutch Shell	39,391	117,079
2	BT	33,326	9,581
3	Royal Bank of Scotland	30,830	25,648
4	Lloyds Banking Group	27,073	42,003
5	BP	23,281	117,465
6	BAE Systems	20,488	13,092
7	Barclays	20,486	41,045
8	HSBC	18,869	116,261
9	National Grid	16,000	15,702
10	Unilever	14,515	59,109
11	British Airways	12,806	2,794
12	GlaxoSmithKline	12,438	66,318
13	Aviva	11,812	10,660
14	Rio Tinto	10,006	59,640

*\*As at 31 March 2010. Source: The FTSE100 and their Pension Disclosures, PCS, May 2010*

This pattern of large legacy pension liabilities and deficits is repeated right across the private sector. PCS estimates that total pension liability of UK private sector pension schemes (on the IAS19 calculation basis) is now nearly £1,200 billion, with an estimated total deficit of nearly £200 billion. In some companies with very large pension deficits, management see little point in making big efforts to grow / save the business if all the profits are swallowed up in the pension black hole.

### The public sector has a mountain of unfunded pension debt

There are several very large pension schemes for public sector workers which are entirely unfunded and therefore represent a liability that tax payers owe to public sector workers. The largest of these pension schemes cover teachers, NHS, Civil Service, Police, Fire and Armed Forces.

These pension schemes have total liabilities in excess of £1,000 billion. According to Neil Record, author of *Sir Humphrey's Legacy: facing up to the cost of public sector pensions*, the total liability for unfunded public sector pensions now stands at £1,300 billion. Moreover, there is very little that can be done about the size of these accumulated liabilities – the new Government's recent publication *our programme for government* contains a commitment to protect accrued pension rights of public sector workers. This has been confirmed by Steve Webb, the recently appointed Pensions Minister, who has said that 'a pension promise made is a pension promise kept'.

### **Regulators are demanding increased protection for pensions**

*In extremis*, if an employer ceases to exist, pension scheme deficits result in scheme members losing a large part of their retirement savings. The introduction of the Pension Protection Fund (PPF) has improved security for members' benefits (although many members would still lose a significant proportion of their pension if their pension scheme fell into the PPF) – but at a cost. The cost of financing the PPF falls onto other pension schemes. This means that well run pension schemes can end up bailing out failed pension schemes.

The recent trend in legislation (particularly from Europe) is to require greater levels of security attaching to savings and financial institutions. Whilst it is not yet expected that pension schemes will be subject to the same solvency requirements that are coming to insurance companies – further pressure to reduce pension risk is inevitable. Indeed a combination of pressure from the UK Pensions' Regulator and the design of the levy used to finance the PPF is already encouraging UK pension schemes to take less risk. However such demand for protections and guarantees comes at a high cost for companies whose pension bills rise ever further, and has been a further reason for private sector employers turning away from DB pension provision.

There has been a call for a return to risk-sharing in DB pension schemes, in an attempt to reduce costs. However current legislation already permits a significant amount of risk sharing (as was highlighted in the Department for Work and Pensions (DWP) paper *Risk Sharing: information for employers considering making changes to Defined Benefit pension schemes* published earlier this year) but there seems little appetite either from employers or employees for increasing risk sharing in pensions. Moreover the particular problem for DB pension schemes is that any form of risk sharing is inevitably very difficult for individuals to control or influence.

Indeed this highlights the fact that there are two forms of ‘risk sharing’ – sharing of the employer covenant risk and sharing of the investment and demographic risks. The sharing of the employer covenant risk is both inefficient (as pension scheme members are unable to diversify employer covenant risk) and creates false savings - promised or guaranteed benefits should have very little or no risk of default attaching to them. When it comes to the sharing of investment and demographic risks, this is better achieved by innovation in the design of Defined Contribution (DC) pensions, which can be more flexible and tailored to individuals' needs, rather than innovation in DB design. It is therefore increasingly unlikely that risk sharing in DB schemes will form the basis of a ‘solution’ to the UK's pension problems.

### **Employment practices are changing**

Much has been written about how employment practices are changing:

- Expectations are that young people joining the work force today will have many more employers and change jobs far more frequently than was the case for previous generations.
- There has been an increase in part-time and flexible working.
- Employment rates among older workers have increased in recent years.
- Many people are now much healthier in old age.
- Retirement is not always the ‘cliff-edge’ change it was once perceived to be - many people now continue working part-time or in voluntary roles for several years into ‘retirement’.

The TUC favours a shift to greater flexibility in working patterns in response to both workers and employers’ changing societal patterns.<sup>3</sup> However, its message is more mixed on the question of extending working life. It contends the right to retirement is an historic right, which it would be ‘reluctant to throw away’; though working on by choice is another matter.<sup>4</sup>

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<sup>3</sup>TUC [www.tuc.org.uk/changingtimes/worktrends.htm](http://www.tuc.org.uk/changingtimes/worktrends.htm) ‘We already know that the rise of flexibility in working patterns in recent years has been fuelled by a demand from both workers and employers.

- Employees want greater work-life balance and increasingly this is across the board rather than just limited to those needing to choose flexibility to accommodate caring responsibilities
- Social research suggests that this trend will intensify in the coming years and that employee demand for work-life balance will expand rapidly.
- In recent years employers have been under increasing pressure to implement flexible working patterns both to meet employee demand and in order to enhance competitions and productivity and to deliver high quality service and products to their customers and clients.’

<sup>4</sup> TUC *Ready, willing and able, employment opportunities for older people* ‘We can see why promoting employment for over-50s is a social priority, but is this fair to the individuals concerned?’ For trade

The proportion of people not in the working population at different ages is illustrated in the following table from the ONS:

<b>UK Economic inactivity rates by age (2004)</b>					
<b>Age</b>	<b>Men</b>	<b>Woman</b>	<b>Age</b>	<b>Men</b>	<b>Woman</b>
<b>50</b>	10.0%	22.7%	<b>62</b>	43.3%	71.0%
<b>51</b>	12.9%	21.4%	<b>63</b>	46.8%	76.4%
<b>52</b>	13.6%	23.6%	<b>64</b>	56.1%	81.8%
<b>53</b>	14.8%	25.8%	<b>65</b>	76.0%	86.5%
<b>54</b>	17.1%	28.1%	<b>66</b>	78.0%	88.3%
<b>55</b>	17.4%	31.3%	<b>67</b>	83.0%	89.4%
<b>56</b>	20.2%	33.9%	<b>68</b>	87.1%	93.8%
<b>57</b>	23.5%	38.7%	<b>69</b>	88.6%	92.2%
<b>58</b>	24.8%	41.2%	<b>70</b>	91.4%	94.1%
<b>59</b>	28.7%	44.5%	<b>71</b>	92.3%	96.6%
<b>60</b>	35.7%	59.6%	<b>72</b>	92.2%	97.3%
<b>61</b>	41.8%	64.5%			

### **DB Pension Schemes are rapidly disappearing in the private sector**

The trend on the provision of DB pension schemes in the private sector is clear. The 2008 Smaller Firms Pension Survey from the Association of Consulting Actuaries (ACA) revealed that 90 per cent of pension schemes amongst smaller employers were closed to new members and nearly half were closed to all future pension accrual. The ACA's 2009 Pension Trends Survey revealed 87 per cent of DB schemes were closed to new members and of these 18 per cent were also closed to future accrual. Moreover it also revealed that 34 per cent of DB schemes were under active review with 39 per cent of companies considering changes to future accrual.

The 2009 report from PCS on the FTSE 250 and their pension disclosures revealed that nearly half of all FTSE 250 companies do not have any DB pension scheme at all. Only 92 FTSE 250 companies were still providing more than a handful of employees with DB benefits (i.e. ignoring companies with DB service costs of less than 1 per cent in total payroll) of these, only 20 companies (less than 10 per cent of the FTSE 250) were still providing DB benefits to a significant number of employees (defined

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unionists, the right to a retirement is one of our historic achievements, and we would not want to throw it away. But the case is altered if there are older people who have not really chosen retirement and face poverty and exclusion as a result. This would justify a substantial effort to help older people who want to remain in (or return to) employment.’

as incurring a DB service cost of more than 5 per cent of total payroll).

Even amongst FTSE 100 companies the trend away from DB schemes is now significant. The latest PCS report on the FTSE 100 companies and their pension schemes showed a 15 per cent decline in employee pension provision in the last year alone.

### **We are not saving enough for our retirement**

The Department for Work and Pensions has estimated that about 7 million people are not saving enough for retirement (*Security in retirement: towards a new pension system* published May 2006).

A recent analysis by DWP ('Workplace pension reform regulations - impact assessment' - January 2010) shows that approximately 750,000 employers currently offer no workplace pension provision at all, and 280,000 offer some provision but make less than a 3 per cent employer contribution. The Association of British Insurers is even gloomier. According to their *The State of the Nation's Savings* (published Nov 2008), there are approximately 9.6 million working people not saving anything for their retirement and another 3.8 million not saving enough.

### **Current pension provision is a complicated mixture of State and Private**

There are 3 tiers of pension provision in the UK.

1. Basic State Pension
2. State Second Pension
3. Private or employer provided pension

The Basic State Pension is currently £5,077.80 per annum for a single person or £8,119.80 per annum for a married couple (unless both qualify for a Basic State Pension in their own right in which case the figure is £10,145.60 per annum). To qualify for a full Basic State Pension, a person must have sufficient qualifying years during which he or she has paid National Insurance Contributions (or is treated as having paid them). The Basic State Pension is payable from State Pension Age which is currently age 60 for women and 65 for men. However between now and 2020 the State Pension Age for women is rising to age 65. From 2024 to 2036 the State Pension Age is rising to age 68 for everyone (although the new Coalition Government has proposed accelerating this timetable).

The second tier of pension provision has been very complicated ever since it was introduced in 1978. It has not been helped by the fact that both the State Earnings Related Payment Scheme (SERPS) and the State Second Pension (S2P) which replaced it have been changed every few years. As a result it is virtually impossible, even for an expert, to work out the correct amount of this second tier pension. A further feature of this second tier pension is that it was originally intended to be linked to the level of National Insurance contributions deducted. However with each change to the rules this link has become more and more tenuous.

The SERPS Pension was based on the amount of earnings and National Insurance contributions paid (or treated as having been paid) before 2002. Until last year, the S2P pension was building up at different rates depending on earnings and National Insurance Contributions. The three bands of earnings were:

- Earnings between the Lower Earnings Limit (LEL - £4,940 in 2009/10) and the Low Earnings Threshold (LET - £13,900 in 2009/10)
- Earnings between the LET and the Upper Earnings Threshold (UET - £31,800 in 2009/10)
- Earnings between the UET and the Upper Earnings Limit (UEL £40,040 in 2009/10)

For those with qualifying earnings and a full working life's membership, the S2P pension was calculated as:

- 40 per cent of LET and LEL (irrespective of actual earnings) *plus*
- 10 per cent of earnings between LET and UET *plus*
- 20 per cent of earnings between UET and UEL

Changes to S2P were set out in a DWP explanatory memorandum earlier this year. But as the extract from the DWP memorandum below shows, this latest change to S2P (which is moving it gradually from an earnings-related formula to a flat rate formula) is not straightforward or clear.<sup>5</sup>

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<sup>5</sup>*Explanatory Memorandum to the Social Security (Maximum Additional Pension) Regulations 2010, No. 426.* The Pensions Act 2007 simplifies State Second Pension accrual rates so that in the future it will become a simple flat rate weekly top-up to the basic State Pension. Accruals at the low earnings threshold will be replaced with a flat rate cash amount of £1.60 a week for each qualifying year, from a date yet to be set but likely to be 2012. Earnings-related accruals will be gradually removed from the system by around 2030 through a combination of earnings revaluation of the flat amount and freezing of the Upper Accrual Point. The Upper Accrual Point was introduced as the ceiling on the State Second Pension accruals from April 2009.'

The third tier of pension provision is then made up of either employer pension schemes (DB or DC) or private pension provision. It is possible to contract out of the second tier of State Pension Provision (in return for lower employee and employer National Insurance contributions) if the employer or private pension arrangements meet specified adequacy requirements. However the rules and regulations for contracting out are even more complicated than the rules governing the second tier pension.

There are also very many complicated rules governing third tier employer provided pension schemes. Here are just two examples:

- The rules governing revaluation of deferred pensions (i.e. the benefit provided to an early leaver in a DB pension scheme) are different for leavers before 1985, leavers during 1985, leavers between 1986 and 1990, and leavers from 1991. Several different rates of revaluation can apply to different tranches of pension for one individual member between date of leaving and date of retirement.
- The rules governing increases to pensions in payment are such that different rates of pension increase can apply to different tranches of pension. Indeed it is quite normal for pensioners to have at least five tranches of pension all with a different pension increase rule.

The rules have been further complicated by the interaction between second tier pensions and contracting out rules and sex equality regulations. All of these rules and regulations mean that the UK has the most complicated pension system in the world. Indeed it would not be going too far to suggest that DB pension schemes have been (and are being) regulated out of existence in the UK.

As already mentioned above, there are large numbers of people not in any form of personal or employer funded pension and therefore reliant entirely on tier 1 and tier 2 State provision. To address this lack of pension saving the National Employee Savings Trust was created.

**NEST is complicated and will provide only minimal benefits.**

NEST is due to receive its first contributions in 2012 and is the UK's first compulsory pension savings scheme. However, although it is in essence a simple scheme, it is unnecessarily complicated by the fact that it will have to deal with huge numbers of very small payments/accounts for low paid and temporary workers, many of whom will not necessarily be any better off in retirement due to means tested State support.

Moreover the level of contributions required by NEST is low:

- The total minimum contribution required will be 8 per cent of qualifying earnings
- There will be a phasing-in period for NEST contributions. Between October 2012 and October 2016 the total minimum contribution required is 2 per cent of qualifying earnings and between October 2016 and October 2017 the total minimum contribution required is 5 per cent of qualifying earnings. The 8 per cent contribution rate applies from October 2017.
- Qualifying earnings are defined as the gross earnings payable to that person in a 12 month period, between £5,035 and £33,540 (in 2006/7 terms - the figures will be updated for 2012).
- The maximum contribution that can be paid into NEST is £3,600 per annum (this figure will be updated in line with earnings growth up to and beyond 2012)

Inevitably, if only minimal contributions are paid in, only minimal benefits can be paid out. It is questionable whether this has been made clear to the public.

### **Politicians do not seem prepared to tackle major pension reform**

Faced with a myriad of problems on pensions, the Coalition Government's proposals as outlined in *The Coalition: our programme for government* are to restore the earnings link to State pensions, protect free TV licenses and certain other benefits and to establish a commission to review the affordability of public sector pensions.<sup>6</sup> John Hutton recently accepted an invitation to chair a Public Service Pensions Commission.

These policies suggest that politicians do not believe there is a pension problem. They are certainly not the urgent actions demanded in the World Bank report to stave off a looming old age crisis.<sup>7</sup>

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<sup>6</sup> *The Coalition: our programme for government* <http://programmeforgovernment.hmg.gov.uk/>

<sup>7</sup> World Bank, *Averting the Old Age Crisis, A World Bank Policy Research Report*, 1994.

## II

### Problems and Difficulties

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The key problems for pensions in the UK can be grouped into six main categories:

**Structural Problems** The UK has the most complicated pensions system in the world. The second tier of State pensions is so complicated that few have any idea what their second tier pension is likely to be which makes planning for retirement very difficult. We need a system where it pays to save for retirement whereas means-testing creates disincentives for pension saving. Moreover, the changing tax treatment of pensions is making it less attractive to save for a pension and the rules are generally far too complicated, as are those for the new NEST scheme.

**Not enough saving** The UK generally is not saving enough. Too many people are saving too little for their retirement and NEST will be inadequate on the current contribution rates.

**Pensions not well designed for today's work/life cycle** Fully guaranteed final salary pensions are now far more expensive than makes sense for any employer. Such final salary pension schemes are less and less relevant for today's workforce. At the same time DC pensions carry risks that are very difficult for many to manage and those on the lowest incomes are least able to bear investment risk.

**Understanding costs** The cost of pension provision has been poorly understood and often understated. As a result, pensions are not properly costed / cross charged.

**Affordability** The impact of increasing longevity must be faced and not passed on to the next generation. Pension deficits in the private sector pose a huge obstacle to economic recovery. At the same time the mountain of debt in the public sector pension schemes will have to be met by the next generation. In addition, State Pensions are becoming unaffordable (particularly if linked to earnings).

**Practicality** Pensions are unattractive for politicians to tackle especially as many solutions will prove unpopular with some. There are many vested interests to manage and inevitably there will be many complicated messages to get across.

Some of these problems have already been considered in the first section, but some further points are noted below.

### **Structural Problems: Means testing and Pension Credit**

There are two different types of Pension Credit. Guarantee Credit is for those who have reached the minimum qualifying age (State Pension Age). Savings Credit is for those aged 65 or over.

The Guarantee Credit guarantees a minimum income by topping up income to:

- £6,895.20 per annum for a single person
- £10,524.80 per annum for those with a partner

These amounts may be more for those who are disabled, have caring responsibilities or certain housing costs, such as mortgage interest payments.

Savings Credit may be paid on its own or with the Guarantee Credit. It is payable to those aged 65 or over who have made some provision towards retirement such as savings or a second pension. The Savings Credit can be up to:

- £1,067.04 per annum for a single person
- £1,408.68 per annum for those with a partner

Savings Credit may be payable where the total income is less than:

- £9,568 per annum for a single person
- £14,040 per annum for those with a partner

Again, these amounts may be more for those who are disabled, have caring responsibilities or certain housing costs, such as mortgage interest payments.

Pension Credit is designed to ensure that people have sufficient minimum income. However, it creates perverse incentives and means that for the low paid it often does not pay to save. There are other means tested State benefits, most notably Housing Benefit, which all contribute to the ‘benefits trap’ where it can make no sense for people to save.

Inevitably a balance has to be struck between universal benefits and means tested benefits. But our system in the UK which sees the level of the Basic State Pension struck at below the basic level of Pension Credit creates the worst of all situations with hugely unnecessary complications and perverse incentives. Why set the universal level of State Pension below this level of Pension Credit, if the State is then going to top up the State pension to the level of Pension Credit and go through all the administrative pain and cost of means testing (including effectively making the pension savings for many low paid of no value)?

### Understanding costs

Many public sector bodies and some private sector bodies do not recognise or pay the full cost of pensions, either in terms of ongoing cost of accrual or in terms of the cost of changes (e.g. early retirement programmes). This leads to poor or inefficient management decisions and policies. In particular, Government should not act as if it, i.e. the public sector, can provide pensions any cheaper than the private sector. Indeed fully guaranteed (i.e. Government backed) pensions are more expensive (and more valuable) than riskier private sector pensions.

In his paper *Sir Humphrey's Legacy*, Neil Record examined the detail of the cost of ongoing DB pension provision in the public sector. He calculated that the total 'real' annual cost of teachers' pensions is 34.7 per cent of salary for men and 39 per cent for women which compares with the amount Government charges employees 6 per cent of salary, and employers 13.5 per cent of salary (i.e. a total cost of 19.5 per cent). Further details of Neil Record's calculations are shown below:

#### Estimated annual 'real' cost of pensions as a percentage of salary (main unfunded public sector pension schemes, 1.1% real yield, March 2006)

Employer	Employees' contribution (%)	Current employers' contribution (%)	Employees' sex	Calculated cost (%)	Employers' contribution required (%)
Teachers	6.0	13.5	Male	34.7	28.7
			Female	39.0	33.0
NHS	6.0	14.0	Male	34.7	28.7
			Female	39.0	33.0
Civil Service	3.5	13.6	Male	39.5	36.0
			Female	45.3	41.8
Police	1.0	26.0	Male	63.7	52.7
			Female	71.8	60.8
Armed Forces	0.0	22.1	Male	49.3	49.3
			Female	54.7	54.7

For those who have championed the many benefits of DB pension schemes, the sad reality is that fully guaranteed final salary pensions are now far more expensive than makes sense for any employer – even if there was not already a question mark hanging over DB schemes due to their complexity and changing employment patterns.

## *Pension Reckoning*

There are very few employers who can rationalise an employment cost for any pension scheme which exceeds 20 or 30 per cent of payroll, let alone a pension scheme that also comes with significant financial and regulatory risk. Most employers will say that they can find a much better mix of the remuneration package for recruiting and retaining employees.

The cost of DB pension schemes can be reduced by changes to design, e.g. raising retirement ages, but achieving a meaningful reduction in cost and risk is extremely difficult.

### **Practicality**

Pensions are very unattractive problems for politicians to tackle. Any solution will involve some short term pain for much longer term gain - never very attractive given the short-term perspective of most MPs. Indeed, this is the likely reason behind many of the failed political initiatives on pensions over the last 10 or 20 years. In particular, whilst the public sector is bracing itself for some significant cuts, nevertheless addressing the issue of public sector pensions will be extremely difficult.

Another key issue when it comes to practicality is the inherent and huge complication of pensions generally and, not surprisingly, the consequent lack of appetite amongst people to engage with and understand the issues. Any change to our pension system has to be explained and ‘sold’ to the population as a whole. This is a huge challenge.

Finally and linked to the previous point, if any significant changes are to be made to our pension system they must be fair and be seen to be fair. Inevitably, any pension changes will be unpopular with many - no programme of change is ever going to be seen to be of benefit to all. But if people understand that change is necessary, then even unpopular change can be accepted if it is considered to be fair.

Any ‘solution’ that attempts to tackle just some of the above problems without recognising the whole picture will be prone to failure. Equally, the issues are now so urgent that papering over the huge cracks in our pension system is no longer acceptable. Big problems require significant solutions.

### III

## The Route to Reform

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There is no unique solution to the many and difficult pension problems which the UK faces. This paper proposes a possible way forward. It is not the only possible way forward. But any solution to our pension difficulties must be ambitious enough to tackle the problem as a whole and tackle all the different elements of this fiendishly difficult issue. Steve Webb has spoken of the 'curse of incrementalism' whereby time and again we have tinkered with our pension system in the UK without introducing the fundamental and holistic change that is needed.

The proposal developed below is based on a number of key principles. It is suggested that solutions and systems should be:

- Simple
- Encourage pension saving
- Affordable
- Durable
- Fair
- Practicable for politicians to implement

The World Bank study, *Averting the Old Age Crisis*, concluded that a three pillar system with a public managed mandatory scheme to reduce poverty, a privately managed mandatory scheme and a voluntary savings system, would be the best way to provide financial security for old age. By separating the redistributive function (the public pillar) from the savings function, the tax needed for funding could be controlled and the problems for growth associated with a dominant public pillar, contained. Spreading the insurance function across all three pillars would offer greater income security to the old rather than reliance on any single system.<sup>8</sup>

In the UK we do already have a three pillar system. But as outlined earlier in this paper, there are major cracks and structural problems in each pillar. The proposals out-

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<sup>8</sup> World Bank, *Averting the Old Age Crisis*, Oxford, 1994, suggests that financial security for the old and economic growth would be better served if governments develop three systems, or 'pillars' of old age security: a publicly managed system with mandatory participation and the limited goal of reducing poverty among the old; a privately managed, mandatory savings system; and voluntary savings. The first pillar covers redistribution, the second and third pillars cover savings and all three coinsure against the many risks of old age.'

lined below would represent a sustainable way forward for pensions in the UK which would be fair, affordable and practicable (although this does not mean they would be universally popular).

The proposed possible way forward can be summarised, as follows:

### **Basic State Pension**

- Increase State Pension Age to 70 or 75 as soon as practicable
- Provide an enhanced flat rate Basic State Pension
- Earnings link to be restored, provided that further increases to State Pension Age are linked to increasing longevity

### **State Second Pension**

- Abolish the State Second Pension
- Enhance and simplify NEST, which becomes a compulsory DC pension scheme for all and a replacement second tier pension scheme (with full private sector competition)

### **Private, Personal and Occupational Pensions**

- Significant simplification of tax rules, restoring tax incentives to save for all, and encouraging greater third tier pension provision
- But introduce additional taxation on DB schemes (which will likely see the end of DB schemes in the UK)
- Protect accrued benefits for public sector workers but rules on future benefits will be the same for the public sector as in the private sector
- Introduce measures to help employers manage their DB legacy liabilities

This would create a stable and affordable three-pillar basis for security in retirement involving a mandatory public and private system and a voluntary system for additional pension savings. Further details on the proposals are given below:

#### **1. Overhaul of State benefits**

State pension provision should be simplified and made more affordable with an increase in the State Pension Age (SPA). In particular, reform needs to increase SPA to age 70 or 75 as soon as possible (a proposal is set out in Appendix 1).

The State Second Pension should be abolished (but see below for proposal on second tier State benefits already earned) and a new enhanced flat rate Basic State Pension

payable from new State Pension Age should be introduced (Government and Treasury to agree on what level of Basic State Pension can be afforded). If at all possible, the level of the Basic State Pension should be high enough to take most people out of the means tested Pensions Credit (ie at least £6,895.20 per annum).

The decision on restoring the earnings link for the Basic State Pension should be linked to possible further increases in SPA for increasing longevity, i.e. if the earnings link is restored then there should continue to be further increases in SPA to reflect increasing longevity (and initially this should mean increasing SPA to age 75). If, however, it is desired that there should be no further increases to State Pension Age beyond age 70 then the Basic State Pension should continue to be linked to prices in order to accommodate the cost of increasing longevity.

## **2. Introduction of a Standard Transfer Value basis**

The adoption of a standard and consistent way of placing a value on a pension is attractive for transparency and fairness. It forms a key part of a number of these proposals. A proposed Standard Transfer Value basis is outlined in Appendix 2. It may be argued that it is too simplistic to reduce the numerous different ways of placing a value on a pension down to this one standard. But the advantages of so doing are significant and outweigh the largely theoretical objections and reservations that may be raised.

If a Standard Transfer Value basis were to be introduced as envisaged below there would also be advantages in promoting this same basis for use in how employers account for pensions.

## **3. Creation of new low risk Default Investment Funds**

Default Investment Funds (DIFs) should be created to allow people to manage better the risks associated with DC pension schemes. The key characteristics of DIFs are:

- The capital value of the invested funds is guaranteed not to reduce
- Interest is added to invested funds (net of all charges) equal to at least the rate of increase in the Retail Prices Index (RPI)
- Provided the above criteria are met, DIFs can be designed to whatever additional investment profile NEST and / or the capital markets can create and support
- The Government is allowed to create unfunded DIFs which pay notional interest at the rate of the increase in the RPI + the yield on index-linked gilts

#### **4. Simplification and enhancement of NEST**

Pension saving must be encouraged and improved and the minimum compulsory contributions increased. At the same time NEST should be simplified and the means testing benefits trap avoided. NEST should have the role of providing the second pillar or tier of pension provision in the UK. The following changes are proposed:

- Auto-enrolment will apply to all employees within 6 months of starting employment with no opting-out (except for the lowest earners - see below). There will be no ‘contracting-out’ by employers of this minimum second tier pension, although existing DC schemes could be converted to qualify as a NEST equivalent scheme. For those whose total earnings are less than 2x the Lower Earnings Limit (currently £10,000), NEST pension provision would not be compulsory and would be by application rather than auto-enrolment (but should be available to all on application).
- The minimum total contributions should be increased to 12 per cent of the greater of basic salary and ‘band earnings’ (i.e. earnings between the Lower Earnings Limit and the Upper Earnings Limit). Employer contributions should be set at a minimum of 6 per cent. This increase in cost will be partly offset by lower National Insurance contributions with the abolition of S2P.

All accrued second tier State pensions should be converted into capital sums (calculated on the Standard Transfer Value basis) and then these entitlements transferred to an unfunded Government Default Investment Fund (DIF).

The concept of a Target Second Pension should be introduced, possibly equal to the enhanced Basic State Pension. The first tranche of pension savings must then be invested in the new low risk DIFs until the total funds so invested reach 15x the Target Second Pension. Once the pension savings have grown so that the total invested funds (including unfunded DIFs) exceed 15x Target Second Pension then all additional pension savings can be invested with greater freedom.

In this way, the level of investment risk is minimised for the lowest levels of pension and can increase as pension savings grow to levels at which individuals can more easily bear investment risk. Funds could be transferred out of DIFs into other pension investment funds provided at least 15x Target Second Pension is maintained in DIFs.

On retirement the accumulated funds must first be used to buy an annuity up to the amount of the Target Second Pension (which should be index-linked and have an attaching 50 per cent spouse's pension – if no spouse on death, a lump sum life assurance benefit would be payable). Retirement should be allowed from age 55, provided the accumulated funds are sufficient to secure the Target Second Pension. Up to one quarter of all pension funds in excess of the amount required to secure the Target Second Pension can be taken as tax free cash at retirement (but see tax rules below).

The private sector should be allowed full and fair competition with NEST. So pension providers should be allowed to create DIFs and pension schemes equivalent to NEST.

## **5. Restore simple 'EET' tax system for pensions**

Introduce a simple and sensible tax framework to encourage savings. If people are to be encouraged to lock away money in savings that cannot be touched until retirement then this requires significant incentives in the form of tax relief or compulsion or both. In order therefore to encourage voluntary savings we need a sensible tax framework.

As well as the key principles of fairness and simplicity, the tax framework should ensure that pension savings are not be taxed as income twice, ie either tax pension contributions at point of deduction from salary or tax at point of payment as pension - and the latter makes more sense for pension savings (and would be consistent with current UK policy).

So, all existing tax rules / limits on pension contributions should be removed. Full tax relief on pension contributions should be unlimited up to 25 per cent of the greater of basic salary and 'band earnings' but tax relief on employer contributions should be granted only where such contributions are the same (as a percentage) for all employees. All pension savings should be allowed to roll up free of income and capital gains tax.

Thus a simple 'EET' system is restored, i.e. pension savings are exempt from tax at the point of deduction from salary, are exempt from tax before retirement, but are taxed as income in retirement.

There is one tax 'loophole' – tax-free cash at retirement, which if not restricted will otherwise be exploited by high earners. But some limited form of tax-free cash (which is so much a part of UK pensions) needs to be retained in order for the

proposals to be acceptable to the public. So a maximum limit of £100,000 is suggested for tax free cash (which could be frozen if there is a desire to remove it over time). It should be possible to take the tax-free cash in more than one installment. But the total tax free cash would still be limited to £100,000. If there is a desire to restrict high earner tax relief further this is better (and more simply) done by further reducing the maximum limit for tax free cash, possibly down to £50,000.

There has been some debate about allowing early access to pension savings before retirement, but this would need very careful control. Within certain clearly defined limits, the prospect could have some merit but any proposal needs detailed consideration.

If a new simple universal DC based system with compulsory minimum contributions is to be introduced for all, then a sad but necessary victim of the proposals is the end of DB pension schemes. So no tax relief on new accrual in DB schemes. Any new DB accrual (including salary linkage or enhanced early retirement) should be taxed as a benefit in kind (calculated as the increase in the accrued benefit valued on the Standard Transfer Value basis). Any transfer value paid from a DB scheme which is in excess of the Standard Transfer Value should be taxed as a benefit in kind on the excess payment.

Full and immediate tax relief should be granted on contributions aimed at removing DB pension scheme deficits (thereby getting rid of complicated rules for deferred corporation tax relief on deficit contributions).

Provided someone has earned a Target Second Pension, then there should be no further requirement to buy an annuity at retirement or any age thereafter. An annuity (which must be whole of life but with optional pension increases / spouse's benefits) could be purchased at any time, but if an annuity is not purchased, the member could draw up to 5 per cent per annum of their pension fund (subject to normal income tax rules) at any time from age 55 onwards.

The above (much simplified) framework would then replace all existing tax rules on pensions.

## **6. Reform of public sector pensions**

This paper recommends that accrued rights to public sector pensions should be treated in the same way as private sector pensions, but with future change driven through the

tax system. There would therefore be no attempt to cut back accrued benefits of public sector workers. This is a debt that the Government must manage over the next 40 or more years.

For future pension accrual, the public sector should be subject to the same rules as the private sector, as outlined above. The public sector could retain existing DB schemes, but the expectation is that the taxing of all DB accrual as a benefit in kind and the required introduction of mandatory NEST schemes would see a very significant rationalisation of DB schemes.

However, it should be noted from a fairness perspective that the additional tax that public sector workers would have to pay, if their DB scheme was retained, would still be less than the significant increase they have enjoyed in the value of their DB pension in recent years. Indeed, public sector workers could be given the choice of retaining their DB scheme and paying the extra tax or transferring to a new enhanced NEST scheme. The public sector could still continue to provide generous pension schemes through enhanced NEST schemes (using unfunded Government DIFs), but there would be much greater transparency on their cost.

These changes would be painful for some, but have the merit of being fair to all (both in this generation and in the next generation).

## **7. Help employers manage DB legacy liabilities**

Employers would not be struggling to manage their legacy DB liabilities if it was normal practice for employees to transfer pensions out of pension schemes on leaving employment. A combination of poor transfer values and an overly complicated regulatory regime has made transfers from DB schemes all but non-existent.<sup>9</sup>

The cost of insurance company buy-outs for deferred pensioners is high and the risk of ongoing management of legacy liabilities is also high. It is not practicable or even possible to take away the layers of extra costs and guarantees that have been heaped on legacy pension liabilities in the UK over many years. But it is possible to provide assistance to employers to help them settle these liabilities.

So, the Standard Transfer Value basis should be introduced for all pension schemes.

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<sup>9</sup> In a small number of cases, some companies and/ or trustees have encouraged pension scheme members to transfer to other pension arrangement by enhancing the transfer value (cash equivalent value) of the pension. These enhanced transfer value exercises are still relatively rare.

Trustees could choose to set transfer values as a percentage of the Standard Transfer Value. Trustees could pay less than the Standard Transfer Value if so advised by Scheme Actuary (ie remove complicated rules on reducing transfer values - leave it to trustees acting on Scheme Actuary advice), but trustees must disclose to members the calculation of transfer values as a percentage of the Standard Transfer Value.

Any pension scheme paying transfer values equal to the full Standard Transfer Value could, at the request of the employer, compulsorily transfer any deferred pensioner under the age of 55 into an appropriate DIF. Pension schemes would thus be able to reduce legacy DB liabilities at a reasonable cost.

### **8. Change approach to employment / retirement**

Greater use of part-time employment between age 55 and SPA needs to be encouraged, possibly led by example from the public sector. This is a much wider issue than pensions, but one possible approach might be:

- Remove references to 'retirement' from employment contracts and 'employment law, whilst retaining the power for employers to 'retire' employees if through ill-health or infirmity they are unable to do their job and there is no suitable alternative job.
- Introduce requirements for training and retraining older employees
- Introduce legislation which would allow employers (indeed drafted in such a way so that it would be normal practice unless both the employer and employee agreed otherwise) to reduce workers hours progressively between the age of 60 and State Pension Age.

## IV

### Pensions for the Future: cutting the Gordian Knot

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A successful national retirement schemes needs a number of foundations, or pillars - a mandatory public pillar, a mandatory private pillar and a voluntary pillar. The public pillar should reduce poverty and eliminate perverse redistribution. The mandatory private second pillar should reflect a close link between contribution and benefit and reduce effective tax rates, evasion or labour market distortion. Overall, a successful system will also encourage long term saving and aim for decentralised control. It will diversify risk with mixed public and private management and aim for a system removed from political pressure. Finally, the system needs to be sufficiently robust and durable to withstand societal changes such as increasing longevity.

The structure described above is not original - the World Bank and many others have highlighted the importance of a ‘multipillar’ national pension and retirement system. This paper suggests a simple structure which can be summarised as follows:

**Pillar 1 – Basic State Pension** An enhanced flat rate Basic State Pension, set at least at the level of the means tested Pensions Credit, but payable from an increased State Pension Age which allows for our much increased longevity. The possible restoration of the earnings link for the Basic State Pension should be tied to further increases in State Pension Age for increasing longevity.

**Pillar 2 – Compulsory Private Pension** A mandatory DC based pension savings system with minimum 12 per cent contributions (which could be phased in if necessary), with a new type of low risk investment funds and a much simplified taxation and regulatory structure.

**Pillar 3 – Additional Voluntary Pension** Voluntary pension savings on top of Pillar 2 savings will be encouraged in the new tax regime (but only to DC schemes not DB schemes which will no longer receive favourable tax treatment). Importantly, for both high earners and low earners, it will pay to save.

## *Pension Reckoning*

This proposed structure not only meets the criteria suggested by the World Bank (and others), but in response to the key problems identified in Section 2, it achieves the following

<b>Structural problems</b>	Significant simplification of the UK pension system and much greater transparency on second tier pensions will greatly ease planning for retirement. There would also be very significant savings in administrative costs.
<b>Not enough saving</b>	A mixture of compulsion and tax incentives to encourage much greater pension saving.
<b>Pension design issues</b>	Replacement of DB schemes with DC schemes (with a new form of low risk investment options).
<b>Understanding costs</b>	Introduction of simplified DC schemes and a Standard Transfer Value basis will significantly improve transparency and understanding.
<b>Affordability</b>	More affordable and sustainable State system, with less cross subsidy between generations; some significant addressing of the public sector pension costs and assistance given to employers to manage legacy DB liabilities.
<b>Practicality</b>	The proposals are fair, simple and affordable. It will be for the politicians to decide whether they can be implemented.

No significant changes to our pension system can easily be implemented without overcoming significant vested interests. Moreover, with such a complicated subject to tackle (at a time when the UK is facing many difficult problems) it is hard enough for the policy makers to get to grips with all the details. Any solution then has to be presented to the public and with pensions that will always be difficult.

But, as is increasingly recognised, the UK pension problems are urgent and need addressing. We cannot afford to wait for another Parliamentary term to run its course without significant palliative action being taken. The depth of the economic problems which the UK is now facing potentially gives the Government an opportunity to take more significant action than would otherwise be possible. People know that drastic action is needed and it is needed now.

# Appendices and List of Abbreviations

## Appendix 1

### Proposed change to State Pension Age

a) Changing the State Pension Age to 70

<b>Born Between</b>	<b>State Pension Age</b>	<b>Reach State Pension Age between</b>
April 1955 and October 1955	65	April 2020 and October 2020
October 1955 and April 1956	66	October 2021 and April 2022
April 1956 and October 1956	67	April 2023 and October 2023
October 1956 and April 1957	68	October 2024 and April 2025
April 1957 and October 1957	69	April 2026 and October 2026
After October 1957	70	After October 2027

b) Changing the State Pension Age to 75

<b>Born Between</b>	<b>State Pension Age</b>	<b>Reach State Pension Age between</b>
April 1955 and October 1955	65	April 2020 and October 2020
October 1955 and April 1956	66	October 2021 and April 2022
April 1956 and October 1956	67	April 2023 and October 2023
October 1956 and April 1957	68	October 2024 and April 2025
April 1957 and October 1957	69	April 2026 and October 2026
October 1957 and April 1958	70	October 2027 and April 2028
April 1958 and October 1958	71	April 2029 and October 2029
October 1958 and April 1959	72	October 2030 and April 2031
April 1959 and October 1959	73	April 2032 and October 2032
October 1959 and April 1960	74	October 2033 and April 2034
After April 1960	75	After April 2035

NB State Pension Age to be the same for men and woman from 2020 onwards

## Appendix 2

### Standard Transfer Value Basis

#### Discount Rate

1. Fixed (non-indexed) benefits Index yield on 15 year gilts + 50 bps
2. Index-linked benefits Real yield on over 15 year index linked gilts + 50 bps

All discount rates rounded to the nearer 0.25%

Base mortality table As certified by the Scheme Actuary to be appropriate

Allowance for future mortality improvement 1% per annum

Members options Value to reflect most valuable option available to the member

### List of Abbreviations

DB	-	Defined Benefit
DC	-	Defined Contribution
NEST	-	National Employment Savings Trust
ONS	-	Office for National Statistics
PCS	-	Pension Capital Strategies
PPF	-	Pension Protection Fund
DWP	-	Department for Work and Pensions
TUC	-	Trades Union Congress
SERPS	-	State Earnings Related Pension Scheme
S2P	-	State Second Pension
LEL	-	Lower Earnings Limit
UEL	-	Upper Earnings Limit
LET	-	Lower Earnings Threshold
UET	-	Upper Earnings Threshold
SPA	-	State Pension Age
DIF	-	Default Investment Fund
RPI	-	Retail Prices Index

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Providing pensions has become an increasingly difficult policy problem for the UK. As people live longer, demand is greater, and the burden on the public and private purse ever higher. At the same time, the cost of pensions, pound for pound, is rising. The new UK government has promised to tackle the problem. But, as Charles Cowling explains in *Pension Reckoning: Paying for public and private pensions*, the problem is more serious and multi-faceted than is generally understood.

Individuals, companies and the public finances can no longer afford today's pensions bill, and yet even that represents only a small proportion of what will be needed in the future to pay for retirement. The author proposes radical change to tackle the structural problems in the system and reverse the inadequacy of saving. He shows how more affordable pensions can be introduced to the benefit of those who pay for pensions: the employer, the individual and the tax payer.

Price: £5.00