Pensions Commission report

TUC initial response

PENSIONS COMMISSION REPORT: TUC initial response

Introduction

We have considered the Pensions Commission recommendations as a package, although we do not endorse every recommendation. We strongly welcome the Commission's recommendations on:

- Compulsion for employers and the creation of the National Pension Savings Scheme (NPSS);
- The re-indexation of the basic state pension against average earnings;
- Improvements in the position of women, including the introduction of an entitlement to the basic state pension on a universal basis

However, we do not accept the Commission's recommendations on the increase in the state pension age.

In evidence to the Commission the TUC argued that differences in life expectancy mean that an across-the-board increase in the pension age would affect the poor the most. Further, an increase in state pension age would have little impact on the retirement age of the better off, so it would be those on lower incomes who would be more likely to work longer to pay for better pensions.

The Commission's first report showed that on average there is a four-year gap in life expectancy at age 65 between men in the highest socio-economic groups and men in the lowest socio-economic group. Among women the gap has increased over the past twenty years. Moreover, those from lower socio-economic groups are less likely to enjoy good-health in retirement. In our evidence to the Commission we pointed to even greater differences in life expectancies when those who live in the poorest districts are compared with those who live in the richest local districts.

We strongly endorse the Commission's central conclusion that the current system of private pension provision is not fit for purpose and that alternative suggestions based on even more generous financial incentives and exhortation cannot address the central problem.

The Commission report establishes a framework for pension provision in the UK but it clearly will not be the final word. We strongly endorse the suggestion that there should be a successor body reporting regularly to Parliament on the pension system.

The TUC will continue to campaign for further increases in the generosity of the basic state pension system and to ensure that private sector workers receive a decent pension on the basis of a fair sharing of responsibilities (or risk) between employers and employees.

The retreat of the private sector

We believe the Pensions Commission report should once and for all end the debate about whether the voluntary UK private pension system can be salvaged.

The evidence that the private sector is in accelerating retreat from private pension provision is overwhelming.

Half of salary related pensions closed to new entrants in just the three years between 2000 and 2003. Altogether two-thirds of final salary schemes are no longer open to new members. In 1995 there were just over 5 million members in open DB schemes in the private sector, in 2004 that figure had dropped to just under 2 million[1]. A survey by the National Association of Pension Funds late last year (2005) said 24 per cent of respondents expected to shut final salary schemes.

So far this decline has been avoided by Britain's boardrooms. In the most recent TUC Pensions Watch survey 2005, we found that the average accrued director's pension is £167,000 a year, over 26 times the average occupational pension. For the directors with the highest accrued pension at each company the average is £288,000 a year, over 45 times the national average.

More recently, some employers have accelerated the shift away from providing decent workplace pensions. A recent and notable case is Rentokil, where the employer announced closure of the final salary scheme publicly before consultation with staff. Rentokil's decision will affect 3,000 current employees, who will have their future pension frozen at their current levels. Rentokil is the first FTSE 100 employer to make this move, but it has promoted calls from the City for others to follow.

In addition, many workers have lost out on their pension rights through no fault of their own. The government introduced the Financial Assistance Scheme to offer support to those who had lost their pensions, the TUC welcomed the introduction of the FAS, however, we feel that the £400m is inadequate to provide decent pensions to those affected. We believe that the Government should review the FAS immediately and substantially increase the amount of money allocated to the scheme.

The challenge for government

Pension reform is a huge challenge for any government in the light of the big demographic changes that are already seeing both a rise in the total number of retired people but also significant increases in the number of years they will, on average, spend in retirement.

The Government's task has been made all the more difficult by the collapse of public trust in the private pension industry and in politicians in general as a result of previous government policies. Partly as a result, public understanding and acceptance of the implications of demographic pressures on the pension system is often incomplete.

We therefore welcome the Government's positive and rapid response in initiating a national debate on the Commission report and the commitment to publish a White Paper in the Spring. It is vital that the momentum created by these announcements is not lost and that key decisions are not postponed.

[1] GAD survey 2004

Some have argued that major reform can only proceed when there is sufficient political or industrial consensus to do so. Both are of course highly desirable and we believe the Commission package offers the best opportunity for building a national consensus in decades.

However, the retreat of the private sector from pension provision means the key decisions must be taken as soon as practicable. Even with a relatively quick decision, implementing many of the Commission's recommendations will take time and on current trends the underlying problem of under-saving can in the meantime only worsen.

National Pension Savings Scheme

A key recommendation from the Pensions Commission final report is the creation of a National Pensions Savings Scheme (NPSS). The Commission's two key objectives for such a scheme were to:

- Encourage individuals and their employers to save for a pension that provided a basic minimum level earnings replacement level;
- Enable all people to have the opportunity to save for a pension at low cost.

The Commission's recommendations on the central features of the proposed new NPSS are as follows:

- All employees would be automatically enrolled into funded pension savings: either the new NPSS or a high quality employer pension scheme, but individuals would retain the right to opt-out.
- The minimum default contribution would be 4 per cent out of individual post-tax earnings; 1 per cent paid for by tax relief, and 3 per cent compulsory employer contribution. The total default contribution of 8 per cent would be paid on earnings above the Primary Threshold and below the Upper Earnings Limit (UEL) for national insurance purposes.
- Contributions above the 8 per cent minimum are to be encouraged and the self-employed allowed to voluntarily enter the NPSS.
- Employers would have to make at least a 3 per cent contribution. Employers can opt out of the NPSS only by meeting certain criteria – they are not able to opt-out of not providing a minimum pension contribution. The criterion for opting out could be where employer provides a DB, DC or hybrid scheme where the overall benefits in/contributions to the scheme are equal to or above the NPSS.
- The contributions to the NPSS would be collected via the PAYE system, or a possible new Pension Payments System. Using this method of collecting contributions would enable charges to be as low as 0.3 per cent. This compares with current Stakeholder Pension charges of 1.5 per cent

A key issue is scheme governance. The Commission recognises this and has put forward some tentative suggestions. These include the establishment of a non-departmental public body with its own board.

The proposal for the NPSS is a major change in private pension provision in the UK. The TUC has been at the forefront of the campaign to introduce compulsory employer pension contributions. The NPSS introduces for the first time such a scheme with a default minimum contribution rate on all employers.

We have argued that all employers should be compelled to contribute to all workers' pensions, and where possible all workers should also contribute. Therefore we welcome the fundamental principles underlying the proposed NPSS, where individuals but not employers would be able to opt out.

We would strongly oppose any suggestion that obligations on employers should be weakened or even abandoned. For example, if employers also had an opt out from the NPSS, most would take it and continue to do nothing. This would not only make the NPSS unworkable, it would make it impossible to address the central issue that between 15 and 20 million working age people today are making inadequate or no provision towards a private pension.

The evidence does not support the general arguments that UK business is suffering from excessive burdens and unreasonable costs. The UK has some of the least regulated product and labour markets in the industrialised world, according to OECD figures. Moreover, as the forthcoming TUC Budget Submission shows, UK corporate profitability has remained robust despite the recent economic downturn.

We can equally see no case for exempting or reducing the requirements on SMEs. Firstly, it is precisely this sector where the problems of under saving are most acute and employers least likely to make any contribution to a pension, so excluding the 9 million people who work for an SME (defined as employing fewer than 250 people) would make the Commission proposals largely worthless. Secondly, a key reason for the Commission recommending a modest contribution rate was because of the impact on SMEs. Thirdly, there is no evidence of any adverse impact on SMEs from regulation or across the board measures such as the National Minimum Wage. Indeed, latest figures suggest that in the year to January 2005 the number of businesses in the UK grew by 300,000. Fourthly, size limits are arbitrary, imposing an artificial barrier to growth by giving firms an incentive to stay just below the size threshold.

We agree with the Commission that previous experience suggests that auto-enrolment will ensure that only a relatively small proportion of employees will decide to opt out, especially if the introduction of the NPSS is accompanied by a strong campaign urging them not to do so. Trade unions have an important role here as they are widely seen as a trusted source of information and advice on pensions, in sharp contrast to politicians and the pensions industry.

However, we are concerned that the opt out for employees may be exploited by unscrupulous employers to allow them (the employers) to avoid making contributions to the scheme, in much the same way that some employers have abused the individual opt out from the Working Time Directive. The Commission has recognised this danger but argues that employers will not have a strong financial incentive to do so because the initial contribution rate for employers has been set at a modest level. However, we urge the Government to set out in the White Paper practical proposals for how adequate safeguards might be built into the system to deter employer abuse.

One of the keys aims of TUC policy has been to ensure that current schemes are not put under threat by any additional compulsory framework. The Commission also recognised this. The TUC believes that any minimum contribution rate must be perceived as being a minimum and those good employers should provide a contribution rate above the minimum.

The Commission has recommended a minimum default rate of 8 per cent with all employees earning less than the primary income threshold (currently just under £4,900) excluded. We believe the proposed rates are an adequate starting point for the NPSS. However, we believe that it would be appropriate for the new oversight body suggested by the Commission to have as part of its remit the setting of future rates, taking account of the need to achieve a fair balance between employers, employees and the state; the impact on existing pension arrangements; and other relevant economic factors. The new body's recommendations would then be considered by the government of the day.

Governance of the NPSS

The governance of the NPSS is an important issue for unions. It is now an established principle in occupational pension schemes that members should have equal representation on trustee boards. In addition, in defined contribution schemes where the individual, rather than the employer, bears the investment risk there is an even stronger case for proper member representation. Therefore it is vital that the governance structure of the NPSS includes significant member representation.

Fund management

It is also important that the fund management arrangements for the NPSS are properly considered. It will be important that the funds are structured in a way that does not offer too much risk where this is inappropriate. There should also be at least one responsible investment fund included in the range offered. Overall our preference would be for a limited number of funds which are badged as NPSS funds, rather than naming the company to which the asset management is sub-contracted.

The default fund should be "life-styled"[2] as evidence suggests that the significant majority of members will not move from the default fund. In addition consideration should be given to whether the default fund should operate a responsible investment policy. Several opinion polls have suggested that the public would be supportive of such investment strategies, especially if returns were unaffected. A responsible investment policy applied to the default fund could be

[2] An investment fund that has an asset mix determined by the level of risk and return that is appropriate for an individual investor at different stages in the lifecycle.

based on engagement as opposed to screening[3] and as such would not constrict investment decisions.

If the Scheme is introduced as suggested by the Commission, any mandates that the NPSS awards should be structured with a long-term investment strategy and demonstrate a commitment to shareholder engagement. Fund managers tendering for the mandates should, for example, be able to demonstrate adherence to the Institutional Shareholders Committee statement of principles on the responsibilities of shareholders.

Alternative models to the NPSS

The TUC is concerned that any alternative model to the NPSS (including those proposed by the ABI and the NAPF) would have a potential negative impact on individuals, some employers and the self-employed. The main reasons for our concerns are:

- The ability of the industry to deliver low cost pensions for many lower and middle-income people. Stakeholder pensions have a maximum charge cap of 1.5% for the first ten years and 1% thereafter. A person saving at 0.3% Annual Management Charge (AMC) over 40 years would have a pension 30% higher than if they had saved at a 1.5% AMC.
- If the pensions industry were allowed to run and manage the NPSS it could result in an individual having to go through the process of transferring benefits each time they changed employer or having lots of small pots. This would add costs and complexity to what is supposed to be a simple, transparent vehicle.
- Having industry run the NPSS could make it difficult and more complicated for those taking time out of paid employment and the self-employed to participate.
- It is unclear how the pensions industry would be able to provide good governance that was independent and represented members' best interests?

The TUC believes that the most appropriate structure for a NPSS is the one proposed by the Pensions Commission, a non-departmental public body, with its own board which is clearly public and most non-profit making. The pensions industry is not able to fulfil these criteria and has to date failed to address the pensions under-saving of those on low to medium earnings.

Reforms to the state pension system

The Commission sets out three central objectives in recommending further reform of the state system:

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[3] Investments with an engagement policy refer to portfolios where the shareholders or fund managers engage with companies to try to improve their social, environmental or ethical policies and practices. Screened investments refer to investments that have been selected on the basis of social, environmental or other ethical criteria.

- Focus available resources on ensuring as generous and non-means tested, flat rate state pension as possible (with the NSPSS proposal for an earnings related supplementary private pension).
- Improve the treatment of people with interrupted paid work records and caring responsibilities.
- Recognise the potential trade-offs between state pension age and state expenditure on pensions.

The Commission recognises that there are a number of options that should now be considered as part of the public debate, partly reflecting difficult issues of timing and affordability. The Commission's preferred way forward is as follows:

- Build on the current two-tier system by accelerating the current change in the State Second Pension (S2P) towards a flat-rate rather than an earnings related supplement to the Basic State Pension. This would be achieved by freezing the Upper Earnings Limit for S2P accruals.
- Index the BSP to average earnings growth over the long term, ideally starting in 2010.
- Maintain the reductions in pensioner poverty achieved through the targeting of the Pensions Credit on the poorest pensioners, but limit the spread of means-testing by freezing the maximum level of Savings Credit payments in real terms.
- Future accruals towards the BSP should be on an individual and universal basis (based on residency) rather than national insurance contributions. Carer credits within S2P should be improved.
- Ideally introduce a BSP for the over 75s on a universal basis as soon as possible.

The Commission argues that state spending on pensions must increase from around 6.2 per cent of GDP today to between 7.5 and 8 per cent of GDP by 2040. The Commission points that even without reform, the cost of the current system is likely to increase to 7.5 per cent of GDP by 2040.

These are important changes and reflect many of the key campaigning goals of the TUC. The re-indexation of the BSP to earnings so that pensioners share in future increase in national prosperity and are less dependent on means-tested benefits in the future has been a long-standing objective.

The TUC has also strongly argued for a better deal for carers and others with interrupted work patterns. The TUC's Pension Task Group recommended moving towards a universal pension precisely because it offered the best way of addressing the gap in pension entitlement between women and men.

However, the Task Group did not take a position on whether entitlement to a universal pension should be residency or citizenship based. The Commission has suggested a 10 year residency requirement. This is an issue we will look at in more detail in the TUC's response to the White Paper.

The TUC has argued for indexing against earnings for the BSP to be introduced immediately, alongside a substantial increase in the level of the BSP to the current level of the Pension Credit. These remain TUC priorities.

Paying for the improvements

The Commission argues that the improvements to the BSP can be paid for in the medium term from the savings generated by the planned increase in women's pension age to 65 by 2020. However, the Commission says that sustaining the cost indexation thereafter in the face of the forecast rapid increase in the number of pensioners will require a gradual increase in the state pension age by 2040.

The Commission sets out a number of options for an increase in the state pension age that would increase the share of GDP spent on pensions to between 7.5 per cent and 8 per cent of GDP. However, in order to have a full debate, other options should be considered, in particular the option of no change in the state pension age beyond 65.

The debate about the options for pension reforms has often underplayed the importance of labour market policies. There is little governments can realistically do to change the ageing of the population, but there is a great deal they can do to increase the share of the working age population in jobs.

A key concern about the affordability of pensions has been the forecast imbalance between the population of working age and the retired population. However, what matters in terms of affordability is the balance between the population in a job and contributing tax revenues and the retired population. The DWP has suggested that an 80 per cent employment rate would sustain the current balance between the number of people in a job and the retired age population through to 2040. We strongly endorse this target and believe it should be factored into the White Paper's consideration of affordability.

The Commission identifies two options for protecting those with lower life expectancy against all or some of the suggested increase in the state pension age. These are:

- The Guarantee Credit would be available at age 65 for all who qualified. At present, the Credit is available from age 60,and is due to move to 65 when pension ages for men and women are brought into line in 2020. The Commission suggest the age for the Credit stay at 65 even if the pension age where to increase any further beyond 2020.
- The pension age for the Basic State Pension and the State Second Pension could increase at different rates, with a faster increase in the qualifying age for the second pension than the qualifying age for the Basic State Pension.

Those who chose to take the Pension Credit at age 65 would, under the Commission's proposals, still be able to accrue future pension rights through the NSPSS until they reached state pension age. This would help reduce the current disincentive effects of the Credit on private saving.

The fact that the Commission has put forward an option of continued retirement at age 65 for the lower paid reflects the strength of the arguments put forward by the TUC. However, it remains the case that some workers who would not be eligible for the Pensions Credit on retirement nonetheless undertake stressful and physically demanding jobs.. Further work will be needed to look at how many people the proposal would affect and how the safeguards for those with low incomes might be built on and improved. We would urge the Government to explore these options in detail in the forthcoming White Paper.

It is worth highlighting that the amount the UK spends on state pensions and related benefits is around 6.2% of GDP. The Pensions Commission final report estimates that this will increase to around 6.9% by 2050. In addition the Commission state that "if current indexation arrangements continue, expenditure would rise more than this, reaching around 7.6% by 2050." The Commission goes on to say "but this rise from 6.2% today to 7.6% by 2050 would still be slight compared with that forecast for most other European countries and would result in a 20% fall in average state pension income relative to average living standards being paid to each pensioner." Expenditure in France is expected to reach 14.5% of GDP by 2050 and in Germany 13.8% of GDP by 2050.

In the Pre Budget Report, the Treasury restated existing policy that there is no commitment to continue to index the Pensions Credit to average earnings beyond 2008 before the Comprehensive Spending Review has reported in 2007. However, the Commission has argued strongly that indexing against earnings must continue otherwise the living standards of the poorest pensioners would fall relative to average earnings. We strongly endorse the Commission's view.

It would however be helpful if, by the time of the White Paper, there were reconciliation between the estimates on the long term cost implications of pension reform in the Commission report and those published by the Treasury in the Pre Budget Report.

Later working

The Commission says that if the Government were to opt for a higher state pension age it would have to accompany the policy with measures to help individuals work longer. However, the Commission also says that measures would be required to protect lower socio-economic groups with lower life expectancy.

The Commission identifies a number of policy levers to help achieve the objective of supporting working longer. These include:

- Age discrimination legislation
- Financial incentives for later retirement
- A strong focus on occupational health
- A strong focus on the education and training of older workers
- A possible employment subsidy for employers taking on workers beyond state pension age.

A combination of all of these interventions could help those older workers who wish to do so remain in the labour force. We urge the Government to give serious attention to all of them in the forthcoming White Paper. The TUC evidence to the Commission emphasised the importance of looking at measures to increase the employment rate across the entire working age population, including the 2 million working age people currently outside the labour market and classified as "economically inactive" but who say they would like a job. Our report, *The 80 per cent Solution*, showed how the Government could over time address the forecast imbalance between the population of working age and the population of retirement age by achieving an 80 per cent employment rate (compared with the current 75 per cent employment rate).

The TUC will be undertaking further work in this area, concentrating in particular at what policy changes are required to support older workers between the age of 50 and the state pension age to remain in work or, if they wish to do so, return to work.

The TUC has not yet taken a formal position on financial incentives to employ older workers beyond state pension age. The Commission notes that at present employers continue to pay national insurance contributions on workers beyond state pension age, even though it does not count towards an individual's pension entitlement (employees pay nothing). The Commission suggests that one option might be to have a reduced rate of employer national insurance, subject to a ceiling, as an incentive to employ older workers.

Tax relief and contracting out rebates

The Commission note that tax relief on private pensions cost nearly £20 billion in 2004-2005, including employer national insurance relief on pension contributions. The Commission estimates that at least half of all reliefs flow to higher rate tax-payers. However, most people have a poor understanding of what tax concessions are available. For many of the low paid any value from tax relief on their contributions is clawed back through mean testing on their retirement income.

The Commission however make no recommendations for immediate reform, mainly because they consider there are significant difficulties in terms of practicality and equity when DB schemes still account for a significant part of total provision.

However, the Commission do recommend a single rate of tax relief on the NPSS. Even more importantly, the Commission recommends that even if a separate tax regime is not established, low earners who pay no tax or only at the 10p starting rate should get tax relief as if they were paying tax at basic rate. This is similar to the current arrangements for contributions for Stakeholder Pensions.

The Commission also decided not to recommend the abolition of contracting out rebates from the second state pension, but recommends simplification and phasing out. The major concern is that immediate abolition would speed up the closure of DB schemes.

The Commission says, however, that if were able to start from scratch it would not build such a feature into the pension system. As well as adding to complexity and being poorly understood, contracting out helped fuel the pension mis-selling in the 1980s. Moreover, government has to set a "fair" rebate but in practice the rebate will either be set too high, wasting public resources; or it will be set too low, so people would be better off staying contracted in.

The TUC highlighted the inequitable nature of tax relief in our final report to Congress, and this is acknowledged in the Commission's report. The Commission has not been able to find a workable solution in the short to medium term. This remains an important issue for further reform and we would urge the White Paper to keep the issue of tax relief reform option open.

Securing long term sustainability and consensus

The Commission says that the effectiveness of the UK's pension system is undermined by low levels of public confidence and trust. The Commission identify three factors:

- Repeated changes by past governments that reduced the generosity of future promises without this being clearly explained to the public.
- A failure to explain the impact of demographics, in particular the fall in the value of the Basic State Pension as an unstated way of containing cost pressures.
- Mis-selling scandals of the 1980s, driven by a misguided attempt to extend personal provision into segments of the market where the economics only made it worthwhile for individuals when stock-markets were doing exceptionally well.

The Commission emphasise the need for a clear division of roles between the state and individuals; that the settlement on pensions should be communicated clearly and openly to people, and that once agreed the pension system should be reasonably stable over time. The Commission recommend that the Government establish a successor body to the Pensions Commission charged with reporting to Parliament every four years on the facts and potential policy changes that might be required.

The TUC strongly endorses the Commission's assessment and the suggestion that we need an independent body to ensure future changes are evidence based. In our evidence to the Commission, we suggested a body with features similar to the Low Pay Commission should be established.