

PENSIONS POLICY INSTITUTE

PPPI

THE PENSIONS LANDSCAPE

The Pensions Landscape

Foreword	1
Summary of conclusions	2
Introduction to the UK pension system	4
Chapter 1: Current pensioners' incomes	7
Chapter 2: The pension prospects for future pensioners	23
Chapter 3: The future pensions landscape	49
Appendix 1	63
Appendix 2	64
Glossary	65
Acknowledgements and contact details	68
References	69

A Reference Manual by Chris Curry & Alison O'Connell
Published by the Pensions Policy Institute
© February 2003
www.pensionspolicyinstitute.org.uk

Foreword

By Tom Ross, Chairman of the Pensions Policy Institute

Five years ago, the Pension Provision Group – of which I was Chairman – published *We all need pensions: the prospects for pension provision*. This was a diagnostic review, and the facts and analysis we presented were intended to inform pension policy reform.

One recommendation we made in *We all need pensions* was as follows:

An organisation independent of government, needs to have lead responsibility for accumulating, analysing and publishing the information about current and future pension provision and its implications for future pensions policy.

The Pensions Policy Institute is the result, thanks to the support of many friends and colleagues. The PPI is in its early days, but has already made an impact, not least with its thoughtful Discussion Paper on the policy option of raising state pension age.

This publication is its first Reference Manual. *The Pensions Landscape* offers a diagnosis of how pension prospects have changed since *We all need pensions*.

The Pensions Landscape demonstrates that today's pensioners are better off than they were in 1998. But it also suggests - on the basis of cogent fact-based analysis - that there is a real risk that future pensioners will be worse off.

It is not within the PPI's remit to lobby for any particular solution. But the PPI should be a helpful contributor to the debate it is evident we need on what pensions policy we want for the UK. After all, it is still true that we all need pensions.

In the midst of so much commentary on pensions, I hope that *The Pensions Landscape* clarifies the important issues and the particular challenges in today's pensions environment. Chris, Alison and I would welcome your feedback.



Tom Ross OBE

The Pensions Landscape: Summary of conclusions

Today's pensions landscape looks better than yesterday's – on average. But pensioner poverty remains, and there are no signs that tomorrow's landscape will look any brighter. To avoid the risk that tomorrow's pensioners are worse off than today's, reform of state pension policy has to be debated.

Pensioners' incomes have risen, but so has the gap between the richest and the poorest.

- **Today's average pensioner is better off than yesterday's.** The average income for a single pensioner is £9,500 a year, or 44% of National Average Earnings (NAE). Most income comes from the state. Pensioners' incomes have grown faster than earnings on average, and so have improved relative to those of working age.
- **Private pension income makes the difference between rich and poor pensioners.** Occupational pension income is important for many pensioners; personal pensions and investments for fewer. Recent growth in private pensions has widened the gap between the richest and the poorest. The richest fifth of single pensioners now have annual incomes of £19,000 a year (87% of NAE), and the poorest fifth £4,600 a year (21% of NAE).
- **A quarter of pensioners are in relative poverty.** Typically, older pensioners are poorer, as are women, people from ethnic minorities and those who have been self-employed.

The make-up of pensioners' incomes will change but there are no signs that future pensioners will be relatively better off than the pensioners of today.

- **Both the state and employers are reducing their long-term pension commitment.** More people will receive state pensions in future. But state pension income per pensioner will fall relative to earnings, despite the earnings-linking of means-tested benefits. Employers are changing the type of provision offered, and reducing the amount contributed.
- **Today's pension saving behaviour seems unlikely to deliver more private pension income in future.** Total contributions to private pensions have stalled. Only a minority save in personal pensions. Pension saving is starting at later ages and tends to be irregular.
- **Pension alternatives are not widespread.** Most people do not have significant amounts of non-pension saving or investments. Those without pensions are less likely to have other assets. Housing is a significant asset for many, but is rarely converted into retirement income.

To avoid the risk that tomorrow's pensioners are worse off than today's, reform of state pensions policy should be debated now.

- **Problems of lower pension income will only become apparent in the long-term.** The average pensioner income will continue to grow in the short-term. But inequalities will increase if means-tested benefits are not taken up and if private pensions remain focused on higher earners - as is likely. More than one-third of future pensioners face being disappointed with their future retirement income.
- **The long-term problems are due to unclear responsibilities now.** Current policy assumes individuals will take more responsibility for pension provision. But the responsibilities of the state, employers and individuals remain largely undefined. Current initiatives address only some of these issues. Many people are unable - or unsure of how - to act.
- **The future cost to the state of current pension policy is not clear.** Current UK pensions policy constrains the cost of state pensions, meaning relatively less per pensioner. The *total* state budget for pensions in the UK will rise in future, although by how much is not clear. The right balance between the cost to the state of paying state pensions and the cost to the state of encouraging private pensions should be debated.
- **Reform of state pensions policy should be debated now.** Even though the average pensioner income may not worsen in the short-term, the long-term issues require a new solution to be debated now. The debate should start where the problems lie - with the structure of state pensions. In an ageing society, what state pension do we want and how much are we prepared to pay for it?

Introduction to the UK pension system

To set the scene, this introduction briefly outlines the UK pension system under current policy. Subsequent chapters of this report describe outcomes from the pensions system.

The foundations of the UK pension system were laid in the 1940s. Change has been a feature since the 1960s, adding new layers to both state and private elements. As a result, the pensions landscape in the UK is complex – too complex to cover adequately in this report. *The Pensions Primer*, published by the PPI, gives a more detailed description of the current system and some of the archaeology of these layers.

A complex multi-component system

This report refers to 3 tiers of the UK pension system, defined as follows:

First tier provision

The first tier of state pension provision consists of a redistributive, basic level of pension provision to which everyone has access. A minimum level of retirement income is provided by:

- The Basic State Pension: a nearly universal flat benefit
- The Minimum Income Guarantee and Pension Credit: means-tested income supplements
- Other (near) universal benefits

The first tier is compulsory, in the sense that every worker has to pay contributions that build up entitlement to BSP. It operates on a ‘pay-as-you-go’ basis – current workers’ payments pay for current pensioners’ benefits, and tax from workers pays for means-tested benefits in payment.

Second tier provision

A second tier is provided by the State Second Pension (S2P), which replaced the State Earnings Related Pension Scheme (SERPS) in April 2002. It is also ‘pay-as-you-go’ and contributory.

The aim of this is to provide further pension more closely related to an individual’s previous earnings level. It is less redistributive than the first tier.

The second tier is not universal, as it is compulsory for employees only. Further, employees have the right to ‘contract-out’ of the second-tier, and instead have their contributions paid into private arrangements in the third tier.

Third tier provision

The third tier is private pensions, namely all those tax-incentivised pension arrangements that are not directly funded by the state. Individuals can retire with a number of private pensions from many different arrangements. While third tier saving is voluntary, employers with five or more employees must provide access to a pension arrangement.

Most individuals in employer-sponsored arrangements are in occupational pension schemes funded by, and administered by or on behalf of, the employer. These schemes may define the expected pension in terms of a proportion of previous earnings (Defined Benefit, DB), or may operate on the money-purchase principle (Defined Contribution, DC).

Individuals can also have their own private pensions. There are several types of these, including personal and stakeholder pensions. Each product works on the money-purchase principle.

Private pension contributions, from the employer and/or the individual, fund designated pensions for the individual. Private pensions redistribute income across an individual's lifetime, not between people.

A large, and growing, number of pensioners

There are around 10.8 million people of state pension age (SPA) or older. This represented 18% of the UK population. There are 3.9 million male pensioners, and 6.9 million female pensioners¹.

The number of pensioners is expected to increase, to 12.0 million (19% of the population) by 2020 and 15.3 million (24% of the population) by 2041. 55% of pensioners in 2041 will be women. The number of very old pensioners - aged 80 or older - is expected to double from 2.5 million today to 4.9 million in 2041².

In addition, there are 2.6 million people today aged between 50 and SPA who are not working - 1.4 million men and 1.2 million women³. Some of these are retired - others are ill, unemployed, or carers. As the income sources of this group are likely to be very different from those over SPA, people aged under SPA are not covered in this publication. Pensioners in this report means people aged SPA and over.

¹ ONS (2002 CEN). Data for May 2001. Rounded to the nearest 0.1 million.

² GAD 2001-based population projections. Available from www.gad.gov.uk.

³ ONS (2003)

Data limitations

A number of data limitations are inherent in any UK pension policy analysis.

Data on the incomes of today's pensioners (chapter 1) is relatively good, although it is based on asking people survey questions, where responses may not be entirely accurate. A number of sources of income are reported jointly. It is difficult to tell, for example, the relative importance of different state pensions, or different types of pensions and savings. Some of these gaps can be filled using administrative data, but this often covers a different time period, or group of people, and is not always directly comparable.

Chapter 2 describes the pattern of accruing pension rights by today's workers. Point estimates have to be relied on; the complexity of the system makes any longitudinal analysis on accrual over the lifetime extremely difficult. Data is drawn from a wide variety of sources, and is often inconsistent. Other data is already out of date, and some simply does not exist.

As well as making it difficult to reflect today's pensions landscape, these data issues make realistic long-term projection of future pensioners' incomes impossible. This report instead uses qualitative analysis to identify some of the likely major trends.

In addition, as shown in chapter 3, there is no published data on the future likely state spend (and receipt) of tax related to private pension saving.

Chapter 1: Current pensioners' incomes

This chapter focuses on the incomes of those currently over state pension age. It concludes that on average, pensioners have been doing increasingly well in recent years, especially those with private pensions. However, there remains a significant number who have lower incomes.

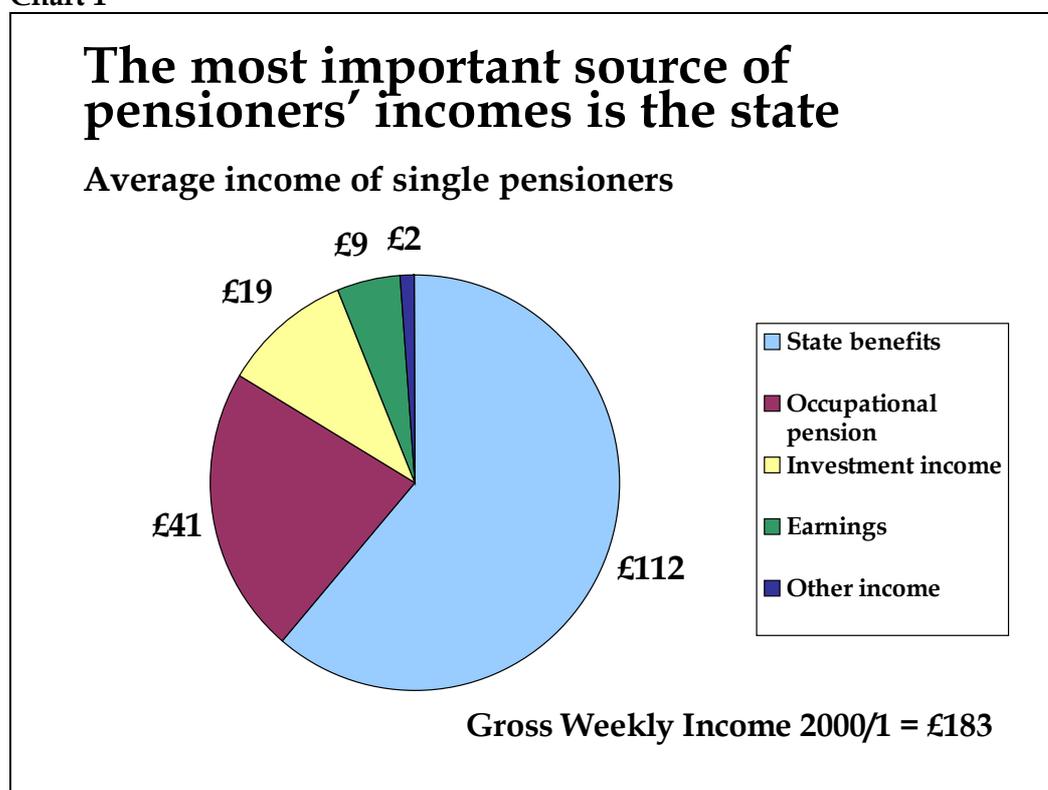
- **Today's average pensioner is better off than yesterday's.** The average income for a single pensioner is £9,500 a year, or 44% of National Average Earnings (NAE). Most income comes from the state. Pensioners' incomes have grown faster than earnings on average, and so have improved relative to those of working age.
- **Private pension income makes the difference between rich and poor pensioners.** Occupational pension income is important for many pensioners; personal pensions and investments for fewer. Recent growth in private pensions has widened the gap between the richest and the poorest. The richest fifth of single pensioners now have annual incomes of £19,000 a year (87% of NAE), and the poorest fifth £4,600 a year (21% of NAE).
- **A quarter of pensioners are in relative poverty.** Typically, older pensioners are poorer, as are women, people from ethnic minorities and those who have been self-employed.

Today's average pensioner is better off than yesterday's

The average gross income of a single pensioner in 2000/1 was £183 per week, or £9,500 per year - 44% of National Average Earnings (NAE). For a pensioner couple, the weekly average was £358 (85% of NAE). Across all pensioners it was £251 (60% of NAE)⁴. 4% of single pensioners and 22% of pensioner couples had gross income above NAE - £21,800 for the year 2000/1.

Today's pensioners draw their income from a variety of sources, of which the most important is the state (Chart 1).

Chart 1⁵



State benefits make up over half of the average income of single pensioners. The Basic State Pension (BSP) is the most common benefit - some BSP is received by 98% of those over SPA. The average BSP received is £61 per week⁶. This is around 85% of the full rate⁷. 34% of all pensioners in 2000/1 also received some means-tested benefit at an average of £47 per week. And 60% of pensioners received some SERPS benefits, the average weekly amount being £16⁸.

⁴ DWP (2002 PIS) Unless otherwise stated, all figures in chapter 1 are derived from this source, and are shown in 2000/1 prices. "All pensioners" totals across all pension units - a combination of singles and couples. This measure is of little practical use, so where possible this report focuses on the single pensioner.

⁵ DWP (2002 PIS)

⁶ DWP (2002 SP). Figure shown is for March 2002.

⁷ This includes couples, who may have BSP in excess of the full single person's rate

⁸ DWP (2002 SP). Figure shown is for March 2002.

88% of single pensioners had income in addition to state benefits in 2000/1, as did 95% of pensioner couples. For 23% of single pensioners and 42% of pensioner couples over half their weekly income came from private sources.

52% of single pensioners in 2000/1 received income from an occupational pension at an average of £79 per week, as did 72% of pensioner couples at an average of £154 per week.

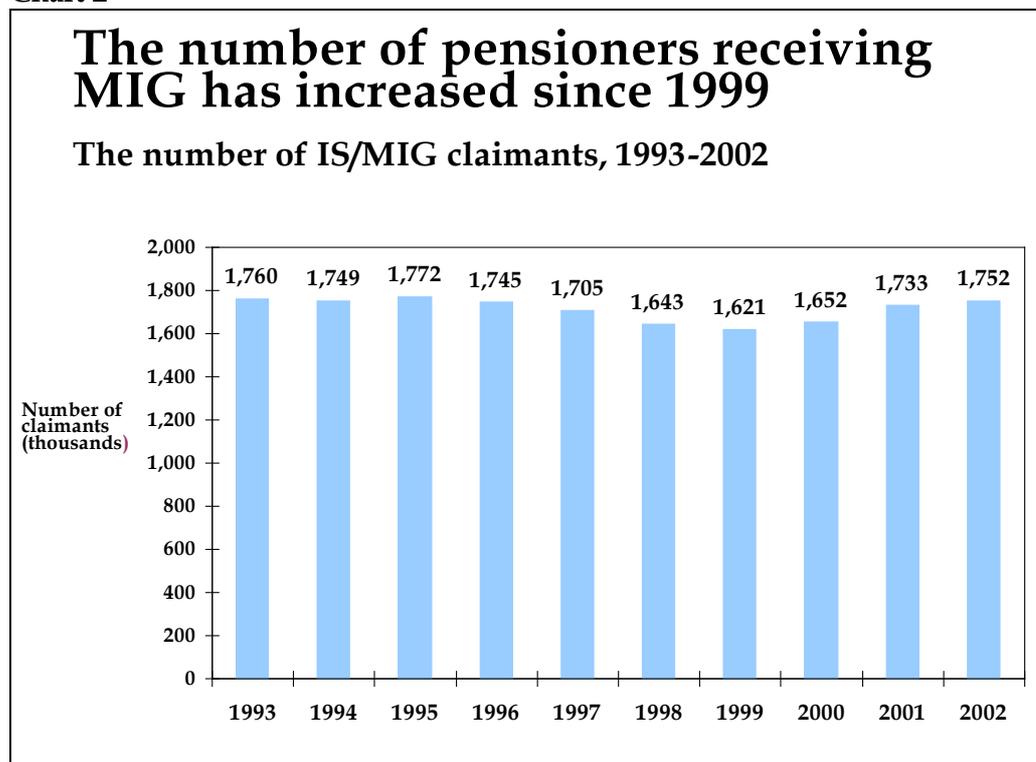
66% of single pensioners received on average £29 per week income from investments (including personal pensions)⁹ in 2000/1. For couples the corresponding figures are 80%, with an average of £65 per week.

Earnings are currently a relatively minor source of pensioner income. In 2000/1 a single pensioner had on average £9 per week of earnings, while for couples the average was £38 per week. 8% of men and 9% of women over SPA were in paid employment in 2002¹⁰.

The number of pensioners receiving the Minimum Income Guarantee (MIG) has recently increased. The number of pensioners receiving income support (the predecessor of MIG) fell between 1993 and 1999. The introduction of the more generous MIG in 1999 has led to the number of claimants starting to rise again (Chart 2). There are currently 1.75 million MIG claimants.

⁹ Annuities, personal pensions, property, stocks/shares, income from savings

¹⁰ ONS (2003)

Chart 2¹¹

Older pensioners are more likely to be receiving MIG. In 2002, 12% of pensioners aged 65-69 were receiving MIG, compared to 41% of those aged 90 or above. Women are more likely than men to receive MIG¹².

Significant numbers of low-income pensioners who are entitled to payments do not claim them. Between 22% and 36% of those eligible in 1999/2000 did not claim, missing out on an average of £22 a week. The median unclaimed benefit was much lower at £12.80 a week, suggesting that some pensioners were not claiming substantial amounts of money¹³.

MIG is to be replaced in October 2003 by the Pension Credit (PC). Like MIG, PC is intended to provide a minimum income for the poorest pensioners (the guarantee credit) and it is also intended to reward those with modest savings (the savings credit). Up to half of all pensioners may be eligible for PC upon its introduction, although not all are expected to take up their entitlement¹⁴.

PC is targeted towards the lower end of the income distribution. The poorest 10% of pensioners are expected to gain by £5.20 a week from October 2003. Those with slightly higher incomes are expected to see the highest weekly gains - £7.80 a week¹⁵.

¹¹ DWP (2002 QSE)

¹² DWP calculations based on DWP (2002 QSE)

¹³ NAO (2002)

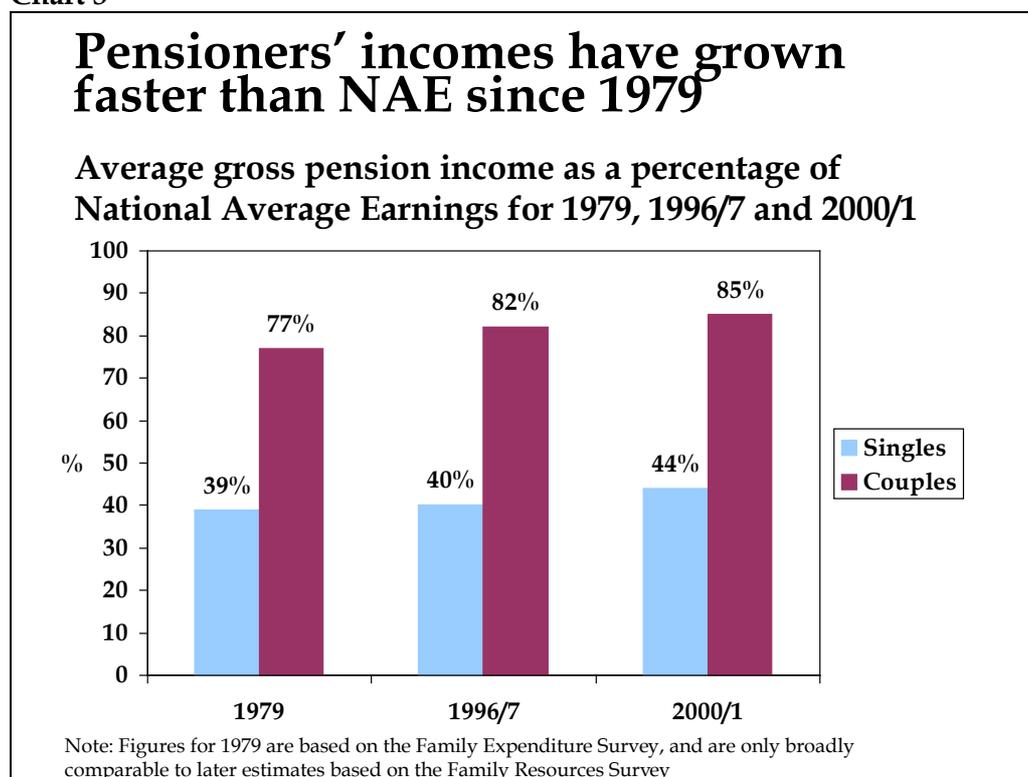
¹⁴ DWP (2002 PC)

¹⁵ DWP simulation based on Family Resource Survey 2000/1 in 2003/4 price and earnings levels

Pensioners' incomes have grown faster than earnings on average

Pensioners today have, on average, a much higher level of pension income than in 1979. This average pensioner income has grown faster over this period than the increase in NAE (Chart 3). This does not mean that all individual pensioners have seen their incomes increase this much. Most have seen little, if any, real increase in income after they retired. Rather, the average income across all pensioners – including those newly retired each year – has been increasing.

Chart 3¹⁶

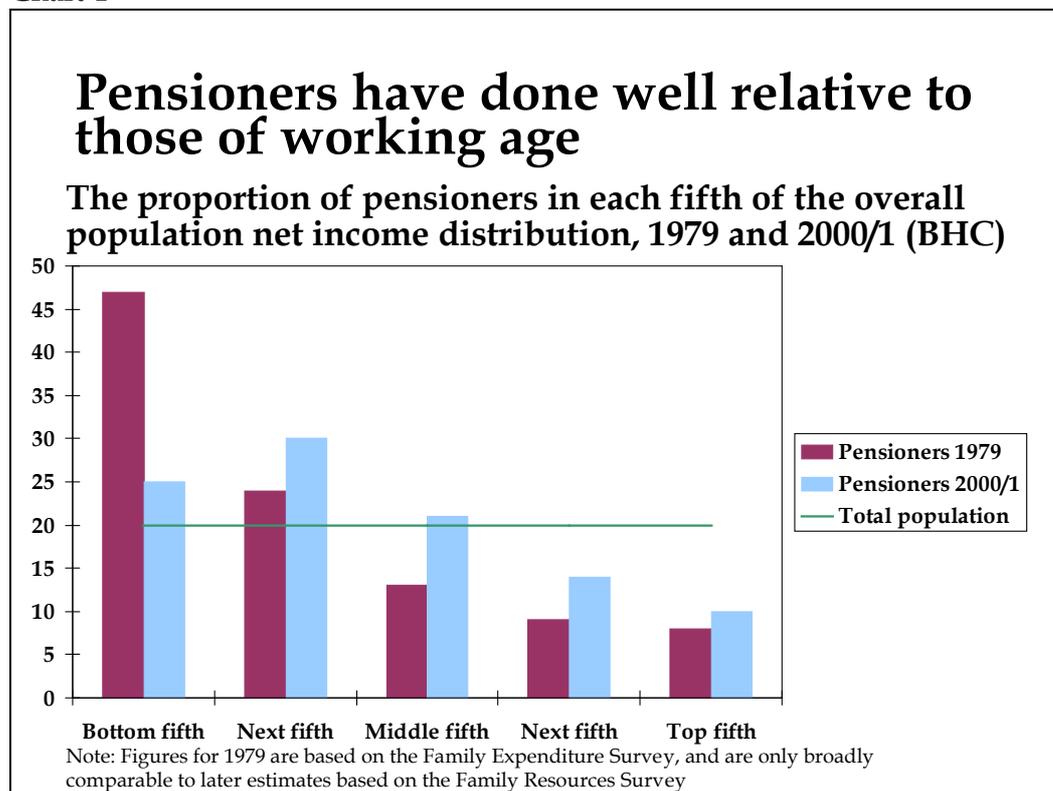


Pensioners' incomes have risen relative to those of working age

If the pensioners' income distribution were to mirror that of non-pensioners, 20% of pensioners would be in each fifth of the overall income distribution. However, pensioners are still over-represented in the lower part of the overall income distribution, with around 50% in the bottom two-fifths. They are under-represented at the top of the overall income distribution, with only 10% in the top fifth (Chart 4).

But this has improved significantly since 1979. The proportion of pensioners in the bottom fifth has halved, from 47% in 1979 to 25% in 2001. The proportion of pensioners in the top two-fifths of the overall population income distribution has increased to 24%, compared to 17% in 1979.

¹⁶ PPI calculation using ONS (2002 NES) and DWP (2002 PIS). Gross income is income before tax (see glossary).

Chart 4¹⁷

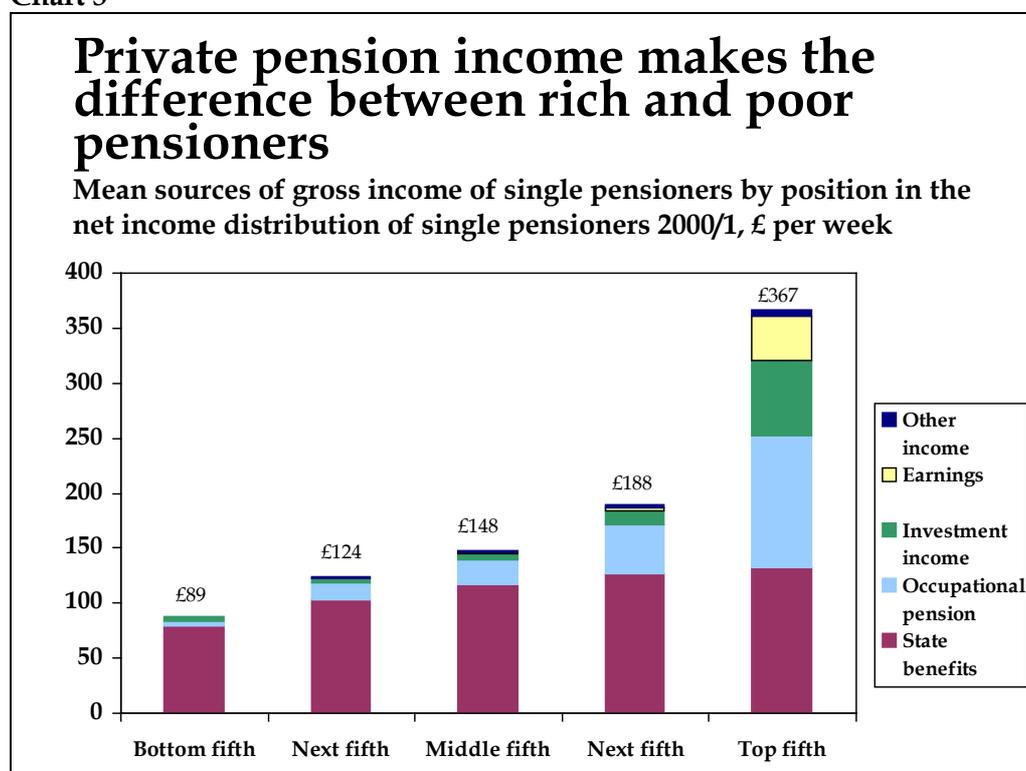
There are a number of reasons for this relative improvement in the position of pensioners compared to the rest of the population. As well as growth in pensioners' incomes, other groups may have seen relative reductions in income. Some low-income groups, such as single parent households, have grown in size. Others, such as the unemployed, have fallen. But the large changes since 1979 suggest that pensioners as a group have done well relative to others.

¹⁷ DWP (2002 HBAI). BHC is Before Housing Costs (see glossary).

Private pension income makes the difference between rich and poor pensioners

Many pensioners now have decent incomes in retirement. Those who have built up investment income and personal pensions, or who have large occupational pension incomes, have the highest incomes (Chart 5). The richest fifth of single pensioners have an average gross annual income of £19,000 (87% of NAE), the poorest fifth have an average gross annual income of £4,600 (21% of NAE).

Chart 5¹⁸



Income from occupational pensions contributes a reasonable proportion of income even at relatively low income levels. 12% of income - £15 a week - for single pensioners in the second fifth is derived from occupational pensions. Over half of single pensioners have income from occupational pensions.

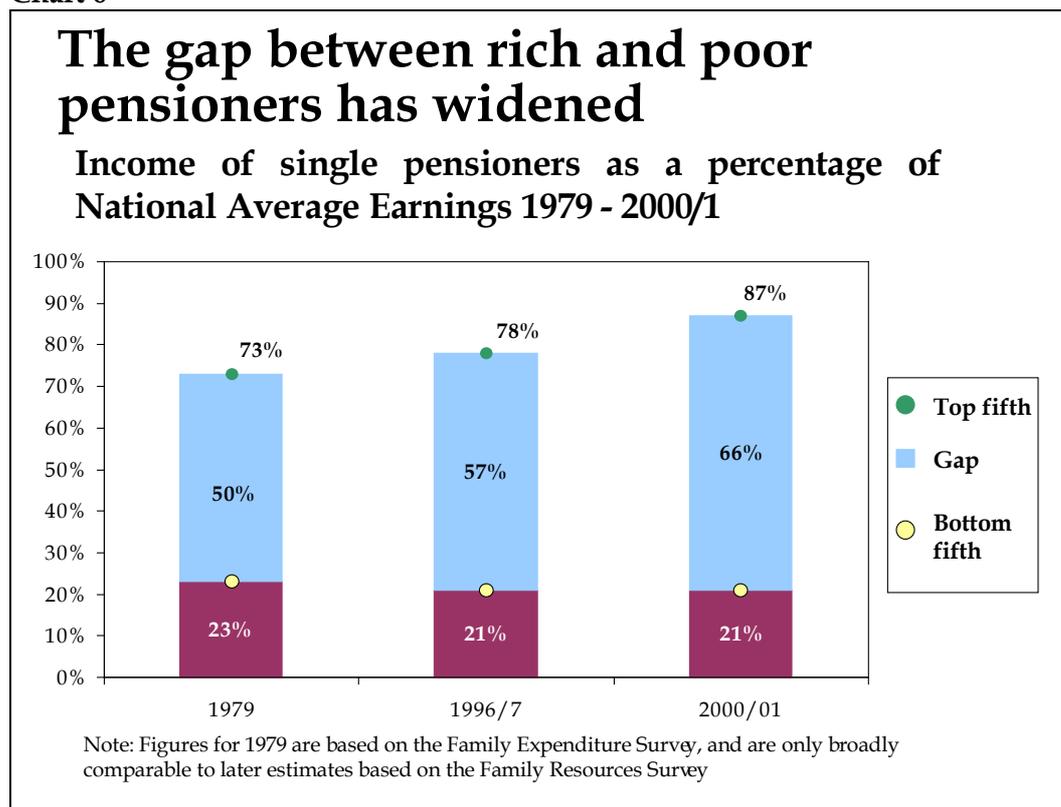
Investment income and earnings only contribute significantly to the incomes of the top 20% of single pensioners, where the average weekly amounts received are £69 and £40 respectively.

¹⁸ DWP (2002 PIS). The income of the top fifth is likely to be affected by pensioners with very high incomes, which may distort the average. There is a similar pattern to the distribution and sources of income for pensioner couples.

Recent growth in private pensions has contributed to widening the gap between the richest and the poorest

Since 1979 the gap has widened between the income of the richest pensioners and the incomes of the poorest (Chart 6).

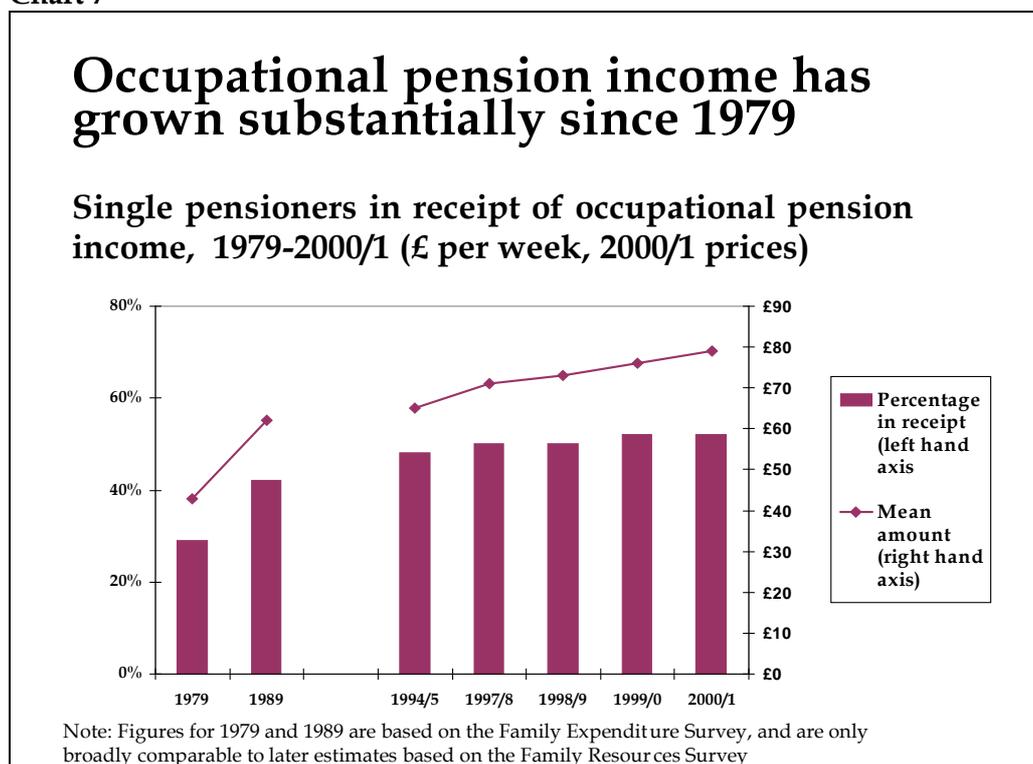
Chart 6¹⁹



Over this period average occupational pension income has grown substantially. In 2000/1, 52% of single pensioners had income from an occupational pension scheme compared to 29% in 1979. The mean average weekly amount for those in receipt has risen from £65 in 1994/5 to £79 in 2000/1 (Chart 7).

The average weekly amount received from occupational pensions across all single pensioners (not just those in receipt) has increased from £31 to £41 between 1994/5 and 2000/1. The average amount in the bottom fifth increased from £3 to £4, and in the top fifth from £100 to £119 per week. Although occupational pensions are therefore a growing source of income at all income levels, cash gains have been higher at higher income levels.

¹⁹ PPI calculation using ONS (2002 NES) and DWP (2002 PIS)

Chart 7²⁰

As well as longer periods of membership, this also reflects the impact of the growth in earnings upon which occupational pension accruals are based.

In addition, index-linking of deferred occupational pensions has meant that pensioners now receive an income from previous schemes which maintains its real value relative to prices.

Recent trends in occupational pension income for recently retired pensioners²¹ suggests that this growth may not continue. The numbers of recently retired single pensioners in receipt of occupational pension income has fallen, from 51% in 1994/5 to 44% in 2000/1 when it fell below the proportion of all pensioners with occupational pensions for the first time. If this trend continues, the proportion of all pensioners with occupational pension income will begin to decline.

Those who have savings have also done well. Since 1979 the average investment income – including personal pensions – of all single pensioners has almost doubled.

²⁰ DWP (2002 PIS)

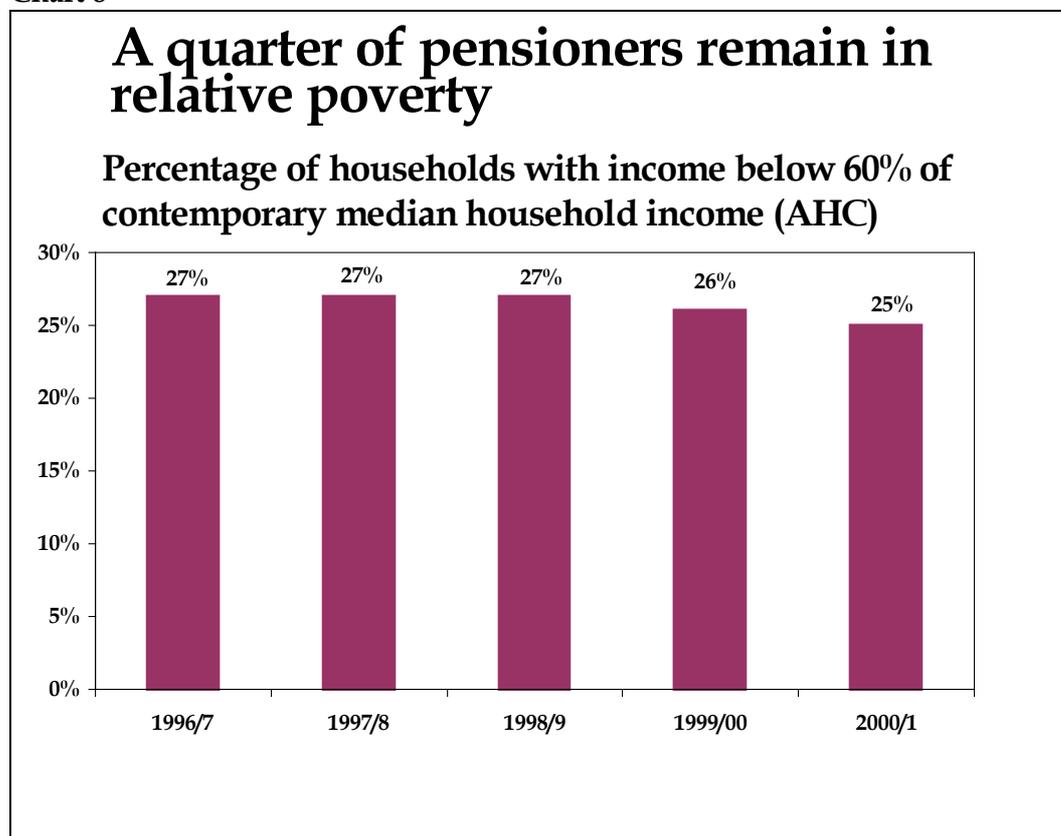
²¹ Retired but within 5 years of SPA – i.e. men aged 65 – 69, women aged 60 – 64

A quarter of pensioners remain in relative poverty

The extent to which pensioners can be defined as suffering from poverty is unclear - there is no single definition of poverty. There is, however, a variety of different measures used to examine particular aspects of poverty. One set of measures is used by the government in the annual evaluation of poverty and social exclusion²². These define poverty as income below a benchmark level, set according to the income levels of the whole population. These include absolute, relative and persistent low-income indicators²³.

The proportion of pensioners below *absolute* income benchmarks has fallen in recent years as pensioners' incomes have grown faster than inflation. However, the proportion of pensioners falling below *relative* measures of low income has remained broadly steady since 1996/7 (Chart 8). In 2000/1 the proportion below 60% of contemporary median income stood at 25%. This means that a quarter of pensioners remain in relative poverty. This general pattern is mirrored in broad terms across all the other relative income measures used by the government.

Chart 8²⁴



²² DWP (2002 OFA)

²³ Absolute low income indicators measure the number of pensioners with income below a level that is fixed at a point in time - e.g. 60% of median income in 1996/7. Relative low income indicators measure the number of pensioners with income below a level that changes over time - e.g. 60% of contemporary median income. Persistent low income indicators measure the number of pensioners with income below relative low income thresholds over a period of time - e.g. 3 out of the last 4 years.

²⁴ DWP (2002 OFA). AHC is After Housing Costs (see glossary).

Many pensioners appear to have low living standards

Another possible measurement of poverty is to compare incomes to a level required to attain a particular standard of living, above a level of essential food and shelter. These include, for example, the ability to participate in the social life of the community. Although such measures require a degree of subjectivity as to what activities and purchases would constitute participation, they attempt to add a “real life” perspective to the measurement of poverty.

One such measurement is the *Low Cost but Acceptable (LCA)* living standard: a minimum income that is sustainable indefinitely and below which health and social integration are at risk²⁵. A single pensioner aged 65-74 needed at least £90 a week (plus rent and council tax) to reach the LCA standard in 1999 - more than the income support level of £78.45 per week for a single pensioner aged 60 - 74 in place at that time. It was estimated that 52% of single pensioners and 24% of couples had net incomes after housing costs of less than these amounts²⁶.

A slightly higher living standard is the *Modest but Adequate (MBA)* standard, which allows for a healthy lifestyle with the opportunity to play a full part in society²⁷. It was estimated that a single tenant needs a net income of just over £200 per week while a single homeowner, without a mortgage, needs around £160 per week to attain this standard. Around half of all pensioners have incomes below the MBA standard.

Older pensioners are poorer

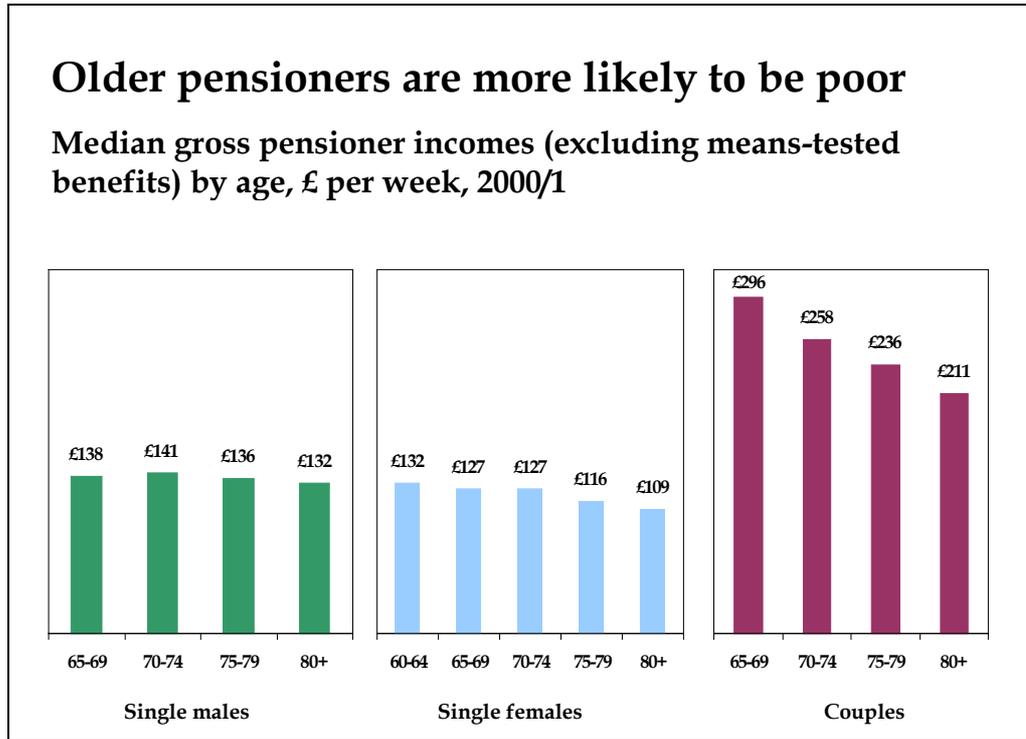
One of the most important reasons for recent changes in pensioners’ incomes is that the incomes of those now retiring are higher than the incomes of those who retired a number of years ago and are still alive today (Chart 9).

²⁵ Parker H. (ed) (2000)

²⁶ Select Committee on Social Security (2000)

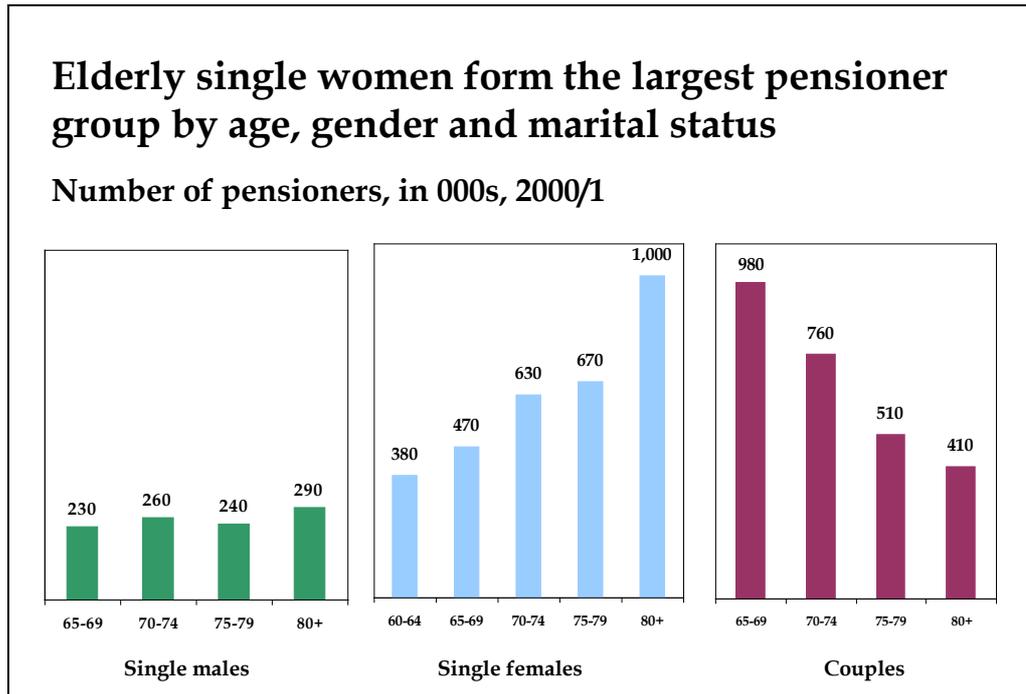
²⁷ Parker H. (ed) (2002)

Chart 9²⁸



This has a large impact on the overall distribution of pensioners' incomes, as there are a large number of older pensioners – and in particular older single women (Chart 10).

Chart 10²⁹



²⁸ PQ Steve Webb, House of Commons, Hansard, 27 June 2002: Column 1060W

²⁹ PQ Steve Webb, House of Commons, Hansard, 27 June 2002: Column 1060W

There are a number of reasons why older pensioners have lower incomes, before means-tested benefits.

The cohort effect

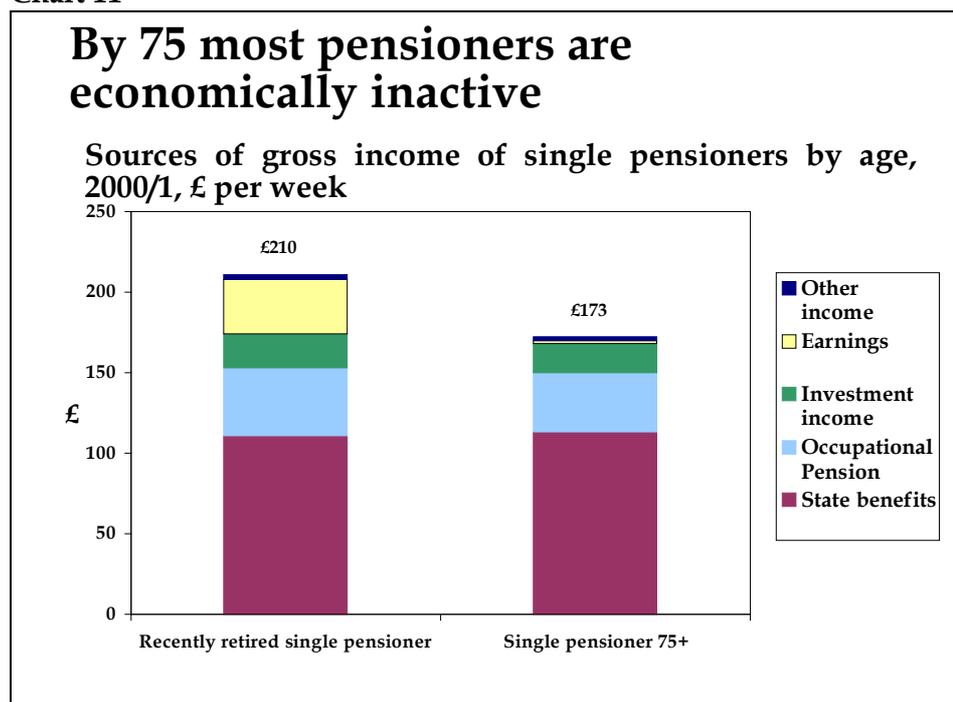
As individuals reach SPA today, they are more likely to have benefited from SERPS (established in 1978) than those already retired. Membership of occupational pension schemes also peaked in the 1960s³⁰, suggesting that those retiring now are likely to have had increased access, and for a longer period of time, to occupational pension schemes. The 1980s and 1990s also saw high investment returns. All of these factors have increased the retirement incomes of people reaching SPA relative to those of older pensioners. This is often called the “cohort effect”.

The cohort effect can be seen as the main driving force behind recent increases in average pensioners’ incomes. It is not that that one fixed set of pensioners has been getting progressively better off. Instead, it is new pensioners, year by year, who reach SPA with higher private pension coverage, and therefore higher incomes, who have pushed up overall income levels.

Age effects

However, one of the largest differences in income levels amongst pensioners at different ages is the value of earnings. This is a direct age effect – younger pensioners are more likely to be able to work, and so more likely to be earning (Chart 11).

Chart 11³¹



³⁰ GAD (2002)

³¹ DWP (2002 PIS). Recently retired is retired but within 5 years of SPA – i.e. men aged 65-69, women aged 60-64.

In addition, the longer one lives, the more private savings are spent. The scope for receiving income from these assets reduces as age increases.

Finally, many sources of income in retirement - in particular, income from state pensions and occupational pensions - increase over time in line with price increases. Therefore, the incomes of people who have been retired for a number of years have fallen substantially relative to average earnings.

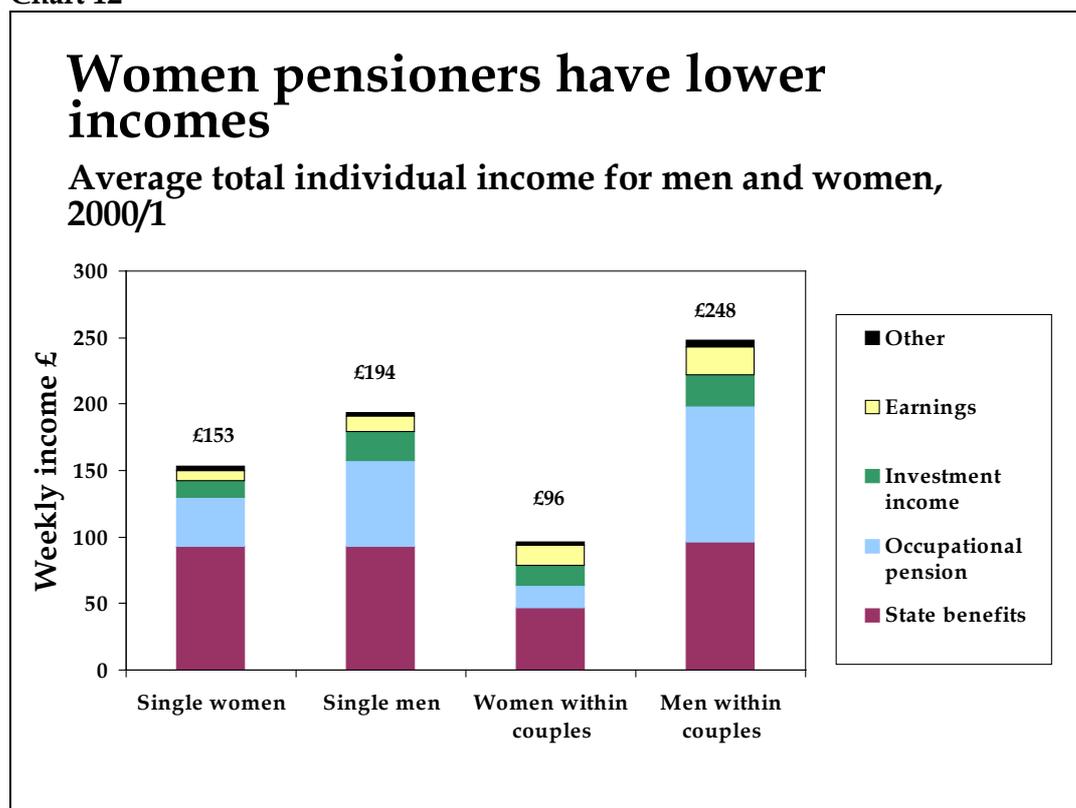
These age effects mean that incomes of older pensioners fall behind the incomes of the rest of the population, while the cohort effect has helped increase the incomes of younger pensioners relative to older pensioners. Therefore, older pensioners are more likely to need to claim means-tested benefits.

Women pensioners are poorer

Women over state pension age are typically poorer than men and predominate at lower income levels.

The average weekly income for single women in 2000/1 was £153 while for single men it was £194 (Chart 12). The gap between married men and women is larger than the gap between singles. However, it does not take account of access to a partner’s income, which makes it a weak comparison.

Chart 12³²



³² Women and Equality Unit (2002). These figures are not directly comparable to other income estimates used in chapter 1, as different definitions of income and pensioner have been used.

The major differences in income between men and women appear to be in state benefits and occupational pensions. Far fewer women, in particular those in pensioner couples, have entitlement to the full BSP, and some have no entitlement. Women are also less likely to have access to an occupational pension scheme, and where they do have access they are likely to accrue smaller pensions. This is primarily a consequence of different work patterns, where women are more likely to have been in part-time, lower paid jobs and to have taken career breaks to raise children or care for relatives.

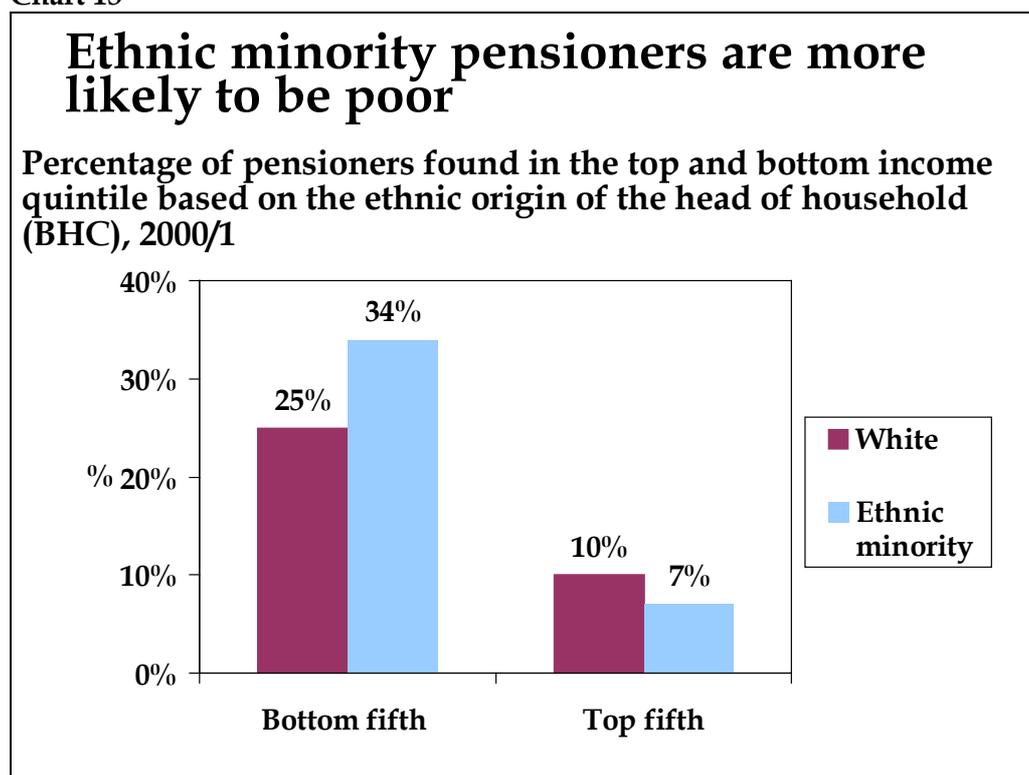
Age effects mean that older pensioners are poorer than younger pensioners. Older pensioners are more likely to be women, who live longer than men.

Ethnic minority pensioners are poorer

Another group susceptible to pensioner poverty, but for which there is limited data and research, are ethnic minority pensioners. 3% of pension households are headed by someone from an ethnic minority³³.

Ethnic minority pensioners are more highly concentrated at the bottom of the income distribution compared to white pensioners. Of the 300,000 pensioners living in households headed by someone from an ethnic minority over a third (34%) are found in the bottom fifth and 7% in the top fifth (Chart 13).

Chart 13³⁴



³³ DWP (2002 HBAI)

³⁴ DWP (2002 HBAI)

There are a number of possible explanations for this. Traditionally ethnic minorities have been more susceptible to unemployment, and are disproportionately found in low skill, low-income employment. In 2000/1 Bangladeshi men had an unemployment rate of 20%, 4 times higher than the average. For most other ethnic minority groups, unemployment rates were between 2 and 3 times higher than the average³⁵. This means that employment-based pensions are less likely to be accrued.

Many entered the UK in the middle of their working lives and so missed out on those years needed to build up UK pension entitlement. For the families of these immigrants, this disadvantage will not occur if their working lives are spent entirely in the UK.

There is also evidence to suggest that the idea of an “intergenerational contract” is particularly strong amongst some ethnic minorities, where it is taken for granted that financial support and care would be provided by their children when they reach old age³⁶.

The self-employed are more at risk of lower pension incomes

Pension coverage among the self-employed has traditionally been low, primarily because the self-employed have not had access to SERPS/S2P or occupational pensions.

The self-employed and employees spend a similar number of years contributing to non-state pensions³⁷, but employees can benefit from employer contributions. Self-employment increases the risk of very low income in retirement, meaning that the self-employed are more likely to continue to work after SPA³⁸.

Regional differences may be slight after housing costs

Over 60% of pensioners living in the North East, Yorkshire and Humber and the East Midlands have low incomes³⁹, and there are higher than average proportions of pensioners with low incomes in Scotland and Wales⁴⁰.

The South East and London have the lowest proportion of pensioners in the bottom two-fifths of the income distribution using a before housing cost measurement of income. However, using the after housing cost measure, these two regions were much closer to the levels seen in the rest of the UK.

³⁵ ONS (2002 ALAFS)

³⁶ Neary and Nesbitt (2001)

³⁷ Knight and McKay (2000)

³⁸ Meager et al (1994)

³⁹ Defined as having income in the bottom two-fifths of the population income distribution before housing costs

⁴⁰ DWP (2002 HBAI)

Chapter 2: The pension prospects for future pensioners

Many factors will determine the level of income of people retiring in the future. Most of these are uncertain – what will happen to the labour market, how long will people live, how will the pensions system change? This chapter analyses one important indicator of what might happen to pensioners' income in future: the level of pension provision that is being made today.

It concludes that the make-up of pensioners' incomes will change in future, but there are no signs that future pensioners will be better off than the pensioners of today. Individuals are not yet doing more to fill the gap left by the withdrawal of the state and many employers from pension commitments. Private pension coverage remains concentrated among those with high incomes, and there is little sign of a recent increase in pension or other saving.

- **Both the state and employers are reducing their long-term pension commitment.** More people will receive state pensions in future. But state pension income per pensioner will fall relative to earnings, despite the earnings-linking of means-tested benefits. Employers are changing the type of provision offered, and reducing the amount contributed.
- **Today's pension saving behaviour seems unlikely to deliver more private pension income in future.** Total contributions to private pensions have stalled. Only a minority save in personal pensions. Pension saving is starting at later ages and tends to be irregular.
- **Pension alternatives are not widespread.** Most people do not have significant amounts of non-pension saving or investments. Those without pensions are less likely to have other assets. Housing is a significant asset for many, but it is rarely converted into retirement income.

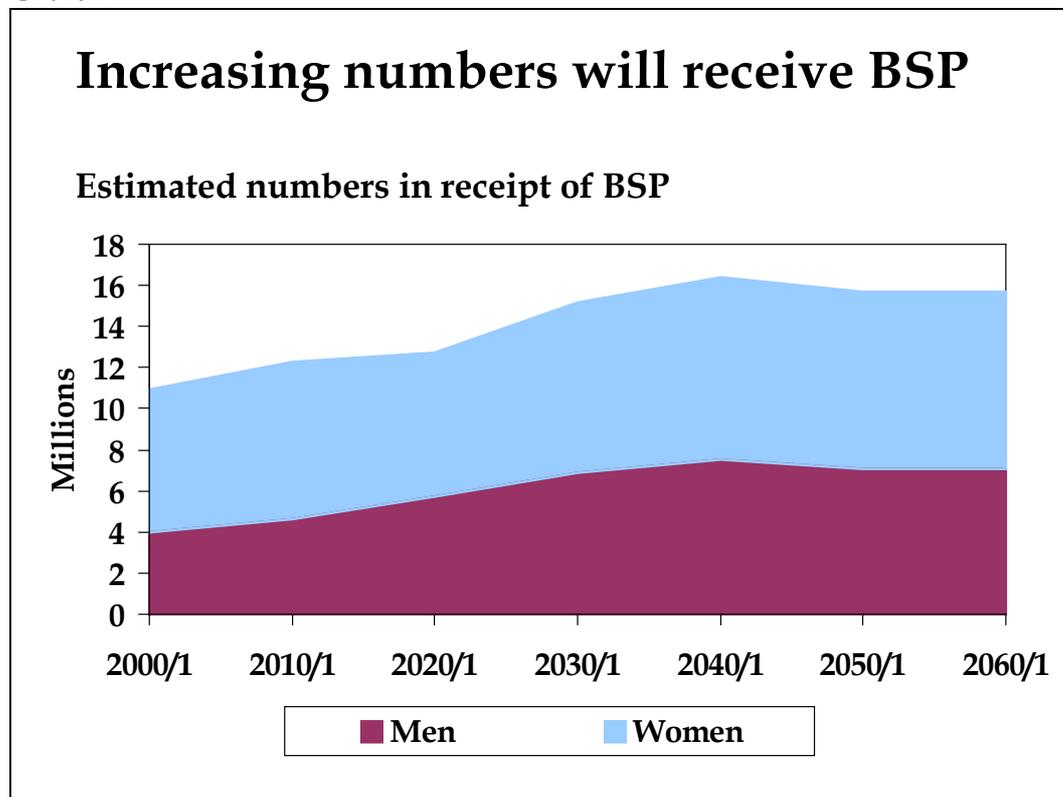
Both the state and employers are reducing their long-term pension commitment

More people will receive state pensions in future. But state pension income per pensioner will fall relative to earnings, despite the earnings-linking of means-tested benefits. Employers are changing the type of provision offered, and reducing the amount contributed.

More people will receive state pensions

The number of people receiving BSP is projected to increase substantially from 11.0 million in 2000/1 to 15.6 million by 2060/1, peaking at 16.4 million in 2040/1 (Chart 14).

Chart 14⁴¹



Much of this increase is due to the increased number of pensioners. But the proportion of pensioners qualifying for the BSP is also expected to increase.

⁴¹ GAD (1999)

Almost 27 million individuals - 80% of the working age population - had a qualifying year for BSP in 2001/2⁴². Of these, 23 million qualified through paying NI contributions on earnings, whilst a further 4 million were credited with a contribution, for example through receipt of a disability or unemployment benefit.

In addition to those with qualifying years, a further 2.5 million people received Home Responsibilities Protection (HRP). Although not creating an entitlement to BSP, this reduces the number of qualifying years needed to receive BSP.

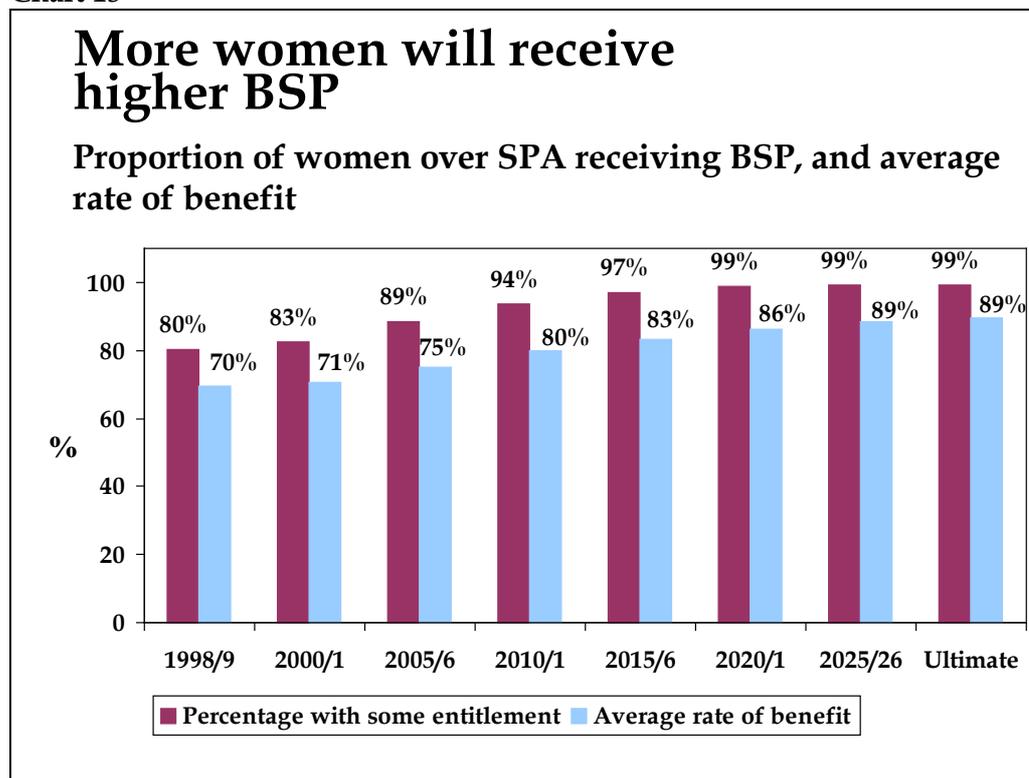
Overall, 87% of the working age population either had a qualifying year or received HRP in 2001/2. Men were more likely to have a qualifying year than women, a third of whom receive HRP, or make no contribution.

Today, one in five women reaching SPA has no BSP entitlement, and only 25% of newly retired women with BSP based solely on their own contributions receive a full BSP⁴³. Average entitlement for women is two-thirds of the full rate. But entitlement is expected to increase in future, reflecting increased female activity rates, the introduction of HRP and the declining numbers paying the married women's NI contribution⁴⁴. By 2025, almost all women reaching SPA will have some entitlement to BSP, averaging nearly 90% of the maximum benefit (Chart 15).

⁴² PPI estimates based on the Family Resources Survey 2001/2. These figures are only a broad approximation of the numbers qualifying. They are based on circumstances in one particular week, while actual qualification is calculated annually. Not all of the qualifying conditions can be accurately modelled. People may also make voluntary contributions to make up qualifying years. See PPI (2003) for further details on entitlement.

⁴³ Many of these may become entitled to some BSP, or a higher rate of BSP once their husband reaches SPA

⁴⁴ Until 1978, married women could opt to pay a reduced NI contribution which did not earn any state pension benefits in their own right. Since then, only those who were paying the reduced rate before that date, and have done so without a break of more than two years, can still pay the reduced rate.

Chart 15⁴⁵

The value of state pensions per pensioner will reduce relative to NAE

As the numbers of people receiving BSP increases, the value of the BSP is expected to fall relative to other earnings.

The maximum BSP is, in the long-term, projected to increase in line with prices⁴⁶. Earnings tend to increase faster than prices. BSP is therefore projected to decline from 16% of National Average Earnings (NAE) in 2003 to 9% of NAE in 2040⁴⁷.

Despite the uprating of BSP being linked to prices since 1981, maximum BSP has grown relative to prices by 0.4% a year over this period as a result of occasional additional increases, such as those in 2001 and 2002⁴⁸. But even if this annual real growth rate continued, BSP would still decline to 11% of NAE by 2040.

In the past, some of this decline in the relative value of BSP has been offset by increases in SERPS. Someone retiring when reaching SPA in 2003/4 who had continuously earned at NAE since 1978/9 will receive a SERPS pension worth £90 a week⁴⁹. For people with the same working patterns but retiring in future years, this level will decline as a proportion of NAE, as changes made to SERPS in 1986 and 1995 (and carried through into S2P) reduce benefits⁵⁰.

⁴⁵ GAD (1999)

⁴⁶ For the remainder of this parliament, BSP will rise in line with prices, or by 2.5% whichever is the greater

⁴⁷ PPI calculations, assuming real NAE growth of 1.5% per year

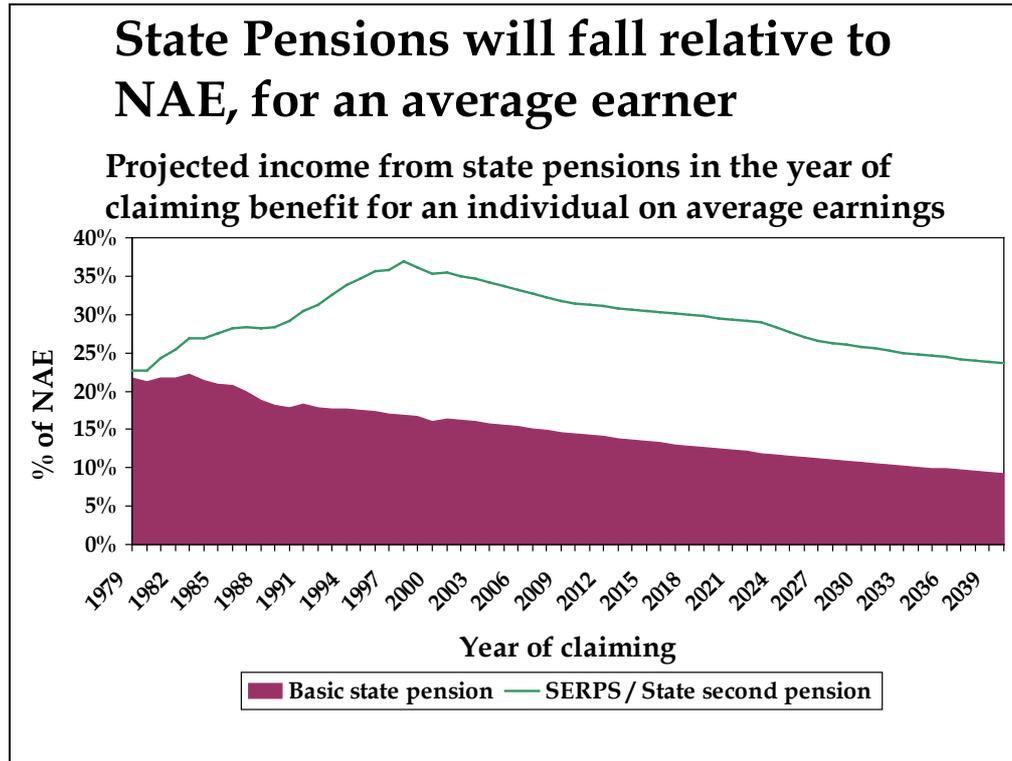
⁴⁸ See PPI (2003) for further details of historical BSP uprating policies

⁴⁹ PPI calculations - see appendix 1 for assumptions

⁵⁰ Details of the changes made in the 1986 and 1995 Acts can be found in PPI (2003)

Taking the first and second tiers together, state pension income for an average person⁵¹ (having peaked at 37% of NAE in 1998) will begin to decline from a level of 35% of NAE in 2003 to 28% in 2025 (Chart 16).

Chart 16⁵²

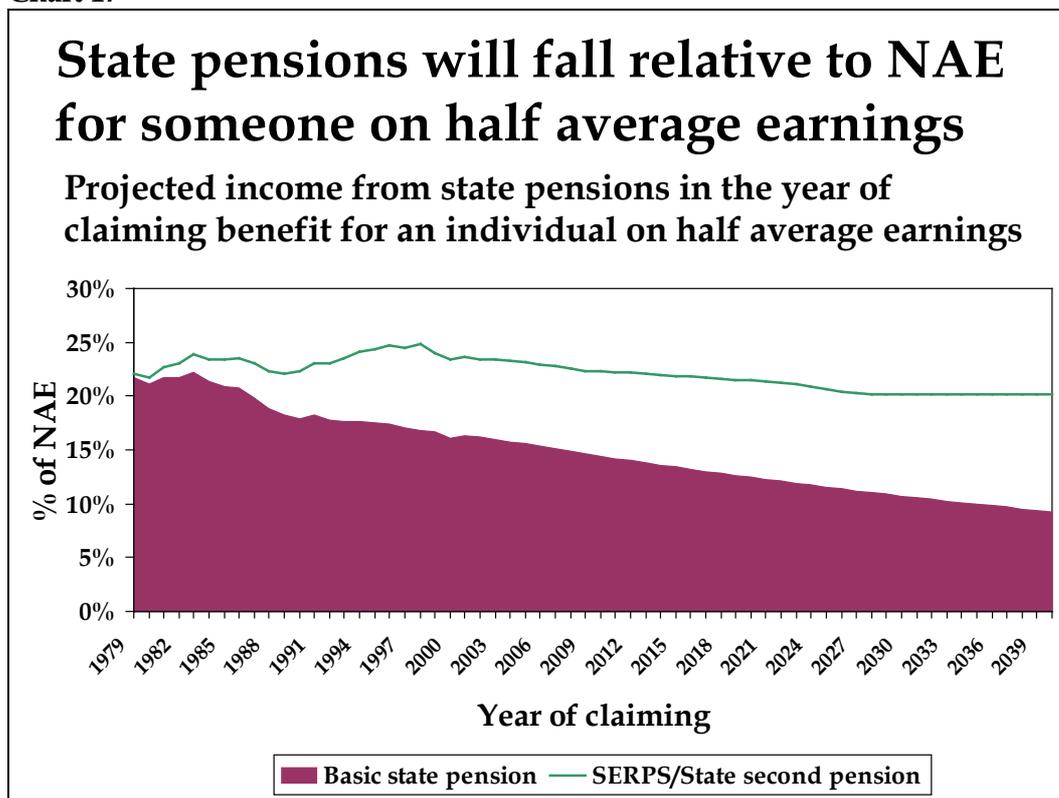


The level of benefits for lower earners is lower – for those on half NAE throughout their working life, the value of state pensions today is 23% of NAE. Those with lower incomes will benefit from the enhanced accrual rates in S2P. However, the increase will not be enough to offset fully the relative decline of BSP, and income relative to earnings is still projected to fall (Chart 17). State pension income for a low earner falls to 21% of NAE for those reaching SPA in 2025.

⁵¹ Earning at NAE throughout a working life of 45 years before retiring at age 65

⁵² Based on PPI calculations – see appendix 1 for assumptions

Chart 17⁵³



A flat-rate S2P would reduce the value of state pensions still further

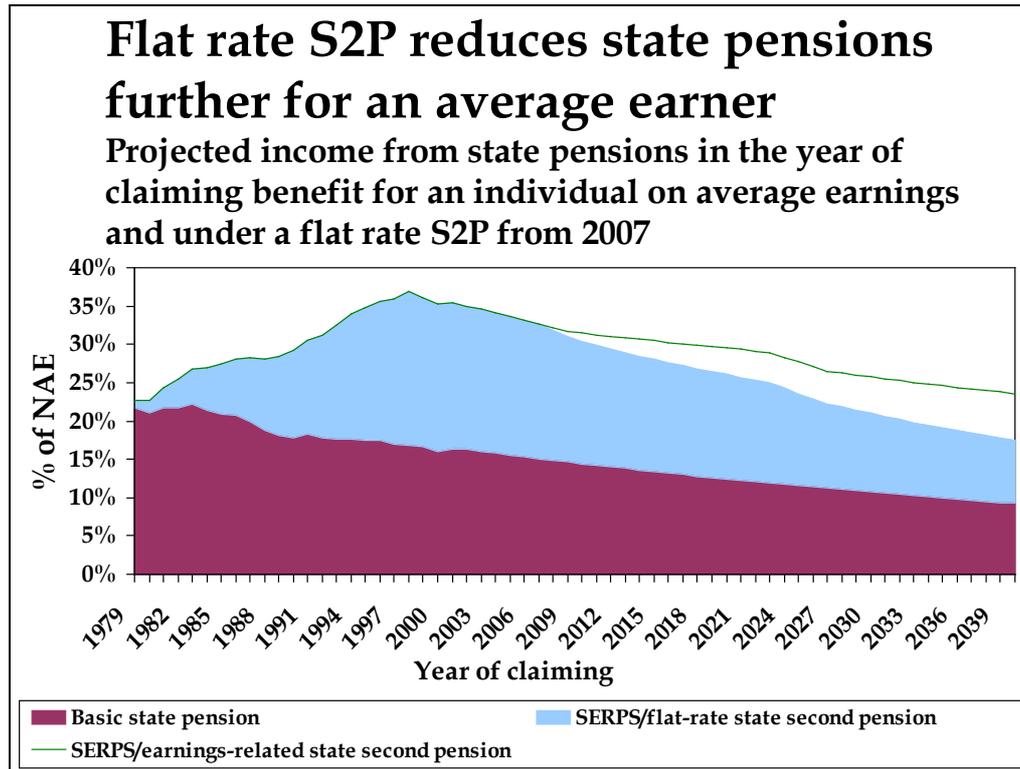
The government intends that S2P will become a flat rate benefit - that is, all future accruals will earn the same benefit, irrespective of earnings. The flat-rate benefit will be at the level of the lower earnings threshold (£11,200 from April 2003). The 1998 Green Paper suggested that the change could happen 5 years after the introduction of stakeholder pensions⁵⁴, which became available from April 2001. Although the benefit would become flat rate, the rebates paid for contracting-out would still be related to earnings. This would give those with earnings above the lower earnings threshold a greater incentive to contract-out, as he or she may be expected to accrue higher benefits in a private scheme.

⁵³ Based on PPI calculations – see appendix 1 for assumptions

⁵⁴ DSS (1998). The 2002 Green Paper (DWP (2002 GP)) gives no further indication on timing, but says the ‘Government will keep the position under review’.

However, an average earner who does not contract-out will receive a lower overall state pension if S2P changes to a flat-rate benefit. State pension income would reduce over time from 33% in 2007 to 24% by 2025 (Chart 18). This compares to total state pensions delivered by the current earnings-related S2P of 28% of NAE in 2025.

Chart 18⁵⁵

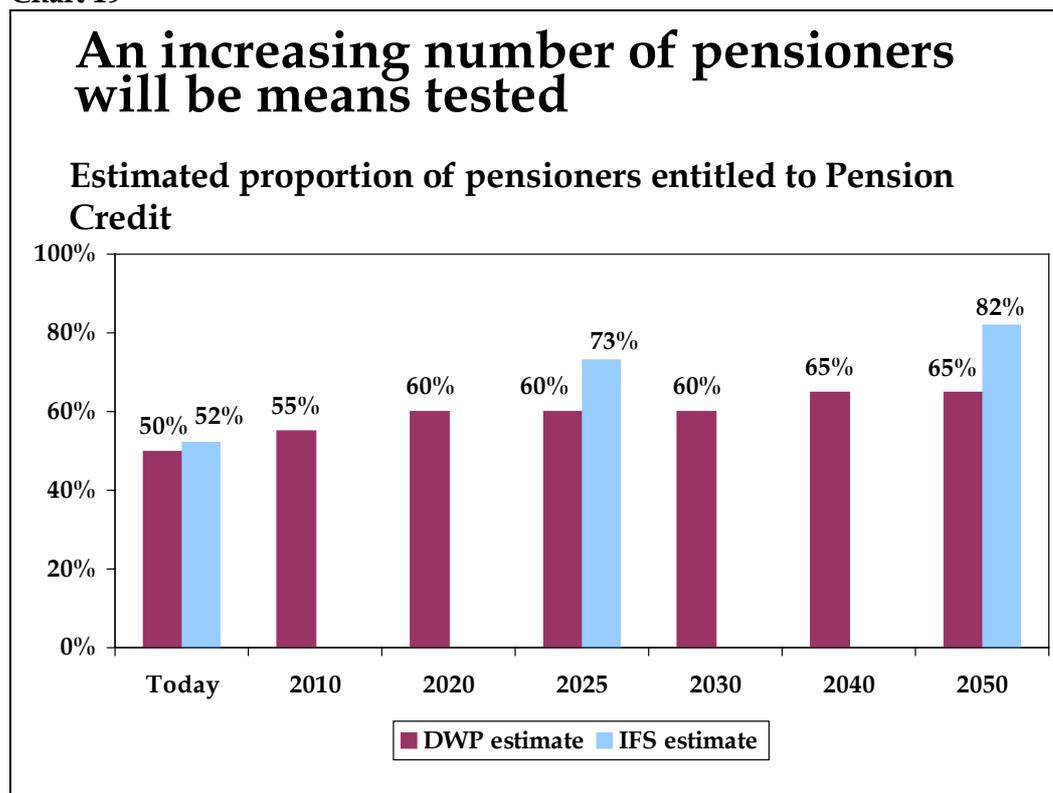


⁵⁵ Based on PPI calculations – see appendix 1 for assumptions

More state income will come through means-testing

On current policies, an increasing proportion of those reaching state pension age will be eligible to receive the Pension Credit (PC). By 2050, between two-thirds and four-fifths of those over 65 may be entitled to PC (Chart 19).

Chart 19⁵⁶



The increasing prevalence of means-testing is a direct result of means-testing thresholds likely to be earnings-linked and other retirement income likely to be price-linked.

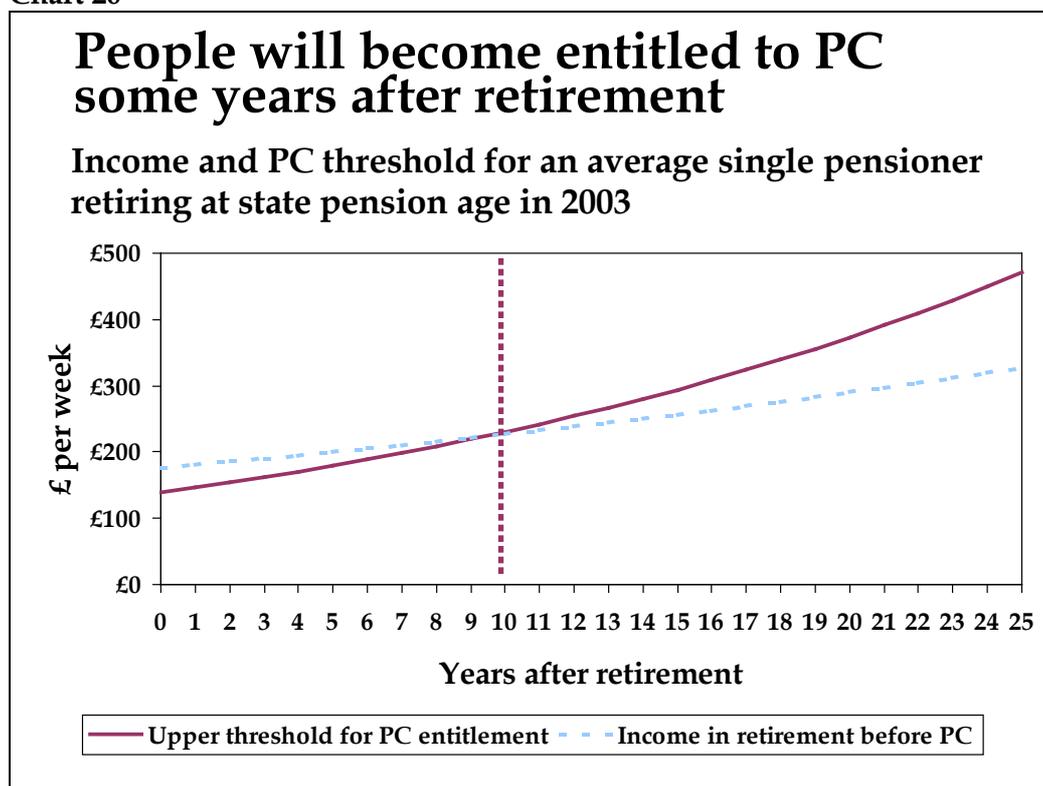
As price-linked income grows slower than earnings-linked PC thresholds, so retirement incomes will eventually fall below the threshold. Even if someone retired at SPA today with an income of £100 in addition to BSP – a total income broadly equivalent to the average net income before housing costs of a single recently retired pensioner⁵⁷– he or she would be entitled to receive PC after 10 years (Chart 20). This is despite starting retirement with an income significantly above the PC level.

In future people who have had average incomes throughout their working life could be entitled to PC as soon as they reach SPA⁵⁸.

⁵⁶ IFS estimate from Clark and Emmerson (2002), DWP (2002 PC). Both estimates assume that PC levels will continue to increase in line with NAE beyond the end of this parliament. The major differences between the estimates are that IFS assume annual real earnings growth of 2% and base estimates on the population aged 65 and older, while DWP assume 1.5% and use the population aged 60 and older.

⁵⁷ DWP (2002 PIS)

⁵⁸ PwC (2002). Example for someone earning at NAE until retirement at SPA in 2037, assuming current uprating conventions remain in place.

Chart 20⁵⁹

Employers are reducing their pension commitments

Employers are reducing their long-term pension liabilities by changing the type of provision offered, and in some cases reducing the amount of contribution.

Employer pension arrangements vary

Employers can provide pension benefits for their employees in a number of different ways – they may run or arrange an occupational pension scheme solely for their own employees, contribute to a group or individual personal pension, or contribute to an employer-sponsored or individual stakeholder pension.

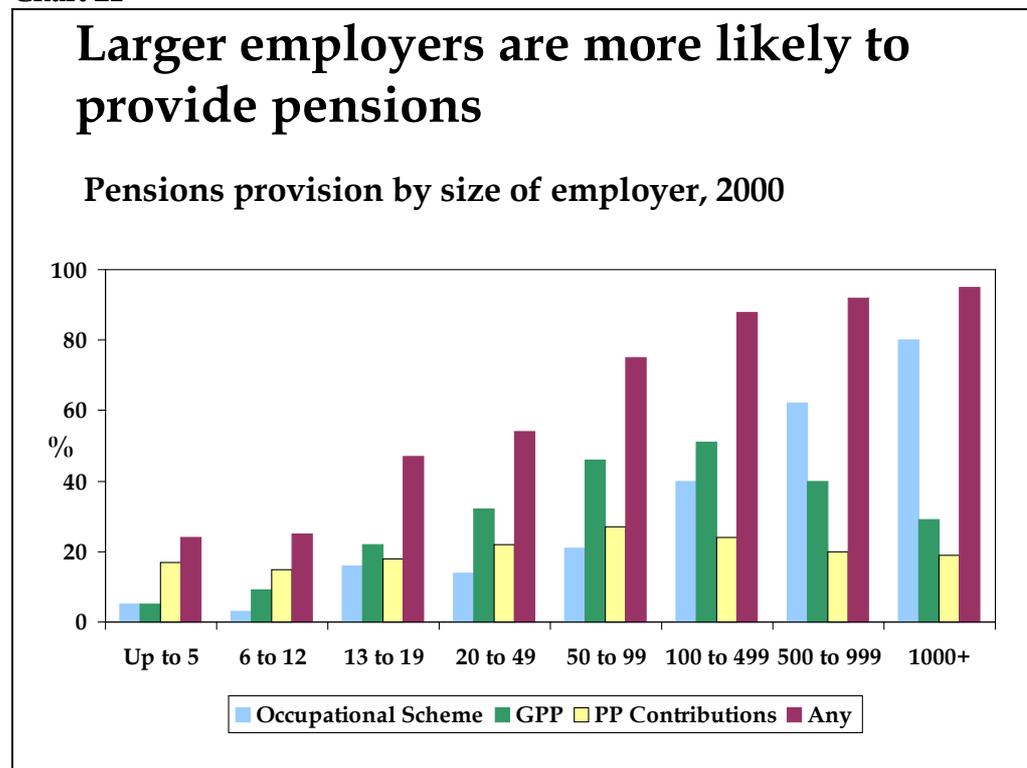
In 2000, 29% of private employers made some kind of pension arrangements for at least some of their employees⁶⁰. Of these arrangements, the most popular were contributions to a personal pension (17%), followed by Group Personal Pension (GPP) arrangements (9%) and occupational pension schemes (7%)⁶¹.

⁵⁹ PPI calculations, assuming RPI of 2.5% per year and real growth in NAE of 1.5% per year

⁶⁰ Smith and McKay (2002)

⁶¹ Employers can have more than one type of arrangement

But larger firms are much more likely to have some general pension provision, and in particular an occupational pension scheme (Chart 21). This means that although most firms do not have pension arrangements, most employees – 72% – work for an employer that does. Over half of employees – 53% – work for an employer with an occupational scheme, and almost 40% for an employer with a salary related scheme⁶². However, not all will have pensions – some will not be eligible for their employer’s arrangements, and others will choose not to join.

Chart 21⁶³

Pension arrangements also vary by industry – employers in the manufacturing and the construction industries are most likely to have pension arrangements (54% and 37%), whilst those in transport and communications are least likely (12%)⁶⁴.

Occupational pensions are the most common employer provision

An occupational pension scheme is still the most common employer-sponsored provision, in terms of numbers of individuals covered. Private sector occupational pension scheme membership was 5.7 million in 2000⁶⁵. However, numbers have been declining from a peak of 8.1 million in 1967, and there were 6.2 million members of private sector occupational schemes in 1995⁶⁶.

⁶² Smith and McKay (2002)

⁶³ Smith and McKay (2002)

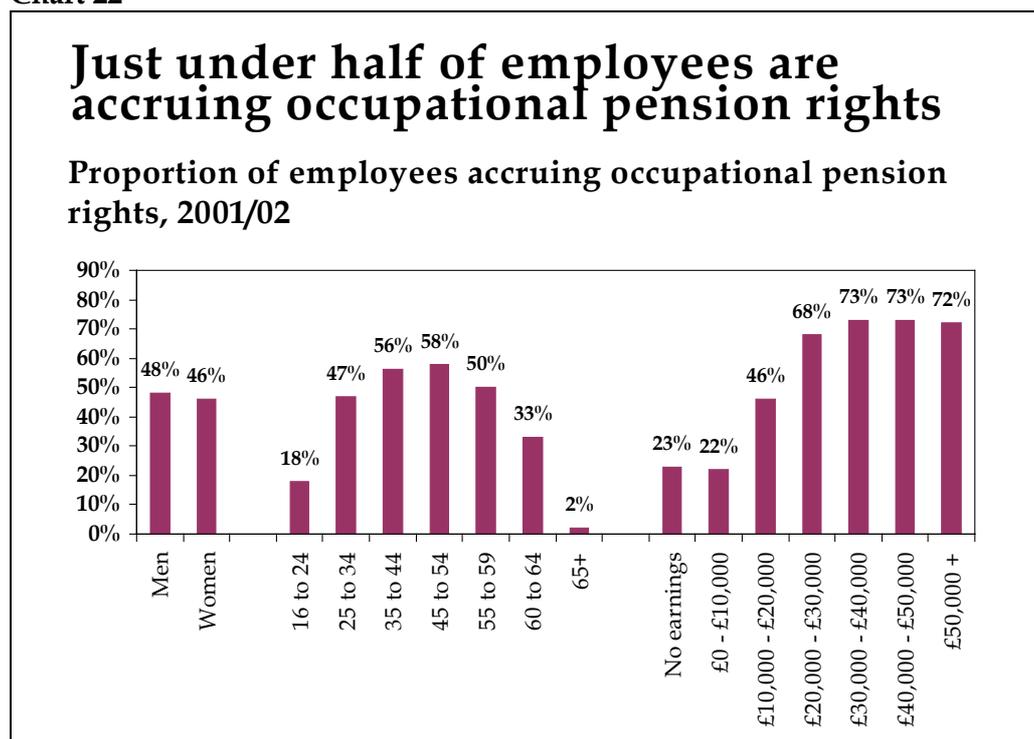
⁶⁴ Smith and McKay (2002)

⁶⁵ GAD (2002)

⁶⁶ GAD (2000)

In total, 47% of adult employees are accruing rights in some kind of occupational pension⁶⁷. Membership varies by age, with those aged 45 – 54 most likely to be members (57%), and also increases with earnings (Chart 22).

Chart 22⁶⁸



Employers are reducing their pension commitments

There appears to have been little change in the number of people with different types of occupational pension provision in recent years, at least until 2000. In that year there were 4.6 million active members of defined benefit occupational pension schemes, and 0.9 million active members of defined contribution schemes (with 0.1 million active members of hybrid schemes)⁶⁹. In 1995, the corresponding figures were 4.7 million active members of defined benefit schemes and 1.1 million members of defined contribution arrangements⁷⁰. This does not suggest a huge shift in the pattern of provision.

However, a number of employers have closed defined benefit (DB) schemes to new (and sometimes existing) members and replaced them with other types of provision – either a defined contribution (DC) occupational pensions scheme, a GPP, or from 2001 an employer-sponsored stakeholder pension scheme. A recent survey suggested that in 2002 fewer than half of surveyed final salary schemes are still open to new members, and that a third of the sponsors of surveyed occupational schemes were reviewing arrangements⁷¹.

⁶⁷ PPI analysis of the Family Resources Survey 2001/2

⁶⁸ PPI analysis of the Family Resources Survey 2001/2

⁶⁹ GAD (2002)

⁷⁰ GAD (2000)

⁷¹ ACA (2002). Based on the pension provision of 336 firms selected at random.

It appears that there has been a recent increase in the number of large occupational schemes being closed to new members⁷². Some have also closed to existing members.

Even for the larger newly-closed schemes there will be a delayed impact on overall pension provision. Closing a scheme (and opening another) does not necessarily impact on existing scheme members, who remain members. Most of the impact will be on those recruited by the employer in the future, who would otherwise have been new entrants to the scheme. It will take time for active membership to switch into the new schemes, depending on labour market movements after the original scheme has closed.

A shift in the type of occupational pension that employers provide may not, in itself, be a cause for concern. It is not always necessarily the case that a DB scheme will be better than a DC scheme - some DC schemes are expected to provide better benefits than many DB schemes⁷³. DB and DC arrangements have different risks and advantages for different groups.

For example, DC arrangements place more investment risk and uncertainty on the individual, as there is no pooling of assets or guarantee of final pension income⁷⁴. Members of DB schemes face different risks - they rely on employers keeping a pension promise. Since 1997, 10,000 occupational pension schemes have started wind-up procedures, affecting over 300,000 pension scheme members (including pensioners, deferred and active members)⁷⁵. Although there are no aggregated figures as to how many of these individuals will receive their full entitlement, some will not.

A greater cause for concern, however, is if employers reduce the level of contribution being paid to pension schemes. Although it is clear that, on average, contributions paid into DC schemes are currently lower than those paid in to DB schemes (Table 1), it is not clear that employers switching from DB to DC are uniformly reducing contributions⁷⁶.

⁷² NAPF (2002)

⁷³ Davies (2003)

⁷⁴ NCC (2002)

⁷⁵ PQ David Willetts, 5 November 2002, House of Commons Hansard Col 188 W

⁷⁶ Davies (2003) does suggest that in most cases, and using a particular measure, new DB schemes were expected to produce lower overall benefits than the DB schemes they replaced, though this was not true in all cases, and is only based on 15 schemes

Table 1: Average contributions to private occupational pension schemes

	Defined Benefit			Defined Contribution		
	Employer	Employee	Total	Employer	Employee	Total
GAD Survey⁷⁷	11.1%	5.0%	16.1%	5.1%	3.4%	8.5%
NAPF Survey⁷⁸	10.5%	3.0%	13.5%	7.5%	2.8%	10.3%

Even if it is the case that new DC contributions are lower than the current DB contributions they are replacing it is not necessarily the case that the final pension will be reduced. This is because contributions to DB schemes are not directly comparable to contributions to DC schemes. In DC schemes, contributions tend to be stable over a period of time, whereas in a DB scheme contributions tend to fluctuate according to the funding level of the scheme. When investment returns are high, many employers reduce or cease contributions into DB funds (known as a contribution holiday). Past and future contribution levels are just as important in determining final pension income as current contributions are.

This means that it is not valid to compare directly employer contributions to a DB scheme just before switching to the employer contributions paid into a new DC scheme. The better comparison would be contributions into the DC scheme compared to what the employer would have paid into the DB scheme over the longer-term had it continued.

In an era of improving longevity, the costs of DB pension provision are growing⁷⁹. Many employers are thought to be switching to DC schemes as DB costs increase beyond what they are prepared to pay. The cost of improved longevity is then passed on to the employee.

Despite the headlines about occupational pension scheme closure, there is still not conclusive evidence to predict that today's workers will be worse off in retirement than if the DB - DC switch had not happened. But it raises a question as to whether employees have realised they now need to do more to manage - and perhaps contribute to - their pension.

Occupational pensions provide additional protection

One difference between occupational pensions and individual pensions is the provision of risk benefits. An occupational scheme, as well as providing a pension may also provide additional insurance benefits. These include life insurance (in the form of death-in-service benefits) and insurance against ill-health (in the form of enhanced pensions for early retirement on the grounds of ill-health). These benefits, not provided by individual pensions, further increase the costs of occupational pension provision.

⁷⁷ GAD (2002). Figures relate to the year 2000, and were collated from a sample of all occupational pension schemes.

⁷⁸ NAPF (2002). Averaged across contributory and non-contributory schemes. Figures relate to the year 2002 and were collated from a sample of NAPF member schemes.

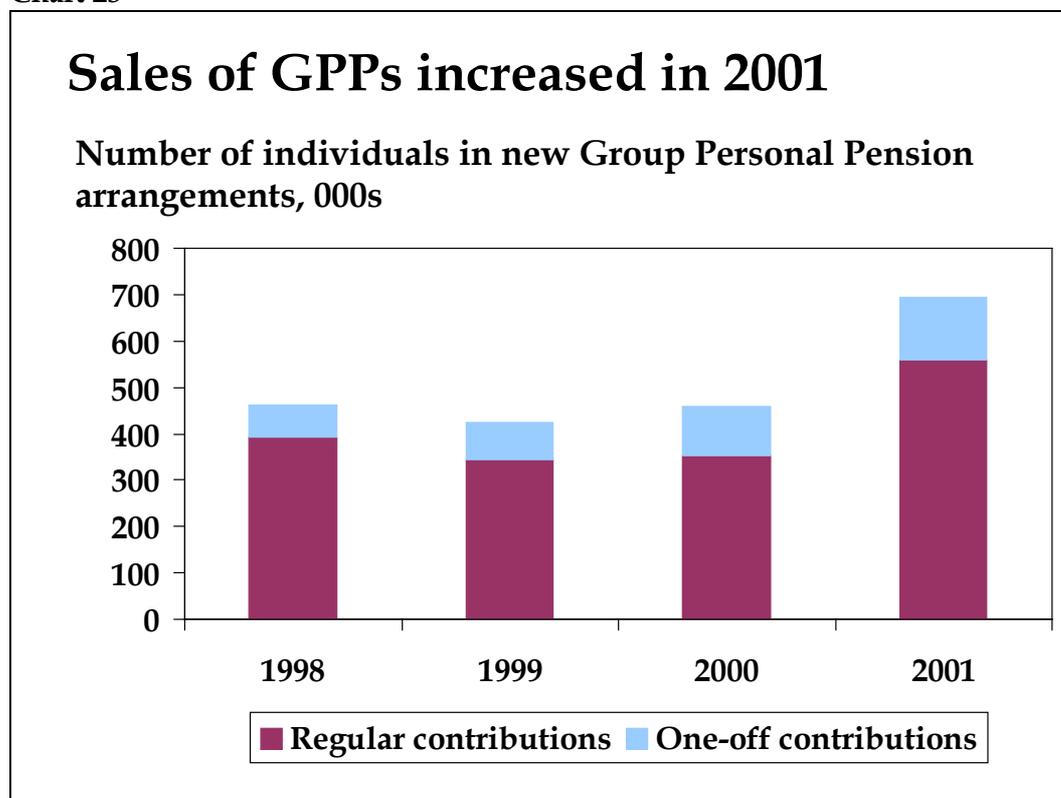
⁷⁹ EC (2002) estimates that by 2050 the cost of providing a pension from age 65 will have increased between 25% and 30% due to increased life expectancy

Other types of employer sponsored provision are growing

As the number of occupational pension schemes has been declining, other types of employer-sponsored provision have been increasing. For example, the number of Group Personal Pensions (GPPs)⁸⁰ has been growing even among larger employers (20+ employees), with active membership in this group increasing from 3% in 1996 to 10% in 2000⁸¹.

More recent figures suggest further increases in sales of GPPs (Chart 23), although many of these are replacing existing GPP or occupational schemes.

Chart 23⁸²



Many GPPs may also have been set up in response to recent changes in legislation accompanying the introduction of stakeholder pensions. Although employers without alternative pension arrangements are obliged to designate a stakeholder pension scheme for their employees, and more than 330,000 have done so, 90% of the designated schemes are receiving no contributions from either employer or employees⁸³.

⁸⁰ See glossary

⁸¹ Smith and McKay (2002)

⁸² ABI new business returns

⁸³ ABI (2002a)

Today's pension saving behaviour seems unlikely to deliver more private pension income in future

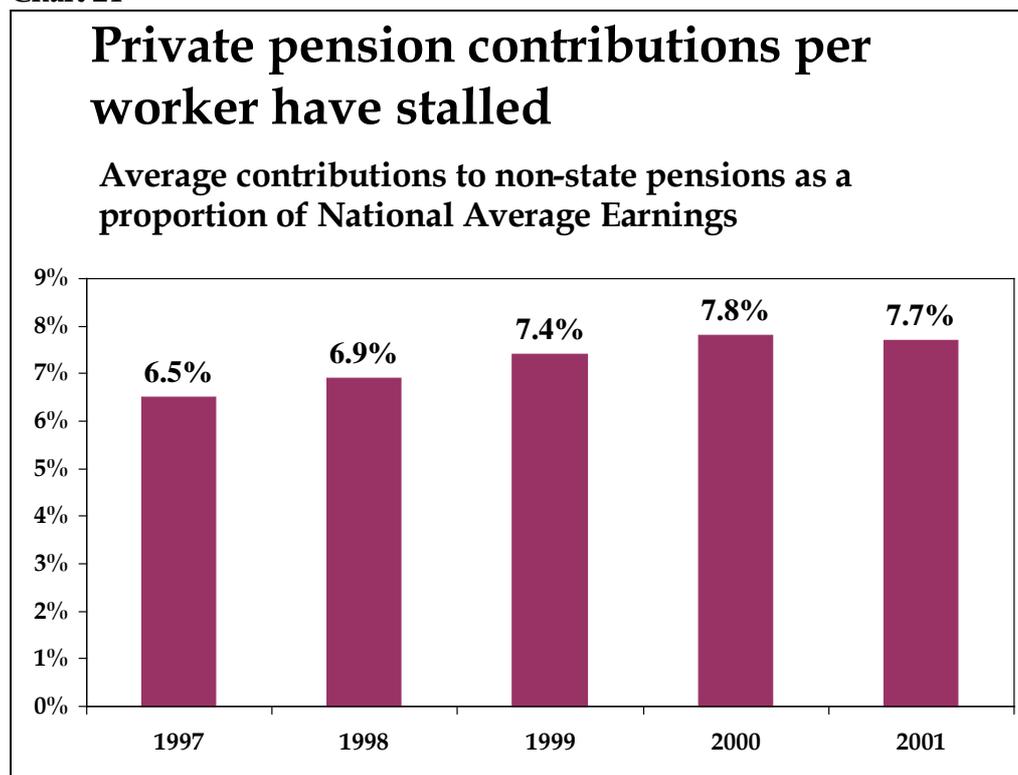
As both the state and employers reduce their pension commitment, pressure has increased for individuals to take responsibility for their own retirement income. But, total contributions to private pensions have stalled and a minority save in personal pensions. Pension saving is starting at later ages and tends to be irregular.

Total contributions to private pension have stalled

In total, £49.9 billion was contributed to private pensions in 2001, compared with £33.1 bn in 1997⁸⁴. This represents a real growth in total pension contributions of 40%⁸⁵.

Over the same period, contributions per head of the working population have increased from £1,240 to £1,780 per year. However, much of this growth in contributions can be attributed to the growth in earnings. Contribution per worker relative to NAE grew only slightly from 1997 to 2001, and appear stalled below 8% of NAE. This suggests that there has been very little new contribution to private pension saving in the last 5 years (Chart 24). There is therefore no evidence to suggest that people are saving more for their pensions.

Chart 24⁸⁶



⁸⁴ PQ Rt Hon Michael Jack, 29 October 2002, House of Commons Hansard Col 689 W. Includes contribution to unfunded and notionally unfunded schemes. These figures are currently being reviewed by the ONS. Any changes are likely to reduce more recent figures, rather than increase them.

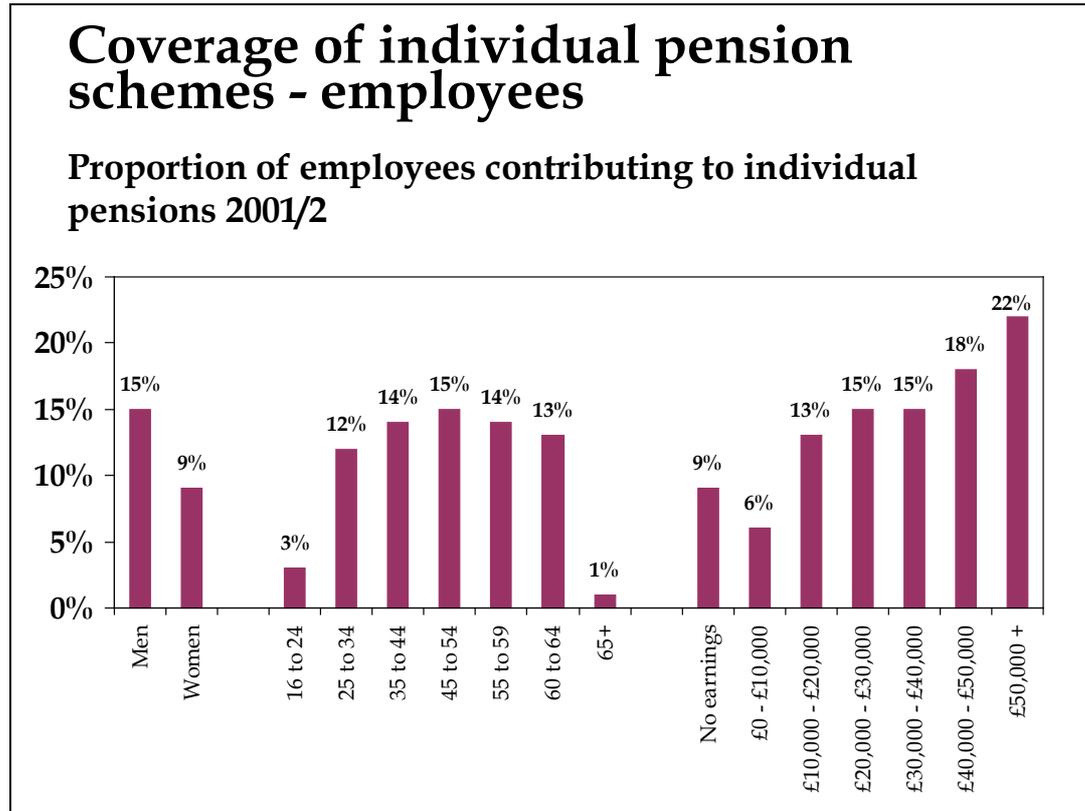
⁸⁵ DWP (2002 GP)

⁸⁶ PPI analysis based on PQ Rt Hon Michael Jack, 29 October 2002, House of Commons Hansard Col 689 W

Individual pensions are held by a minority

Individual pensions⁸⁷ currently have a much smaller role than employer-sponsored arrangements. 12% of adult employees report having individual pension arrangements (Chart 25). For the self-employed – who do not have access to employer-sponsored schemes – coverage is higher, at 41% (Chart 26).

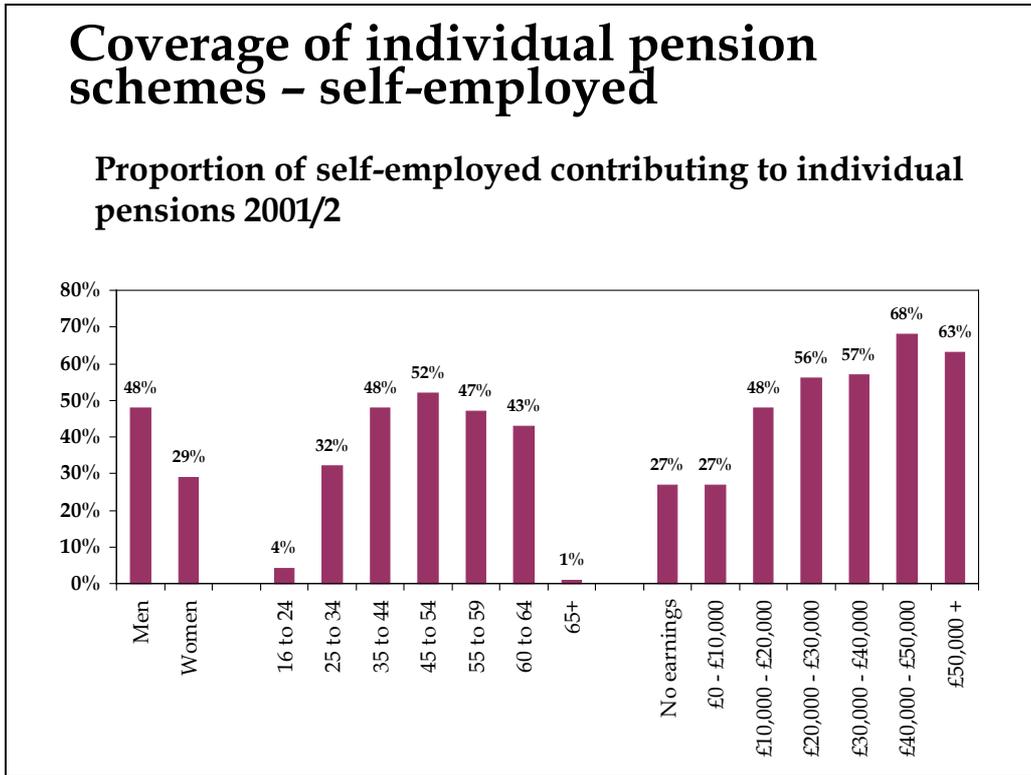
Chart 25⁸⁸



As with employer-sponsored coverage, men are more likely to contribute than women, and coverage increases with earnings for both employees and the self-employed. There is little difference in coverage among workers aged between 35 and 64.

⁸⁷ In this context, personal and stakeholder pensions

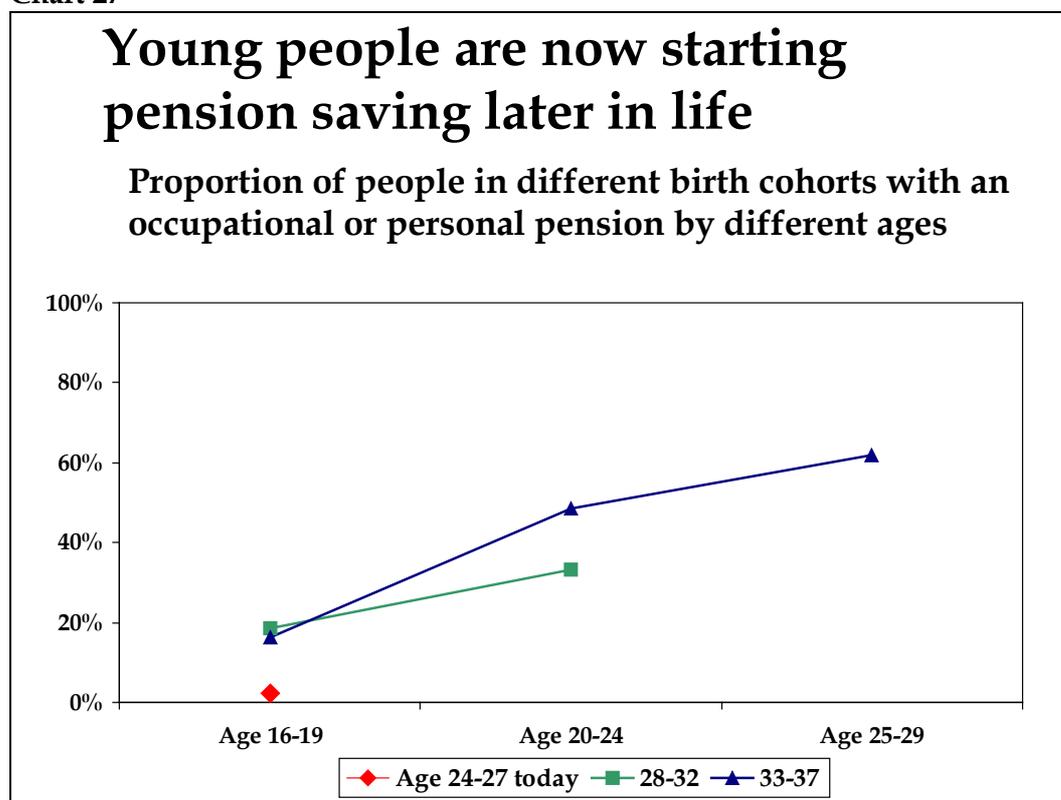
⁸⁸ PPI analysis of the Family Resources Survey 2001/2

Chart 26⁸⁹⁸⁹ PPI analysis of the Family Resources Survey 2001/2

Pension saving is starting at later ages

Until recently, membership of a private pension scheme had become more likely with each successive generation. Whereas less than half of those aged 65 to 69 in 1995 had built up any private pension rights, two-thirds of those aged 45 to 49 had already done so⁹⁰. However, this situation appears to be changing. Of people now aged between 28 and 32, 33% had a private pension by age 24. Of people 5 years older, 49% had a private pension by age 24. Of those aged 24-27 today, only 2% had a private pension by age 19, compared to nearly 20% of their older peers (Chart 27).

Chart 27⁹¹

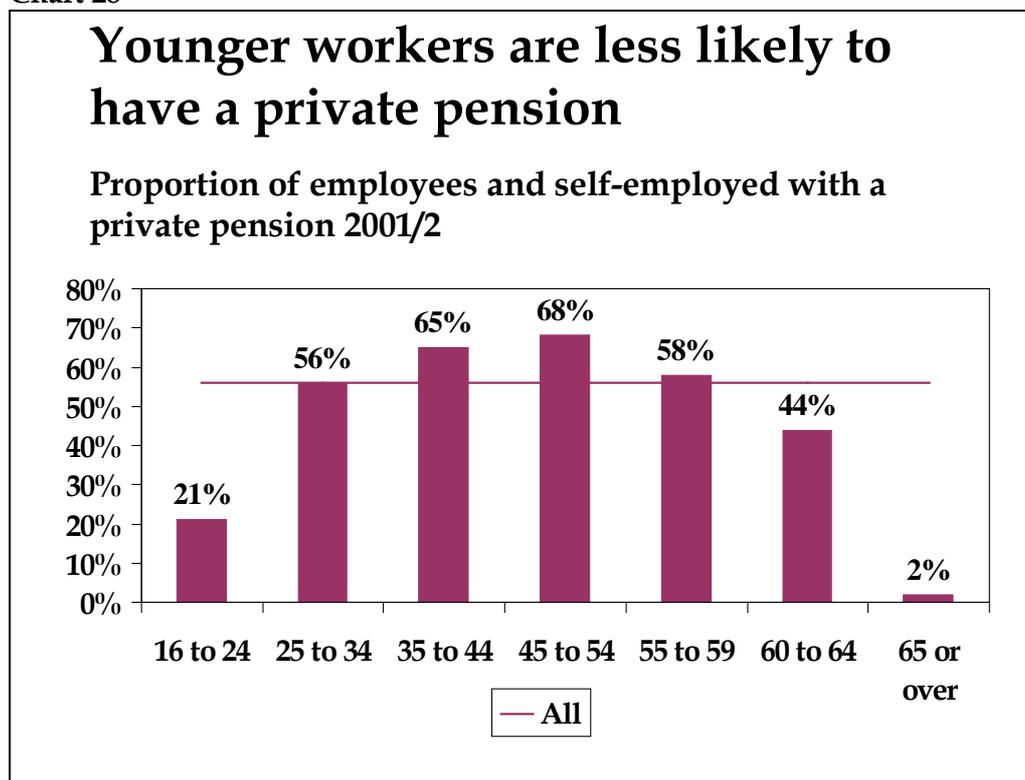


This trend is reflected in the proportion of those in work who currently have any type of private pension. Older workers are more likely to have a private pension – 68% of workers aged 45 to 54 have a private pension, compared to 56% of those workers aged 25 to 34 (Chart 28).

As people are not saving more, and starting to save later, they may have to save for longer to build up the same private pensions as older generations.

⁹⁰ McKay et al (2000)

⁹¹ PPI calculations based on data from McKay et al (2000), relating to 1995

Chart 28⁹²

Individual pension saving is irregular

Most of the information available concerning membership of private pension arrangements relates to current membership – that is, where an individual currently belongs to the scheme. Much less is known about the rights previously accrued in pension schemes – and of course later accrual patterns are not known.

Patterns of accruals over lifetimes are crucial in assessing the potential future level of retirement income from private pensions. For example, if the people belonging to a pension scheme were broadly the same individuals each year, the resulting income distribution would be very different than if a large number of people moved in and out of pension provision.

Of those without a private pension in 2000⁹³, 45% had been a member of a scheme in at least one of the previous 8 years⁹⁴. However, the average length of membership was less than 2 years, suggesting that the rights held in these schemes may not be significant thus far⁹⁵.

⁹²PPI analysis of the Family Resources Survey (2001/2)

⁹³27% of those employees and self-employed aged 25 – 59

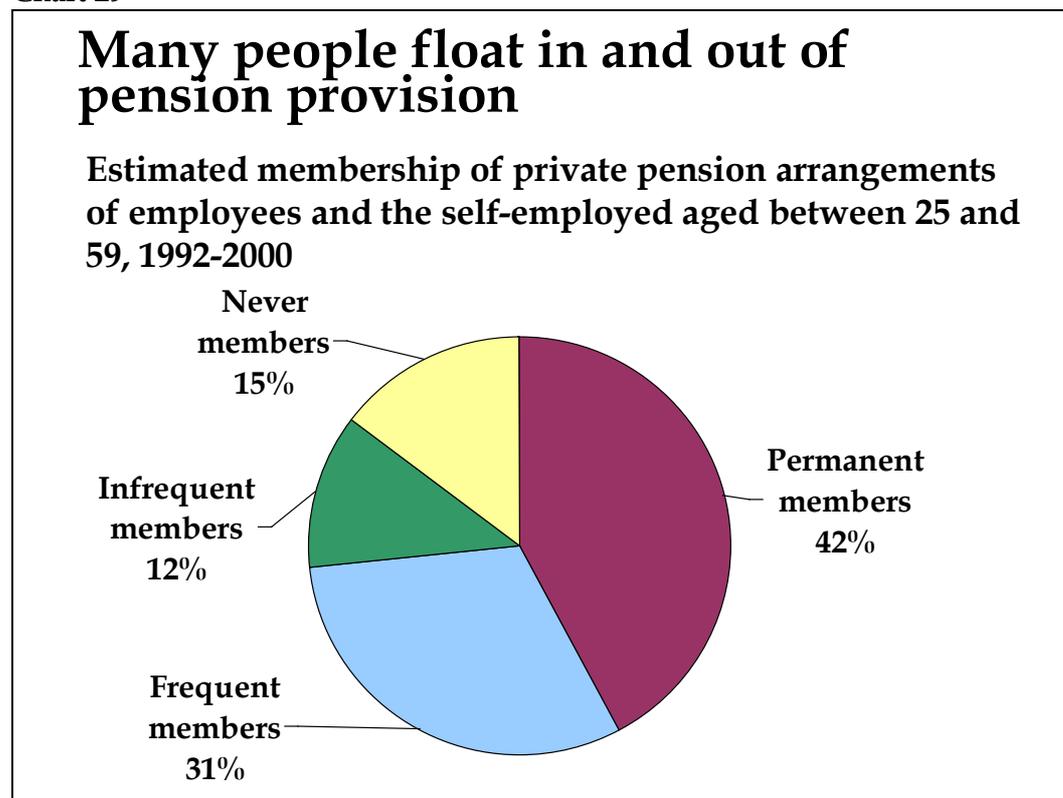
⁹⁴ Banks, Blundell et al (2002). The analysis in this section is based on 9 years of data from the British Household Panel Survey from 1992 to 2000. It is similar to that shown in DWP (2002 GP) but includes those earning less than £10,000. Includes saving in personal and occupational pensions.

⁹⁵ For spells of less than 2 years, any personal contributions may have been refunded

Of those with a pension in 2000⁹⁶, 42% described themselves as an “occasional” member of a scheme. The average period of membership of those who were members in 2000 was 7 ½ years⁹⁷.

In total, 43% of employees and the self-employed aged 25 to 59 considered themselves to be “occasional” members, implying that there is a similarly-sized group who considered themselves to be “permanent” members (Chart 29).

Chart 29⁹⁸



An alternative measurement often used to estimate the numbers of regular members of private pension schemes is the proportion of working age adults who are members in 3 out of the last 4 years. In the period 1997 – 2000, 49% of working age individuals were in this group, up from 47% in the period 1992 to 1995⁹⁹.

⁹⁶ 73% of the sample

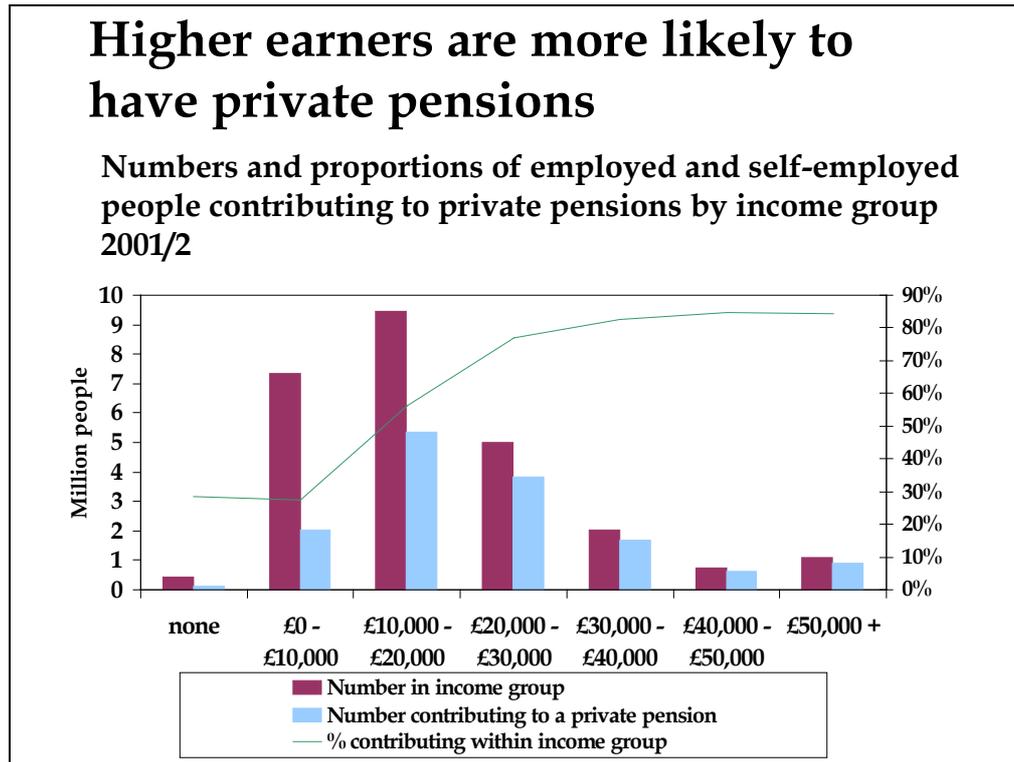
⁹⁷ This will be skewed upwards by those who are always members

⁹⁸ PPI analysis of data contained in Banks, Blundell et al (2002)

⁹⁹ DWP (2002 OFA)

Higher earners are more likely to make contributions more regularly
 Most members of private pension schemes earn more than £20,000 a year. Over 80% of those earning over £30,000 a year contribute to a private scheme (Chart 30).

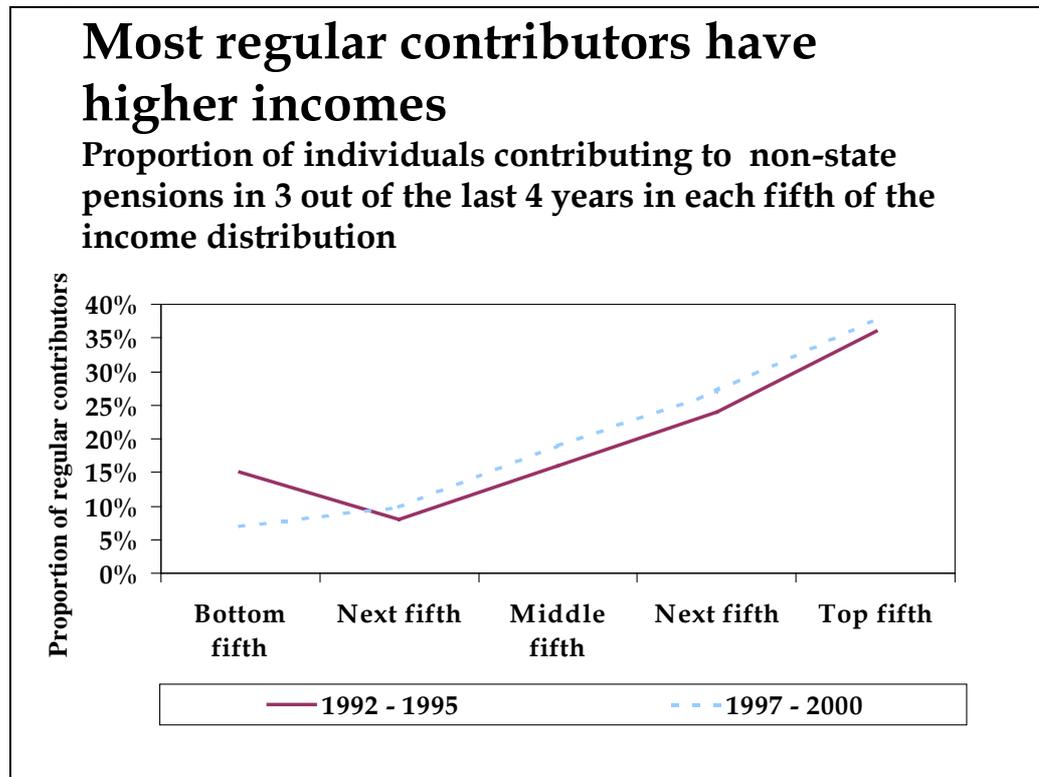
Chart 30¹⁰⁰



¹⁰⁰PPI analysis of the Family Resources Survey 2001/2, updating analysis in HMT (2002)

The likelihood of making regular contributions is also linked to income, with those in higher income groups more likely to do so (Chart 31). If regular contributions were not linked to income, 20% of regular contributors would appear in each fifth of the income distribution. Instead, almost 40% of regular contributors have incomes in the top fifth of the income distribution, and less than 10% are in the bottom fifth. Between 1995 and 2000, the proportion of regular contributors in the bottom fifth of the income distribution fell from 15% down to 7%.

Chart 31¹⁰¹



¹⁰¹ PQ Steve Webb 24 October 2002, House of Commons Hansard Col 487 W

Pension alternatives are not widespread

Most people do not have significant amounts of non-pension saving or investments. Those without pensions are less likely to have other assets. Housing is a significant asset for many, but is rarely converted into retirement income.

Savings - and debts - are not equally distributed

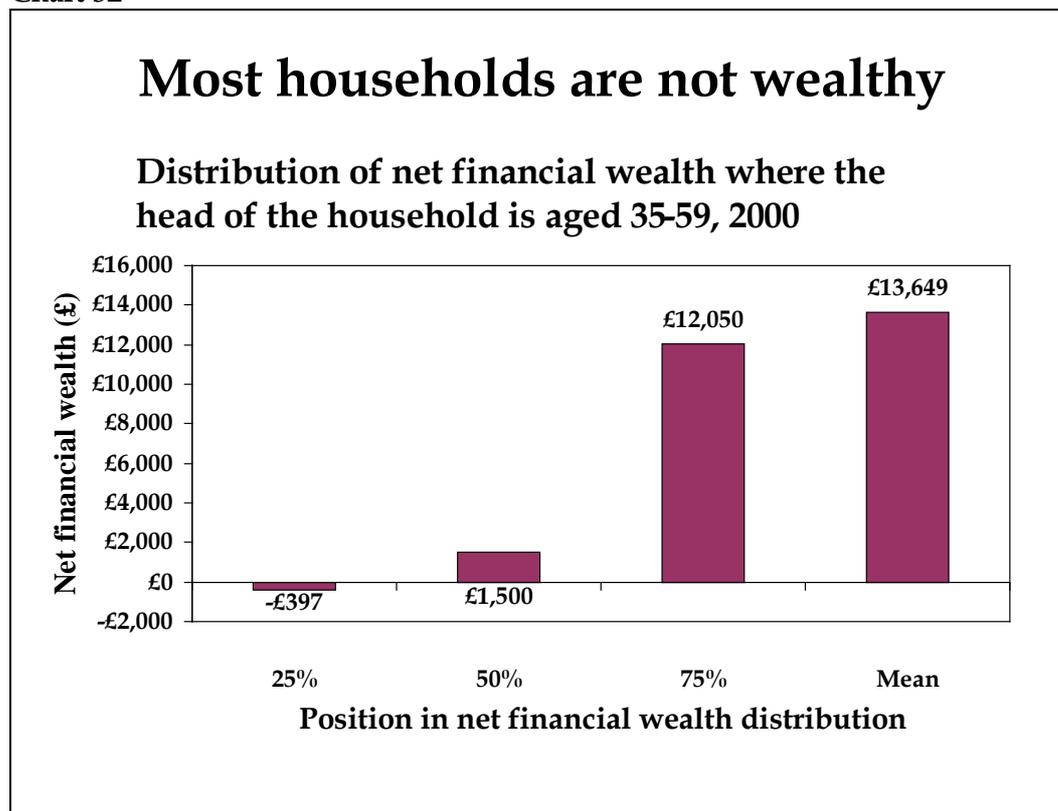
Figures on savings are difficult to interpret. Many people do not save for very good reasons - they may be young, have low incomes, have other responsibilities or priorities or even be retired. The following analysis is based on those who are most likely to need to save - the households where the head is aged 35-59.

An average household has savings of £7,417 and investments¹⁰² of £8,913¹⁰³. But a quarter of households have little or no savings, and half have savings of less than £1,500. Only half of households have investments and three quarters have less than £4,000.

Many households also have debts (excluding mortgage debt). Reducing debts can often be a better financial option than saving, given different interest rates for saving and borrowing. The average net financial household wealth (savings + investments - debts) is £13,649. But more than a quarter of households have debts larger than their combined savings and investments, and half of all households have net financial wealth of £1,500 or less (Chart 32).

¹⁰² Savings in this context are defined as interest-bearing deposit accounts. Investments are other savings such as shares and unit trusts, but do not include pensions or housing.

¹⁰³ Banks, Smith et al (2002)

Chart 32¹⁰⁴

Those without pensions are less wealthy

The closest alternative to pension saving is saving in investments. However, only 33% of those households without pension saving have any investments, with an average holding of £7,786¹⁰⁵. Around two-thirds of occupational and personal pension holders have investments, with an average of £12,798 for occupational pension holders and £13,646 for those with personal pensions.

This lack of investments is reflected in net financial wealth. The average net financial wealth for those without a pension is £5,357, compared to £12,745 for those with an occupational pension. 48% of those without a pension have negative net financial wealth.

Housing is a significant asset for many, but it is rarely converted into retirement income

Non-financial assets, of which the most important part is residential housing, formed the largest component – 41% – of household assets in 2000 (although outstanding mortgages were also the largest liability)¹⁰⁶.

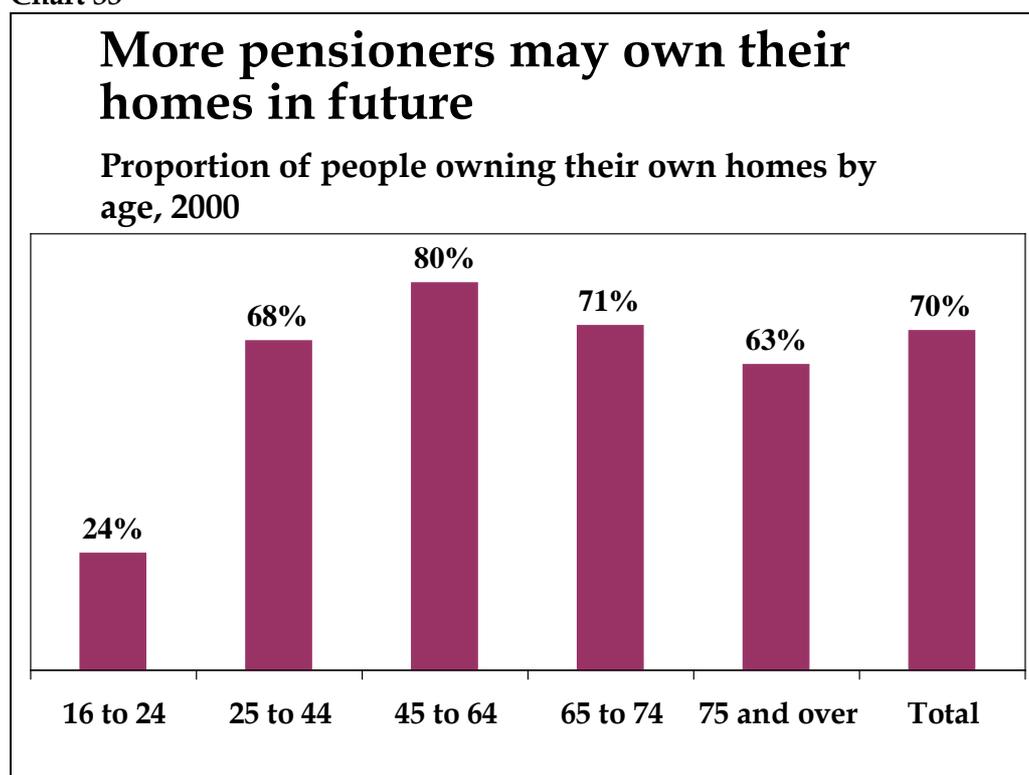
¹⁰⁴ Banks, Smith et al (2002)

¹⁰⁵ Banks, Smith et al (2002). Based on employees aged between 35 and 59.

¹⁰⁶ Matheson and Babb (2002)

At the household level, there have been significant increases in home ownership levels in recent years, increasing from 57% in 1981, to 68% in 1991 and 70% in 2001/2¹⁰⁷. Of those households where the head is aged between 45 and 64, 80% are owner-occupiers, compared to 71% of those aged 65 to 74 (Chart 33). This suggests that future pensioners may be more likely to own their own homes than current pensioners.

Chart 33¹⁰⁸



The size of housing assets is closely linked to income and wealth, as well as age. Those with higher financial wealth, higher income or pension provision are more likely to have housing assets, and on average of higher value¹⁰⁹.

Increased home ownership at older ages may provide an alternative source of retirement income, through housing equity release. It is estimated that in 1998, of the 8.7 million mortgage borrowers in England, 8% were aged 60 or over, and 4% aged 65 or over. Older people have equity worth at least £400 billion yet currently have drawn on less than £5 billion. Housing assets are rarely converted into retirement income.

Equity can also be released by “down-sizing” – selling a home and buying a cheaper property. There is little evidence to suggest that this is used by many pensioners.

¹⁰⁷ ODPM (2002)

¹⁰⁸ ODPM Survey of English Housing-
www.housing.odpm.gov.uk/research/seh/live/tenuretrend/index.htm

¹⁰⁹ Banks, Smith et al (2002)

It has also been suggested that there has been an increase in the use of property other than a main residence as an investment, and in particular buy-to-let properties. These may provide a capital sum in retirement (through sale of the property), or continue to be let to provide an income stream. There is currently little data available with which the amount of property investment for retirement could be accurately measured.

Chapter 3: The future pensions landscape

Previous chapters have shown that, although today's pensions landscape looks better than yesterday's, there are no signs that tomorrow's landscape will look any better. This chapter reviews the problems in the current pensions system that lead to the risk that tomorrow's pensioners will be worse off than today's. To avoid that risk, reform of state pensions policy should be debated now.

- **Problems of lower pension income will only become apparent in the long-term.** The average pensioner income will continue to grow in the short-term. But inequalities will increase if means-tested benefits are not taken up and if private pensions remain focused on higher earners - as is likely. More than one-third of future pensioners face being disappointed with their future retirement income.
- **The long-term problems are due to unclear responsibilities now.** Current policy assumes individuals will take more responsibility for pension provision. But the responsibilities of the state, employers and individuals remain largely undefined. Current initiatives address only some of these issues. Many people are unable - or unsure of how - to act.
- **The future cost to the state of current pension policy is not clear.** Current UK pensions policy constrains the cost of state pensions, meaning relatively less per pensioner. The *total* state budget for pensions in the UK will rise in future, although by how much is not clear. The right balance between the cost to the state of paying state pensions and the cost to the state of encouraging private pensions should be debated.
- **Reform of state pensions policy should be debated now.** Even though the average pensioner income may not worsen in the short-term, the long-term issues require a new solution to be debated now. The debate should start where the problems lie - with the structure of state pensions. In an ageing society, what state pension do we want and how much are we prepared to pay for it?

Problems of lower pension income will only become apparent in the long-term

The average pensioner income will continue to grow in the short-term. But inequalities will increase if means-tested benefits are not taken-up and if private pensions remain focused on higher earners – as is likely. More than one-third of future pensioners face being disappointed with their future retirement income.

The average pensioner income will continue to grow in the short-term

Growth in occupational pension coverage has been one of the main factors behind growth in pensioners' incomes in recent years. There are signs that this is slowing, and could possibly reverse. It is likely to be supplemented in the next few years by income from personal pensions, as the large step increase in individual provision from 1988 feeds through into the retired population. Growth in income from private pensions overall is therefore likely to remain reasonably strong in the next few years, maintaining growth in total pensioners' incomes.

Inequality will increase if means-tested benefits are not taken up

For lower income pensioners, Pension Credit (PC) is designed to maintain income levels relative to the incomes of those in work – and also relative to those pensioners in subsequent cohorts. Today it is the oldest pensioners who have the lowest incomes. In future there will be more older pensioners and a higher proportion of them are likely to be entitled to PC, even if they were not at the time that they retired.

Low take-up is likely to remain, as it is the oldest pensioners who will be eligible, and, at first, for small amounts. If take-up rates remain at current levels, there will be a large group of pensioners living on very low incomes. Potentially up to a quarter of all pensioners may not receive income to which they are entitled¹¹⁰, and could see incomes fall relative to earnings.

Inequality will widen further if private pensions remain focused on higher earners

Those with higher incomes are still more likely to make regular pension contributions. This group will be less affected by the relative reduction in state provision as most of their income is derived from private provision. They will continue to see higher incomes than previous cohorts as they can afford to compensate for increasing pension costs.

¹¹⁰ Based on 75% of pensioners being entitled to PC and a take-up rate of 66%

Over one third of working-age people face being disappointed with their future retirement income

The recent DWP Green Paper¹¹¹ produced estimates of the number of people who “need” to save more to achieve a benchmark retirement income. These estimates assume that recent trends in pensions, other savings and housing assets continue into the future, under current state pension policy.

Saving more is only one way in which their incomes could be improved – working or saving longer, or increased state pensions would also lead to higher incomes in retirement. Given the impact of increasing longevity¹¹² and lower real state pensions, increased saving alone is unlikely to be enough to increase future retirement income sufficiently.

The DWP analysis suggests that 3 million people are likely to have a replacement rate of less than half of final gross earnings, and up to a further 10 million are currently heading for a replacement rate of between half and two-thirds. 13 million people are therefore likely to achieve an income in retirement below the two-thirds final earnings benchmark. 4.5 million people are currently estimated to be saving enough to meet this benchmark level.

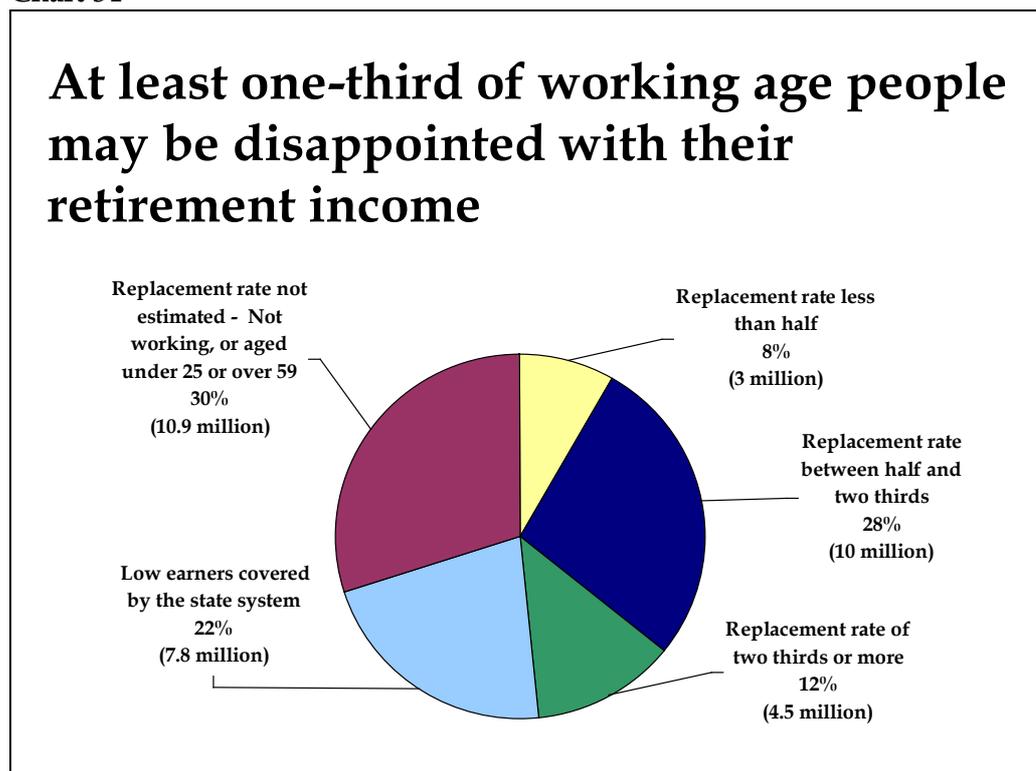
This benchmark income is a blunt instrument to measure adequacy. For lower earners it will be too little, for higher earners it will be more than adequate. Given that the average income of a single pensioner today is 44% of National Average Earnings, the two-thirds benchmark could be seen as generous. Despite these comments the analysis makes a useful attempt to estimate future retirement income adequacy. The following suggests that taking into account other factors, the DWP analysis under-estimates the scale of the issue.

¹¹¹ DWP (2002 GP)

¹¹² EC (2002) estimates that by 2050 the cost of providing a pension from age 65 will have increased between 25% and 30% due to increased life expectancy

The 13 million people “not saving enough” represent one third of the total working age population (Chart 34).

Chart 34¹¹³



There are a further 18.7 million people of working age not covered by the DWP analysis¹¹⁴. 7.8 million of these earn under £10,000 a year, and are assumed to have a reasonable retirement income, relative to their earnings, provided by the state system.

The remaining 10.9 million people of working age are not working, and/or aged under 25 or over 59.

Although the DWP analysis does take into account current levels of the length of time spent saving in a pension, it cannot fully take account of future movements into and out of work. Many of those currently earning less than £10,000, or not working, will earn more in the future. They may then not meet the two-thirds benchmark applicable to their final earnings. Many will not ever have a private pension. Currently, 70% of those earning less than £10,000 do not have a private pension¹¹⁵. And only some will be partners of those who are working and saving enough for both of them.

¹¹³ PPI analysis based on DWP (2002 GP)

¹¹⁴ 2001-based population projections available from www.gad.gov.uk. The total number of working age people is 36.2 million.

¹¹⁵ Chart 30

Those under 25 may be able to save in future and so build-up sufficient pension income to meet the benchmark, but some may not. Chapter 2 suggests that people are beginning to delay entry to the private pension market.

Many of those over 59 may already have stopped working, or be approaching the end of their working lives. However, some will continue to work, not least as government policy is to encourage working at older ages. For these people saving, while working and delaying retirement, could enhance their replacement rate significantly.

It therefore seems likely that many of those outside the DWP analysis will not achieve a two-thirds replacement rate. This means that the DWP analysis underestimates the potential long-term problem. More than one-third of people currently of working age may be disappointed with their future retirement income.

The long-term problems are due to unclear responsibilities now

Current policy assumes individuals will take more responsibility for pension provision. But the responsibilities of the state, employers and individuals remain largely undefined. Current initiatives address only some of these issues. Many people are unable – or unsure of how – to act.

Current policy relies on individual responsibility

The state is reducing the value of its commitment on average, but paying pensions and means-tested benefits to more people. The shift towards means-testing in itself increases uncertainty, as levels are more easily changed, and individuals will not know how much they will receive – if anything – until they claim.

Even if employers are maintaining the level of contributions – and it is far from clear that they are – they are reducing their future liabilities. Employers are reducing their commitment to pension provision, and passing on some of the risks associated with pension provision – such as investment and longevity risks – to individuals as they move from DB to DC arrangements.

Current policy relies on people taking responsibility for their own pension provision. It is up to each individual to decide how much to save in a private pension and in what type of arrangement, and if in a DC arrangement how to change investments over time. After retiring, the onus is on individuals to claim state means-tested benefits if necessary.

People who do not take on this responsibility – either through saving or claiming benefits – are most likely to see the lowest retirement incomes in future. But half of people in work are not saving for retirement¹¹⁶, and between a quarter and a third of pensioners entitled to means-tested benefits do not claim them¹¹⁷.

Many people are unsure of how to act

Confusion surrounding state pensions is well documented¹¹⁸, particularly – but not only – amongst the lower paid. This is not helped by the complexity of the system, nor the frequent changes that are made¹¹⁹.

People underestimate the amount of money they need to save in private pensions. People are shocked by the amount they need to save in order to meet their expectations in retirement and how little their current savings will provide when they retire¹²⁰.

¹¹⁶ See chapter 2

¹¹⁷ See chapter 1

¹¹⁸ See, for example, Mayhew (2001)

¹¹⁹ As illustrated in PPI (2003)

¹²⁰ Curry and Wood (2002)

In many cases it is not clear whether people should be saving – the disincentives to save that many still face in PC are well documented¹²¹. Even if people do not understand whether or not it is worthwhile saving, the possibility of being able to claim means-tested benefits in future is likely to affect the perceptions of individuals or their advisers.

Further, there is a general lack of interest in retirement planning. Individuals find it difficult to imagine what their circumstances might be so far into the future, or are unwilling to contemplate anything with negative connotations – such as old age and death. They fear disappointment from not achieving what they might plan, so those without high incomes tend to avoid planning. Many people follow the behaviour of their peers. As a result there is widespread avoidance of retirement planning¹²².

The disinterested are not a natural target group for pension providers. The cost of persuading people to save can outweigh the benefits of new pensions business¹²³. Employers can make a difference here: where there is a pension contribution from an employer to a stakeholder pension, it is more likely that individuals will contribute¹²⁴, and the costs to pension providers of accessing this market are lower.

Many people are unable to act

When people do make financial plans, pensions are often low on their list of financial priorities, especially at younger ages. For many people pension contributions are just not affordable¹²⁵. For those with debts, low incomes or a lack of short-term saving, saving in a pension does not make good financial sense, and may not accord with best advice¹²⁶. 70% of moderate earners not saving for retirement gave “lack of money” as the main reason for not saving¹²⁷.

Current initiatives address only some of these issues

The government has announced initiatives to increase the information available to individuals. Statutory Money Purchase Illustrations and Combined Pension Benefit Forecasts will provide people who already have saving with information as to whether they are saving enough. But, they will only reach those who already save.

¹²¹ See for example Clark and Emmerson (2002), ABI (2001)

¹²² Rowlingson (2002)

¹²³ OWC (2001)

¹²⁴ ABI (2002a)

¹²⁵ Cooper (2002)

¹²⁶ Clark and Emmerson (2002)

¹²⁷ ABI (2002b)

For those not saving, tools such as pensions calculators help to quantify the benefit from saving¹²⁸. But these initiatives do not take account of means-tested benefits. They rely on people choosing to access the information, and so do not address the problem of apathy. Nor do they directly solve a lack of money to save.

If this issue of unclear responsibilities is not addressed now, and individual pension saving does not increase as contributions from the state and employers fall in value, there is a substantial risk that pensioners' incomes will stall in 20 to 30 years time. When those of today's workers who are not saving reach state pension age, they will be faced with a choice of a retirement on low income, or continuing to work.

¹²⁸ For example that developed by the ABI and the FSA at www.pensioncalculator.org.uk

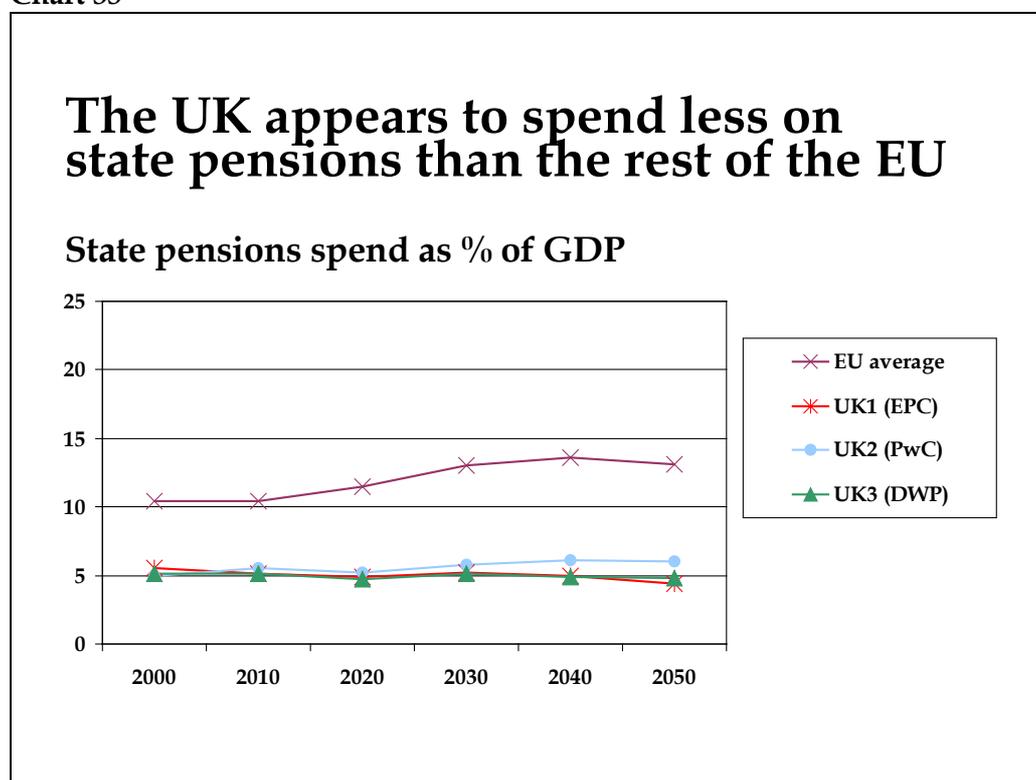
The future cost to the state of current pension policy is not clear

Current UK pensions policy constrains the cost of state pensions, meaning relatively less per pensioner. The *total* state budget for pensions in the UK will rise in future, although by how much is not clear. The right balance between the cost to the state of paying state pensions and the cost to the state of encouraging private pensions should be debated.

Current UK pensions policy constrains the cost of state pensions, meaning relatively less per future pensioner

A comparison is often made - between the UK and the average of other EU countries - of the percentage of GDP spent directly on state pension benefits and their means-tested supplements (Chart 35).

Chart 35¹²⁹



This comparison is used to illustrate the fiscal sustainability of UK pensions policy, relative to other EU countries^{130, 131}. However, any comparison is fraught with data limitations¹³².

¹²⁹ EPC (2001), Hawksworth (2002a), DWP (2002 GP). See Appendix 2 for an explanation of UK1 - 3.

¹³⁰ DWP (2002 GP)

¹³¹ And relative to other countries, which have been analysed, on yet another basis, by the OECD. See, for example, Disney and Johnson (eds) (2001)

¹³² See Appendix 2

Despite the data limitations, it is still clear that the UK spends less on *direct* state pension-related benefits than other EU countries. The UK spends around 5% of GDP; the EU average is around 10% of GDP.

This is not surprising, as the largest EU countries have had for many years a culture of generous earnings-related state pensions. There are other cultural differences, for example, in the extent of property owning, in the expectations of family support in older age, and the availability of other benefits such as those for housing costs and healthcare. The different patterns of social partnership in the pensions systems across Europe mean that comparisons of the direct spend on pensions cannot be the only way of understanding whether the UK pension system is better or worse than that in other countries. In fact, the pension outcomes in the UK are ‘middle of the pack’ in terms of level of pensioner income and inequalities¹³³.

The thrust of UK current policy is to constrain the proportion of the nation’s wealth spent directly on state pensions. The projected cost of pensions by 2050 is still in the order of 5% of GDP. The extra cost of pensions as the population ages is being more than mitigated by UK pensions policy¹³⁴, in aggregate. From a purely macroeconomic perspective, there is no apparent crisis of affordability in UK state pensions.

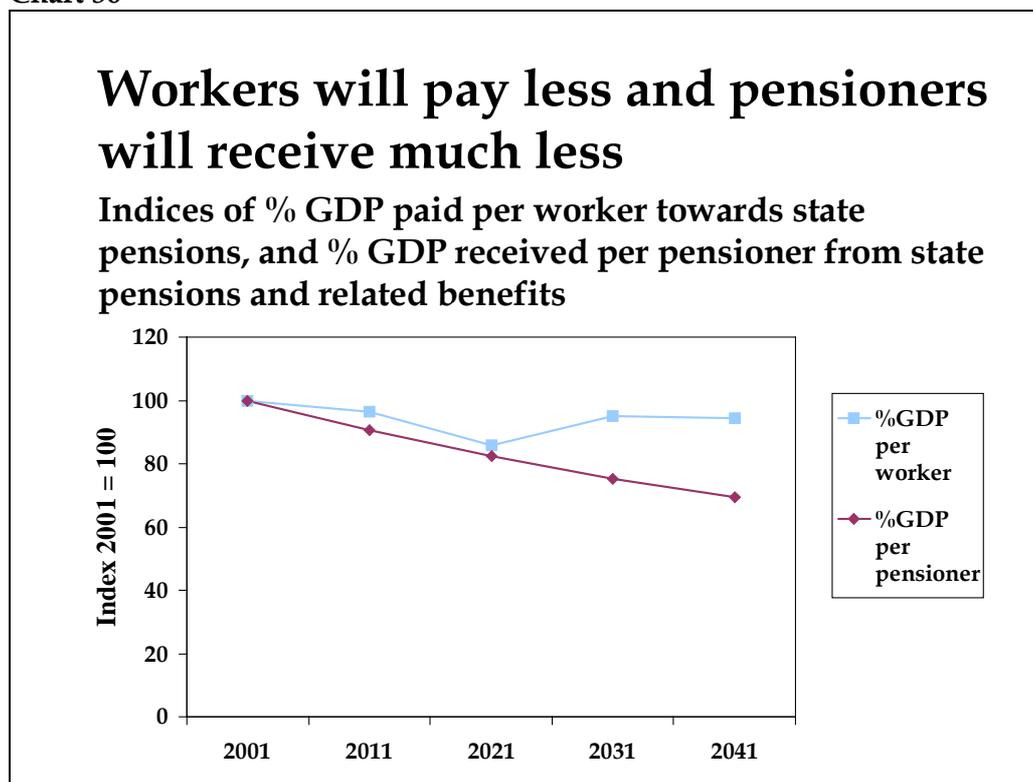
But although total direct state pension spend is being kept level, the number of pensioners is increasing. This means that the direct spend to be received by each future pensioner will fall by nearly 20% over the next 20 years and by 30% over the next 40 years. This raises the question of whether state pension money is being appropriately distributed among the pensioner population.

At the same time the number of people of working age is predicted to rise only slightly. This means that the amount to be paid by each future worker to pay state pensions will fall by about 5% over the next 40 years in GDP terms. This raises the question of whether direct spend on state pensions is not being constrained too far.

In summary, the UK faces fast growth in the number of pensioners, slower growth in the number of workers and a level projected state spend on pensions. This means that, relative to how tax revenues are used at the moment, less will be taken from each worker to give much less to each pensioners (Chart 36).

¹³³ Disney and Johnson (eds) (2001) especially Tables 1.13 and 1.14, and Fleiss (2001)

¹³⁴ Most significantly, the increase in SPA from 60 to 65 for women between 2010 and 2020, the indexation of state pensions in line with prices and the targeting of benefits using means-testing. More details can be found in EPC (2001).

Chart 36¹³⁵

The total state budget for pensions in the UK will rise in future

The direct spend on state pensions and means-tested supplements to current pensioners is only part of the total state spend on pensions. The state also supports current pensioners indirectly as people over 65 have higher personal tax allowances. The state also incentivises future pensioners by giving tax relief on private pension contributions and on the investment income in pension funds. The state receives tax from private pensions in payment (Table 2).

Table 2: UK indirect state expenditure as % GDP in the year 2000/1¹³⁶

Higher tax allowances for pensioners	0.2%
Tax relief on contributions to private pensions	1.6%
Contracting-out rebates	1.0%
Tax relief on investment income in pension funds	0.4%
Tax relief on lump sum pension benefits	<0.1%
Less tax liable on private pensions in payment	(0.7%)

¹³⁵ PPI analysis using the UK3 projections for direct pensions spend and GAD-2001 based population estimates, available from www.gad.gov.uk

¹³⁶ PPI calculations based on Inland Revenue Statistics table 7.9 (www.inlandrevenue.gov.uk/stats/pensions/p_t09_1.htm), HMT (2001) and HMT guide to GDP deflators (www.hm-treasury.gov.uk/economic_data_and_tools/gdp_deflators/data_gdp_fig.cfm).

These items are different types of spending. A high figure now for tax relief on contributions to private pensions should be expected to lead to a high amount of tax paid back in the future. But they are all costs incurred during the current year, so it is valid to point out that the UK currently spends around 2.5% of GDP in addition to the 5% of GDP spent directly on state pension benefits.

In the largest EU countries, there is still a limited private market, and the costs of such tax relief would be nil or negligible. Therefore, the total cost to the state of pensions in the UK (around 7.5% GDP) in the current year is closer to the average cost for EU countries (around 10% GDP) than is often portrayed.

Two examples provide further evidence that tax incentives can be a considerable cost in any one year. In Ireland, where there is a well-developed market for private pensions, the net cost of tax relief for occupational pensions currently amounts to around 66% of the cost of social insurance and social assistance¹³⁷. In Australia the net cost of tax concessions on superannuation is estimated to be almost 60% of the amount spent on age and service pensions¹³⁸.

The right balance between future cost to the state of paying state pensions and the cost to the state of encouraging private pensions should be debated

Current UK pension policy is to encourage private pension saving. This implies that the indirect cost of state support for pensions can be expected to rise over time (as would the tax later recouped on private pension benefits).

There are no available projections of these developments, even though they are an important cost to public finances. This raises the question of whether better long-term cost projections should not be published. This would allow a more informed debate on the overall fiscal sustainability of current policy, and avoid the misconception that *total* state spending on pensions will be flat.

It should also encourage an open debate on, given an appropriate total state spend, what the balance should be between:

- paying state pensions to today's pensioners, and
- encouraging tomorrow's pensioners to save in private pensions.

¹³⁷ Hughes (2001)

¹³⁸ Department of Family and Community Services (2002)

Reform of state pensions policy should be debated now

This report has shown that in the short-term, the average income of pensioners should continue to rise. But it has also suggested that problems will become apparent in the long-term. Pensions are a long-term issue. Any policy change will take many years to implement, so clear thought needs to be given now to secure good pensions for the long-term.

At the heart of the problems being stored up for tomorrow's pensions is the structure of the state pensions system.

The state system is needlessly complex

While there are many initiatives to simplify the private market, severe complexity in the state system remains. This report was intended to include a summary of the UK's pension system. It became so long and complicated that an edited version now forms a separate (long) document¹³⁹. The complexity - particularly the multiple components - makes it difficult for individuals to know what their state pension and benefits will be. The simplest state pensions can be described in one phrase; for example New Zealand's is "65 at 65", meaning a pension of 65% of NAE (for a married couple) at age 65. The administration of a multi-component state system is likely to be more costly than it needs to be.

In particular, the state system's interface with the private market is complex

Contracting out of S2P is even more complicated than contracting out of SERPS was¹⁴⁰. This makes the first step into private provision more difficult than it needs to be. The existence of pervasive means-tested benefits means that it cannot be said with absolute security that "it always pays to save". This makes giving pension advice difficult, and adds to the perceived difficulties in private saving¹⁴¹. Key policy questions in the private pensions arena, such as whether compulsion to save in private pensions should be introduced, may be better considered after problems with state provision have been answered.

The state system penalises the oldest pensioners

The gaps between state pensions and means-tested benefits means that even people with moderate savings on top of full state pension will face having to claim benefits in later life. The structure of the current system means that older pensioners are more likely to have to claim benefits than younger (on average healthier) pensioners. As older pensioners have lived longer, they have fewer other sources of income available. Then, if they do not claim benefits, they become more likely to be poor. In an era of increasing longevity this structural problem can be expected to become more significant.

¹³⁹ The Pensions Primer (PPI (2003))

¹⁴⁰ See PPI (2003)

¹⁴¹ See chapter 2 of this document and earlier sections in this chapter

It is doubtful that the current pension system can be sustained long-term

Earlier in this chapter, the total cost to the state of paying current state pensions and encouraging provision for future private pensions was discussed. Estimates of the future balance of these two items are not available, so the fiscal sustainability of pensions policy is not yet proven.

It remains policy to grow private savings and keep the cost of paying state pensions level – despite the number of pensioners increasing. The social acceptability of this has been questioned. Others have noted many of the points made in this report that question the wisdom of continuing long-term with current pensions policy. Similar ideas for state pension reform are now emerging. A higher flat-rate pension, at or above the level of means-tested benefits, has been a key component of a number of policy proposals¹⁴², and was also the long-term outcome of Government proposals for S2P originally announced in 1998¹⁴³.

The inescapable conclusion of these points is that **more debate is needed on the state's role in pension provision**. Simplifying state provision will help to make the interface with the private market clearer, and will allow the private market to flourish in an appropriate way. Debate on the relative size of state and private pension provision is a pre-requisite to this. Such a debate is necessary to ensure that the total cost to the state of pensions policy is at least estimated, so that we can debate how much we, as an ageing society, are prepared to pay for pensions. Debate is also needed on how pensions spend is distributed between certain groups, for example older as compared to younger pensioners.

Despite widespread criticism of the state pension system, the role of the state and the structure of state provision itself are not being openly debated. Instead, the focus is on encouraging current workers to work longer and to save more in the private market¹⁴⁴. This may be an appropriate short-term focus, but both these issues are inextricably linked to the size and nature of state pensions.

This report has suggested that problems will become apparent in the long-term, and that the problems are being stored up in the state pension system. Pensions are a long-term issue. As well as pushing ahead with good recent initiatives, more debate is needed on the state's role in pension provision.

¹⁴² Such as those from IPPR, NAPF, Help the Aged and Pension Reform Group

¹⁴³ DSS (1998)

¹⁴⁴ DWP (2002 GP)

Appendix 1

The calculations made by the PPI in chapter 2 of this report are based on the following data and assumptions.

General Assumptions

Price inflation of 2.5% per year. Historical price levels are based on the CHAW series produced by the ONS.

Real growth in NAE (i.e. above price inflation) of 1.5% per year. Historical earnings levels are based on the New Earnings Survey.

Threshold and Benefit levels announced for the year beginning April 2003

Basic State Pension (single pensioner)

Basic State Pension £77.45 per week

The Basic State Pension is assumed to increase each year in line with prices.

Pension Credit (single pensioner)

Guarantee Credit £102.10 per week

Savings Credit minimum income level £77.45 per week

Savings Credit taper 60%

Savings Credit clawback taper 40%

Maximum Savings Credit £14.80 per week

The Guarantee Credit increases in line with earnings growth.

The Savings Credit minimum income level increases in line with prices.

State Second Pension

Lower Earnings Limit £77 per week (£4,004 per year)

Lower Earnings Threshold (S2P) £215 per week (£11,200 per year)

Upper Earnings Threshold (S2P) £492 per week (£25,592 per year)

Upper Earnings Limit £595 per week (£31,535 per year)

The Lower and Upper Earnings Limits increase in line with the BSP, rounded down to the nearest £1. The Lower Earnings Threshold increases in line with earnings. The Upper Earnings Threshold is increased until all gains from the flat-rate element of S2P are eroded by the lower accrual rate above the Lower Earnings Threshold. When the Upper and Lower Earnings Thresholds reach the Upper Earnings Limit, they increase in line with prices. For flat-rate S2P illustrations, flat-rate accruals will be introduced in 2007.

Illustrative average individual

The average individual works for 45 years, from the age of 20 until 65. Earnings remain constant as a proportion of National Average Earnings.

Appendix 2

The EU and UK1 figures in Chart 35 should be on a consistent basis, having been prepared by governments in October 2001 for the same EU Economic Policy Committee purpose¹⁴⁵. The UK2¹⁴⁶ figures are updated estimates by PricewaterhouseCoopers, current as at September 2002, including for the first time an estimate of the costs of the Pension Credit. Finally, UK3¹⁴⁷ is the latest DWP projection published in the Green Paper in December 2002.

The three sets of data differ by the starting date and components (Table A1). UK3 updates UK1 with the latest employment, demographic and productivity forecasts, but has excluded the cost of Incapacity Benefit. It is therefore no longer comparable to the other EU country figures in the EPC report.

Table A1: Costs of state pensions and related benefits as % GDP in the UK

	UK1: EPC, 1999/00	UK2: PwC 2000	UK3: DWP 2001/2
Basic State Pension	3.6%	3.6%	3.8%
MIG/Pension Credit	0.4%	0.4%	0.5%
Incapacity Benefit	0.8%	Excluded	Excluded
Other first tier provision	0.2%	0.5%	0.2%
SERPS/S2P	0.5%	0.5%	0.6%
Total Year shown above	5.5%	5.0%	5.0%
Total, 2030	5.2%	5.8%	5.1 %
Total, 2040	4.4%	6.0%	4.8%

¹⁴⁵ EPC (2001). The definition of the figures is "Public pension expenditures (including public replacement revenues) to people aged over 55 before taxes (as a % of GDP)". For the UK analysis see the UK country fiche (europa.eu.int/comm/economy-finance/epc/documents/uk_en.pdf).

¹⁴⁶ Hawksworth (2002a). See also Hawksworth (2002b) for a reconciliation with UK Government figures.

¹⁴⁷ DWP (2002 GP)

Glossary

The Pensions Primer, available at www.pensionspolicyinstitute.org.uk contains more details on some of the pension terms used in *The Pension Landscape*.

State Pension Age (SPA)

State pension age is the age from which state pensions are normally payable. This is currently 65 for men, and 60 for women. SPA for women will increase from 60 to 65 between 2010 and 2020.

Basic State Pension (BSP)

Basic state pension is the flat-rate state pension paid to all people who have met the necessary National Insurance (NI) contribution conditions. It is payable from state pension age, although claims can be delayed in return for an increased level of benefit. The full amount of BSP for those with a sufficient NI contribution record is £77.45 per week for a single person from April 2003. For a married couple, based on husband's contributions, the rate is £123.80 per week.

State Earnings Related Pension Scheme (SERPS)

SERPS is a state earnings related pension. Benefit is calculated from the earnings-related contributions paid between April 1978 and April 2002. It is paid in addition to the basic state pension, and is payable from state pension age.

State Second Pension (S2P)

S2P replaced SERPS from 6 April 2002. Compared to SERPS, S2P will pay enhanced benefits to those with earnings below £25,592 per year, with the largest enhancements directed at those earning less than £11,200 per year, those caring for the disabled or young children, and those with a long-term illness or disability. It is payable from state pension age.

Minimum Income Guarantee (MIG)

Minimum income guarantee is the main means-tested benefit for pensioners, payable to those aged 60 and above. From April 2003, the minimum income will be £102.10 per week for a single person, and £155.80 per week for a couple. The state pension actually receivable by a person is taken into account (along with other income) in calculating the amount of MIG received.

Pension Credit (PC)

Pension credit is a new means-tested benefit to be introduced in October 2003. PC combines a guarantee credit for those aged 60 and above (which in many respects is the minimum income guarantee renamed), with a new savings credit for those 65 and above. The savings credit provides an additional amount related to how much other income is being received on top of the level of the full amount of BSP. The maximum top-up is expected to be £14.80 per week for a single person and £19.20 for a couple.

Housing Benefit (HB), Council Tax Benefit (CTB)

People on low incomes may be eligible for some or all of their rent and council tax to be paid by means of housing benefit and council tax benefit. Generally, people receiving the MIG receive the full amounts of HB and CTB, though they must be claimed.

Home Responsibilities Protection (HRP)

HRP was introduced in 1978 and gives protection where an individual is caring for children, the elderly or disabled by reducing the number of years of contributions required to secure full BSP.

Defined Benefit (DB) Occupational Pension

A DB occupational pension scheme will provide a pension that is expressed as a proportion of earnings - for example $1/60^{\text{th}}$ - for each year of membership. Earnings are usually based on an individual's salary at, or close to, retirement, but can also be based on an average across the length of time spent working.

Defined Contribution (DC) Occupational Pension

A DC occupational pension scheme is based on contributions that are invested on behalf of the employee. At retirement the pension will depend on the accumulated fund and the annuity rates available at that time. The employer makes no guarantees regarding the level of benefits that the accumulated fund will provide - as investment returns or annuity rates worsen the resultant pension reduces; conversely if they improve the pension will be higher.

Personal Pension

Personal pensions are arranged by an individual. Contributions are invested and at retirement the accumulated fund will be used to purchase an annuity.

Stakeholder Pension

Stakeholder pensions, which were introduced in April 2001, are a form of personal pension with charges limited to a maximum fund management charge of 1% per year, among other requirements.

Group Personal Pensions (GPPs)

Instead of offering an occupational pension scheme, an employer may arrange to pay into a group personal or stakeholder pension on behalf of their employees. A GPP is a collection of individual arrangements, but compared to the total cost of individual plans the total charge is likely to be lower.

Gross Income

Gross income is the full amount of income pensioners receive from different sources of income, including income from employment and self-employment, investment income, private and occupational pensions, and other market income, plus state benefits.

Net Income

Net income is the same as gross income minus income tax payments, National Insurance Contributions and local tax payments. Net income is the amount actually available to spend for pensioners, either before or after housing costs.

Before Housing Costs (BHC)

BHC income is how much net income is received in total, counting income from all sources.

After Housing Costs (AHC)

AHC income is net income left after expenses on housing. It is derived by deducting a measure of housing costs – such as rent and mortgage interest payments - from the Before Housing Costs (BHC) measure.

Equivalised Income

Income adjusted for the number of people in a household, to allow standards of living to be better compared. For example a couple will need a higher income than a single person to maintain the same standard of living.

Acknowledgements and Contact Details

The Pensions Policy Institute is grateful for input from many people in support of this paper, including:

Martin Black
Ian Davis
Steve Ellerd-Elliott
Jane Falkingham
Michael Martin
Fiona Matheson
Sue Richardson
Stewart Ritchie
Rhoslyn Roberts
Tom Ross
Aidan Smith
John Snow
Lawrence Wakeham
Jane Wheeler
Sally West
Andrew Young

The authors take responsibility for any remaining errors and omissions.
© Pensions Policy Institute, February 2003

The Pensions Policy Institute is an educational charity promoting the study of retirement provision through research, analysis, discussion and publication. The PPI takes an independent view across the entire pensions system.

The PPI is funded by donations and benefits-in-kind from a range of organisations. To learn more about the PPI, see www.pensionspolicyinstitute.org.uk

To contact the PPI please call, email or write to
Alison O'Connell, Director
Pensions Policy Institute
King's College
Waterloo Bridge Wing, Franklin Wilkins Building
Waterloo Road
London, SE1 9NN

Tel no. 020 7848 3751 Email alison@pensionspolicyinstitute.org.uk

References

- Association of British Insurers (ABI) (2001) *Response to the Pension Credit Consultation paper* www.abi.org.uk/Admin/Display/File/300/Pension_credit.doc
- Association of British Insurers (ABI) (2002a) *Stakeholder Pensions – Closing the savings gap* www.abi.org.uk/Display/File/301/stakeholder_oct_02_final_2_Version.doc
- Association of British Insurers (ABI) (2002b) *What makes people save?* www.abi.org.uk/Display/File/301/what_makes_people_save_report.pdf
- Association of Consulting Actuaries (ACA) (2002) *Occupational Pensions: Widening the Gap.* [www.aca.org.uk/Members_content/Pension_Survey_%202002_Scheme_preliminary_report_\(final_13_Nov\).doc](http://www.aca.org.uk/Members_content/Pension_Survey_%202002_Scheme_preliminary_report_(final_13_Nov).doc)
- Banks J, Blundell R, Disney R, Emmerson C. (2002) *Retirement, Pensions and Adequacy of Saving: A Guide to the Debate*, Institute for Fiscal Studies Briefing Note No. 29. www.ifs.org.uk/publications/briefnotes.shtml
- Banks J, Smith Z, Wakefield M. (2002) *The Distribution of Financial Wealth in the UK: Evidence from 2000 BHPS Data.* Institute for Fiscal Studies Working Paper WPO2/21 www.ifs.org.uk/pensions/workingpapers.shtml
- Clark T, Emmerson C. (2002) *The Tax and Benefit System and the Decision to Invest in a Stakeholder Pension*, Institute for Fiscal Studies Briefing Note No. 28. www.ifs.org.uk/publications/briefnotes.shtml
- Cooper D. (2002) *Family Fortunes: A Guide to Saving for Retirement* www.actuaries.org.uk/index2.html
- Curry C, Wood C. (2002) *Closing the Savings Gap - The Role of a Pensions Ready Reckoner* in Insurance Trends Issue 22: April 2002 Association of British Insurers
- Davies B. (2003) *Pension Scheme Profiles 2003* London: Union Pensions Services
- Department of Family and Community Services (2002) *Submission to Senate Select Committee Inquiry into Superannuation and Living Standards in Retirement* www.facs.gov.au/internet/facsinternet.nsf/aboutfacs/programs/seniors-senatesubmission.htm
- Department of Social Security (DSS) (1998) *A new contract for welfare: Partnership in Pensions* CM 4179 London: The Stationery Office www.dwp.gov.uk/publications/dss/1998/pengp/index.htm
- Department for Work and Pensions (DWP) (2002 GP) *Simplicity, security and choice: Working and saving for retirement.* CM 5677 London: The Stationery Office www.dwp.gov.uk/consultations/consult/2002/pensions/index.htm
- Department for Work and Pensions (DWP) (2002 HBAI) *Households below Average Income 1994/5- 2000/1* www.dwp.gov.uk/asd/hbai/hbai2001/contents.html

Department for Work and Pensions (DWP) (2002 OFA) *Opportunity for All: Fourth Annual Report 2002* www.dwp.gov.uk/publications/dwp/2002/oppal-fourth/index.htm

Department for Work and Pensions (DWP) (2002 PC) *The Pension Credit: Long-Term Projections* www.dwp.gov.uk/publications/dwp/2002/pencred/pencred.pdf

Department for Work and Pensions (DWP) (2002 PIS) *Pensioners' Income Series 2000/1*. www.dwp.gov.uk/asd/asd6/pi_series_001.pdf

Department for Work and Pensions (DWP) (2002 QSE) *Income Support Quarterly Statistical Enquiry*. www.dwp.gov.uk/asd/isqse.html

Department for Work and Pensions (DWP) (2002 SP) *State Pension Summary of Statistics*. www.dwp.gov.uk/asd/sossp.html

Disney R, Johnson P. (eds) (2001) *Pension Systems and Retirement Incomes across OECD countries*. Edward Elgar

European Commission (EC) (2002) *Joint report by the commission and the Council on Adequate and Sustainable Pensions (draft)* europa.eu.int/comm/employment_social/news/2002/dec/joint_pensions_report_en.pdf

European Commission Economic Policy Committee (EPC) (2001) *Budgetary Challenges Posed by Ageing Populations* www.europa.eu.int/comm/economy_finance/epc/documents/summary_en.pdf
UK country fiche available from www.europa.eu.int/comm/economy_finance/epc/documents/uk_en.pdf

Fleiss.A. (2001) *Pensioners' Incomes: An International Perspective* in *Insurance Trends* Issue 3. October 2001 Association of British Insurers

Government Actuary's Department (GAD) (1999) *National Insurance Fund Long-Term Financial Estimates* CM 4406 www.gad.gov.uk/publications/docs/qrs.pdf

Government Actuary's Department (GAD) (2000) *Occupational Pension Schemes 1995 – Tenth Survey by the Government Actuary*. London: The Stationery Office

Government Actuary's Department (GAD) (2002) *Occupational Pension Schemes 2000 Eleventh Survey by the Government Actuary: Preliminary Results for the Private Sector* www.gad.gov.uk/pensions/docs/occupational_pension_schemes_2000.pdf

Hawksworth J. (2002a) *Long-term outlook for UK public spending and tax shares of GDP*. Pricewaterhouse Coopers, July 2002

Hawksworth J. (2002b) *UK state pensions policy at the crossroads*, in *A New Contract for Retirement: Modelling policy options to 2050*. eds. Brooks R, Regan S, Robinson P, Institute of Public Policy Research

HM Treasury (HMT) (2001) *Tax Ready Reckoner and Reliefs* www.hm-treasury.gov.uk/media/0d307/TRR01Draft6%20-%20final.pdf

HM Treasury (HMT) (2002) *United Kingdom National Strategy Report on the Future of Pension Systems September 2002* europa.eu.int/comm/employment_social/socprot/pensions/uk_pensionreport_en.pdf

- House of Commons Hansard www.parliament.uk/hansard/hansard.cfm
- Hughes G. (2001) *The cost and distribution of tax expenditure on occupational pensions in Ireland*, ESRI, Dublin
- Knight A, McKay S. (2000) *Lifetime Experiences of Self-employment* DSS Research report no. 120. www.dwp.gov.uk/asd/asd5/rrep120.html
- Matheson J, Babb P. (2002) *Social Trends*, Office for National Statistics
www.statistics.gov.uk/StatBase/Product.asp?vlnk=5748&Pos=&ColRank=1&Rank=422
- Mayhew V. (2001) *Pensions 2000: Public Attitudes to Pensions and Planning for Retirement* DWP Research report no. 130 www.dwp.gov.uk/asd/asd5/rrep130.html
- McKay S, Heaver C, Walker R. (2000) *Building Up Pension Rights*, Department of Social Security Research Report No 114 www.dwp.gov.uk/asd/asd5/rrep114.html
- Meager N, Court G, Moralee J. (1994) *Self-employment and the distribution of income* Institute of Manpower Studies Report no. 270
- National Association of Pension Funds (NAPF) (2002) *NAPF Annual Survey 2002*
- National Audit Office (NAO) (2002) *Tackling Pensioner Poverty: Encouraging Take-up of Entitlements*: London: The Stationery Office
www.nao.gov.uk/publications/nao_reports/02-03/020337.pdf
- Neary D, Nesbitt S. (2001) *Ethnic Minorities and their pension decisions: A qualitative study of Pakistani, Bangladeshi and white men in Oldham*, Joseph Rowntree Foundation
www.jrf.org.uk/knowledge/findings/socialpolicy/531.asp
- O'Connell A. (2002) *Raising State Pension Age: Are we ready?* Pensions Policy Institute
www.pensionspolicyinstitute.org.uk
- Office of the Deputy Prime Minister (ODPM) (2002) *Housing Statistics Summary, Number 13*
www.housing.odpm.gov.uk/statistics/publicat/summaries/013/index.htm
- Office for National Statistics (ONS) (2002 ALAFS) *Annual Local Area Labour Force Survey 2001/02*
www.statistics.gov.uk/StatBase/Product.asp?vlnk=9651&Pos=&ColRank=1&Rank=272
- Office for National Statistics (ONS) (2002 CEN) *Census 2001*
www.statistics.gov.uk/census2001
- Office for National Statistics (ONS) (2002 NES) *New Earnings Survey Streamlined analyses GB 2002*
www.statistics.gov.uk/downloads/theme_labour/NES2002_GB/NES2002_streamlined_analyses.pdf
- Office for National Statistics (ONS) (2003) *Labour Market Trends, January*
www.statistics.gov.uk/StatBase/Product.asp?vlnk=550&Pos=&ColRank=1&Rank=422

- Office for National Statistics (ONS). (2002 NES) *New Earnings Survey 2002*
www.statistics.gov.uk/statbase/source.asp?vlnk=428&more=y
- Oliver, Wyman & Company (OWC) (2001) *The Future Regulation of UK savings and investment* www.abi.org.uk/oliverwymanreport.pdf
- Parker H. (ed). (2000) *Low cost but acceptable incomes for older people. A minimum income standard for households aged 65-74 years in the UK.* Bristol: Policy Press
- Parker H. (ed). (2002) *Modest but adequate: A reasonable living standard for households aged 65-74 years.* Age Concern
www.york.ac.uk/res/fbu/documents/ageconcernmodad2002.pdf
- Pensions Policy Institute (PPI) (2003) *The Pension Primer*
www.pensionspolicyinstitute.org.uk
- Pension Provision Group (1998) *We All Need Pensions – the prospects for pension provision.* London: The Stationery Office
- PricewaterhouseCoopers (PwC) (2001) *Live long, die poor? Pensions projections for the millennial generation*
www.pwcglobal.com/extweb/ncpressrelease.nsf/DocID/3F28EFAC6A6845B780256C4D004F90EA
- Rowlingson J. (2002) *Private Pension Planning: The Rhetoric of Responsibility, The Reality of Insecurity*, *Journal of Social Policy* 31,4: 623-642
- Select Committee on Social Security (2000) *Select Committee on Social Security 7th Report – Pensioner Poverty* House of Commons
www.publications.parliament.uk/pa/cm199900/cmselect/cmsocsec/606/60602.htm
- Smith A, McKay S. (2002) *Employers' Pension Provision 2000*, Department for Work and Pensions Research Report No 163 www.dwp.gov.uk/asd/asd5/rrep163.html
- Terry R, Leather P. (2001) *The Market for Equity Release Schemes.* Council of Mortgage Lenders.
www.cml.org.uk/servlet/dycon/zt-cml/cml/live/en/cml/pdf_pub_resreps_39full.pdf
- Women and Equality Unit. (2002) *Individual incomes of men and women 1996/7 to 2000/1* Department for Trade and Industry,
www.womenandequalityunit.gov.uk/research/individual_incomes3/individual_incomes_3_contents.htm

Crown copyright material is reproduced with the permission of the Controller of HMSO and the Queen's Printer for Scotland.