Providing for Pensions

Principles and Practice for Success

Theresa May

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Politeia
22 Charing Cross Road
London WC2H 0QP
Tel: 020 7240 5070 Fax: 020 7240 5095

E-mail: info@politeia.co.uk
Website: www.politeia.co.uk

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THE AUTHOR

Theresa May MP is Shadow Secretary of State for Work and Pensions and Shadow Minister for Women. She has served in the Shadow Cabinet since 1999 where her responsibilities have included Education and Employment, Transport, Local Government and the Regions. She has also served as Chairman of the Conservative Party. For Politeia she has written *Restoring Parliamentary Authority: EU Laws and British Scrutiny* (2007).

Foreword

Sheila Lawlor

As many economies today struggle with the aftermath of boom and bust, governments face further additional costs. As western societies age, they can expect rising pensions and healthcare bills. Here in the UK the position is particularly serious. Not only is the UK's fiscal position comparatively worse than that of other similar economies; its pensions provision has also been damaged by a series of misguided measures and regulations over the past decades. Changes to the accounting rules, systematic means-testing and the 1997 budget removal of tax credit on pension dividends, have all contributed to the erosion of the UK's once successful pension system. Occupational pensions too are beset by crisis; most private sector final salary schemes are closing to new entrants and even to further accrual for existing members. It has been estimated that 73 per cent of all pensioners will be in households eligible for means-tested pension credit by 2025 and 82 per cent by 2050. Meanwhile the proportion of working taxpayers to those in retirement is shrinking. In the UK by 2050 the dependency ratio will be approaching one working person to every dependant (children or the elderly). And, to make matters worse, the system is extremely complex and confusing, and little understood in the population as a whole.

How can this serious state of affairs be reversed? What policies are needed for security and dignity in retirement? Successful pension policy, pioneered by the UK from the turn of the 20th century, was founded on certain principles. The *Old Age Pensions Act* (1908) and *National Insurance Act* (1911), the 1925 *Widows', Orphans' and Old Age Contributory Pensions Act* and the subsequent measures which built on them before the 1946 Act, reflected a consensual approach which was set out in Beveridge's 1942 *Social Insurance and the Allied Services.* In particular, it was agreed that the framework for social security (in which pensions played a vital part) must avoid means-testing or penalising thrift and savings; that it must be affordable and would depend on people being in work, with high levels of employment and little or no long-term unemployment; and that in any successful scheme the actuarial rules must be respected. It was also vital that the basic state system must be supplemented by additional personal savings and retirement schemes. For this, government must facilitate and encourage a mixture of providers and schemes to suit different incomes, personal circumstances and a variety of occupations. Beveridge's analysis went beyond the problems of wartime Britain and identified the principles for successful policy thereafter.

In this *Address,* Theresa May MP, Shadow Work and Pensions Secretary, considers the serious problems we face today and proposes a course for the future, drawing on many of the principles of Beveridge and his precursors. She stresses that the system must reward, rather than penalise, saving and that the law must be clear and transparent. So, the legislative framework will need attention. A culture in which working life is extended is also important. So practical changes, such as raising the retirement age, on which there is cross-party agreement, should be encouraged. Indeed, as Mrs May also explains, greater flexibility is needed for those who wish to continue to work after retirement. The UK must also be more open to allowing access to funds in time of need, something which has been explored by overseas models. The underlying approach must be to encourage a mixture or provision and promote the principles which have made for success in the past, developing them for the future. Theresa May's approach to pensions addresses questions which have been avoided by her predecessors but which must be solved if Western societies are to pay for retirement.

I am most grateful to Theresa May for giving Politeia's *Anniversary Address,* which has led to this pamphlet, and for her work to restore pensions policy to the centre of the UK's policy debate as the basis for ensuring sufficent saving in Britain's ageing society.

SL
Director, Politeia, 2010

Providing for Pensions: Principles and Policy for Success[1]

Theresa May

The future of pensions in the UK is of vital importance, not only to every individual saving for retirement, but also for the economic and social health of the nation. Recent years have been extremely difficult for occupational pensions, and the years ahead will only get tougher if the right action is not now taken. The challenge that will face a new government after the next election is twofold: not only must confidence in our pensions system be restored but the habit of saving in Britain must once again be revived so that all citizens can enjoy the security in retirement that currently eludes so many.

Conservative principles

There are three key principles which should guide any government in this vital area, principles which will be at the heart of a future Conservative government under David Cameron. First, we must ensure a decent level of security for all in retirement, recognising that many will rely on the state for additional support in their retirement years. We should respect all those who depend on the basic state pension by making the tough choices necessary to provide for them.

Second, we must seek to restore the health of our occupational pensions, which were once lauded as the best in Europe but have been decimated by tax raids and stock market fluctuations as well as other factors. We should be guided by the desire to preserve the strengths that remain in the system and eradicate the weaknesses that have developed. This may require new and radical solutions and we must consider any measures that will strengthen pensions and be seen to strengthen pensions, restoring public confidence in the value of pension saving.

And third, we should encourage responsible saving for the future and make sure that people are rewarded, not punished, when they do the right thing and put money aside for retirement or a rainy day. That means we need to renew the culture of saving that has been so badly diminished over the last decade and recognise the responsibility that the government has to set the right example by its own actions.

I will take each of these in turn, but before doing so it is necessary to recognise the serious situation that we are in and how we got here.

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[1]It is an honour to have been invited to give Politeia's *Anniversary Address* which led to this publication. Politeia is admired across the political spectrum for the integrity and intelligence of its contributions to public debate on a wide range of issues. By bringing together academics, politicians and others to tackle pressing issues of public policy, Politeia is an important forum for debate, and I am delighted to contribute to that work.

The current landscape

Twelve years ago Britain's pensions regime was in a strong position. Frank Field, the respected former Labour minister, famously noted[2] that in 1997 Britain's pensions provision was one of the strongest in Europe. The new Labour Government was quick to acknowledge the strength they had inherited. The 1998 Department of Social Security Report, to which the Prime Minister, Tony Blair, wrote a foreword, stated that Britain had "a well-developed framework of funded pensions. Occupational pension schemes…are one of the great welfare success stories."[3]

The same could not be said today. Whereas in 1991 active membership of private sector pension schemes reached a 30-year high of 6.5 million,[4] this had fallen to just 3.6 million last year – a 45 per cent decline in just 17 years.[5] It is no surprise therefore that the proportion of people with no pension provision whatsoever has increased in every age group under 50 since 1997. Over 12 million jobs have no pension provision.[6]

It is not just that fewer people are saving in a pension scheme; many of today's schemes are less generous than those of the past and will not provide the retirement outcomes that might once have been expected. This is principally due to the decline of Defined Benefit provision and increased use of Defined Contribution. In the 30-year span from 1975 to 2005, the proportion of employees with DB schemes declined from nearly half to around a third. Meanwhile the proportion in DC schemes steadily increased.

The trend continues to this day, highlighted by a recent *Financial Times* headline that said, 'End game near for final salary pensions'. Not long ago such a headline would have seemed unthinkable but now, every month, we hear stories of final salary schemes closing to new members or to future accrual. A recent survey[7] found that the vast majority of DB schemes are now closed to new entrants, and a fifth of those are also closed to future accrual. Of course, the most important factor is not the type of scheme but the value of the pension that it will provide, but it is unavoidable that the decline in DB provision could contribute to worsening retirement outcomes for many.

The consequences of these trends could be deeply damaging. We cannot afford any further weakening of pension provision if increasingly poor retirement outcomes are

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[2] BBC Radio 4, *Today Programme*, September 2004.

[3] *A New Contract for Welfare: Partnership in Pensions*, Department for Social Security, 1998.

[4] Source: House of Commons Library.

[5] Source: http://www.statistics.gov.uk/pdfdir/ops1009.pdf

[6] ONS, *Annual Survey of Hours and Earnings,* Pensions Tables 1997/2009.

[7] Association of Consulting Actuaries, *Twilight or new dawn for Defined Benefit Schemes?* London, 2009.

to be avoided. This is particularly the case for the lowest paid. The sad truth is that millions of people are reaching retirement and finding that their pension is not worth what they thought it would be. People who have worked hard all their life are discovering too late that they do not have the security they wished for. This must change.

How we got here

It is important to understand how we reached this position. As we look back on recent years, we should all regret that we cannot do so with praise for the wise decisions that have been taken, or with any great sense of pride in the security enjoyed by our older people. Rather, we do so seeking to learn lessons so that past mistakes will not be repeated.

Some argue that the roots of the decline stretch back to the Conservative Government of the 1980s; that Nigel Lawson set the precedent for raiding pension funds that was later embraced so disastrously by Gordon Brown. While policies implemented in the late 1980s to restrict the accumulating of assets in a pension fund were appropriate in the context of the time - set against the background of a historically strong pension system - it is also true that Labour used those policies to justify their reckless tax raid, and that is to be regretted.

But it cannot be disputed that our pensions were in an extremely strong position in 1997, attracting widespread praise and admiration. Nor can it be disputed that Gordon Brown's removal of the tax credit on dividend payments to pension schemes, announced in the 1997 budget, has been a hammer blow to those once strong pension funds. Indeed, even the BBC's Robert Peston has referred to "the wreckage of occupational schemes bashed by Brown's tax grab."[8]

There is a slight myth that has developed that somehow nobody realised the effects the tax raid would have, and that only over time did we come to see the damage it was doing. In particular some have accused the Conservatives of failing to notice or oppose the changes announced in that first Labour budget. However, nothing could be further from the truth. Just minutes after Gordon Brown had delivered his budget address, William Hague, then Leader of the Opposition, described it in the House of Commons and as "a smash and grab raid on pension funds…and a cynical betrayal of the millions who have built up pensions."[9] Sadly those words proved entirely accurate.

The Director General of the CBI, Richard Lambert, described the raid as "a significant contribution to the weakening of the country's occupational pensions platform"; the

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[8] Robert Peston, *Who Runs Britain?*, London, 2008, p. 226.

[9] Hansard, 2 July 1997, Column 321.

National Association of Pension Funds said it was "the biggest attack on pensions in living memory."[10]

The tax raid was the most serious of several blows to pensions in the late 1990s and the early years of this decade. Stock market fluctuations, unhelpful regulations, accountancy rules and increased longevity have also contributed to the problem.

However, there is also a wider issue. It is not just that the structures and balances of our pension funds have been hit. We have also seen a decline in what might be termed our culture of saving. Reduced respect for the value of saving has been both a cause and a consequence of the weaknesses in our pensions. The truth is that as a nation we are not saving enough for the future. Thirteen million working people save either too little or absolutely nothing in a pension – around half the working population. The UK's annual savings gap is at least £27 billion.

The amounts that households save provide a telling illustration of the position. The household savings ratio was a relatively healthy 10 per cent in 1997, whereas last year it went into negative territory. In fact, the savings ratio has been lower in every year under Labour than it was in even the lowest year of John Major's Government.

Many factors have contributed to this situation. But to get to the bottom of it I think we need to start at the top. Debt has been at the heart of the economic downturn in this country: government debt, corporate debt and personal debt. The Government turned a blind eye as all three rocketed, fuelling the unsustainable boom of the past decade. As a nation we have lived for too long on borrowed money and our economy on borrowed time. We need the Government to live within its means just as every responsible household should live within its means.

Labour's financial irresponsibility and their cavalier approach to debt has damaged our economy, but almost as seriously their message of unlimited spending without consequence has undermined Britain's culture of sensible saving, prudent budgeting and sound finance. People cannot be blamed for getting into debt when their Government takes such a casual attitude towards its own debt. People cannot be blamed for failing to save when their Government failed to prepare the public finances for a rainy day. Families across the country will have looked at their Government over the last 12 years and thought, 'if you don't need to save money, then why should we?'

Security for all in retirement

The growth of personal debt and the decline in our culture of savings, combined with the problems with occupational pensions, have left many people anxious or even fearful about their retirement. It is unacceptable that 2.5 million pensioners live in

[10] http://www.iii.co.uk/articles/articledisplay.jsp?section=Pensions&article_id=6266104.

poverty in 21st century Britain. For this reason, the first principle for any government dealing with these issues must be to ensure security for all in retirement.

That means making tough decisions about the basic state pension. The state pension should be a source of pride for our country. It was in the 18th century that Thomas Paine and others proposed state payments to every person reaching old age – which in those days, according to Paine, was 50 years of age. As policy developed and pressure grew, the case for a state pension was one that spanned party political association. It was championed by Joseph Chamberlain, the Liberal who formed an alliance with the Conservatives, was supported by Arthur Balfour, the Conservative Prime Minister, and eventually implemented by the Liberal government of Asquith. All the while it was consistently promoted by the fledgling Labour movement. After the First World War came the key piece of pension legislation, the 1925 Widows', Orphans' and Old Age Contributory Pensions Act, later followed by the 1946 National Insurance Act implementing the Beveridge Report.

But the state pension today does not arouse quite so much pride as it might. Since the late 1970s its value has steadily fallen as a proportion of average earnings.[11] It is true that a Conservative Government broke the link between the state pension and average earnings. But since then, both the Labour and Conservative Parties have discussed restoring the link, yet it has still not happened. It has been promised so many times that pensioners and those approaching retirement might be excused for thinking that it will never happen. One of the less dignified sights of the last 12 years has been that of Gordon Brown, so profligate in many areas, desperately attempting to extract himself from his pledge to restore the earnings link. In 2005 he memorably attempted to sabotage Lord Turner's review when it became clear that restoring the link from 2010 onwards would be recommended. Shortly before the review was published, the then Chancellor wrote to Lord Turner to warn him that he should not assume that the link of Pension Credit to earnings would continue beyond 2008, knowing full well that the affordability of Turner's recommendation was based on this.[12]

Though probably only a ruse, it confused the issue. Not only did the Government soon afterwards confirm that Pension Credit's link to earnings would remain, it enshrined this in law under the 2007 Pensions Act. However, it was enough to throw some confusion onto the Turner recommendation and give the Government enough room to wriggle out again. Pensioners should be treated with greater respect than that.

We are determined to be the Party that finally restores the earnings link, not just for one year but for every year. This will benefit all pensioners, but particularly the poorest who rely most on the state pension. To pay for this we have said that we must look at bringing forward the rise in the state pension age to 66. The need to raise the

[11] Source: House of Commons Library .

[12] Robert Peston, *Who Runs Britain?* p. 247.

pension age is accepted by all parties. The case is clear: between now and 2050 the number of people at state pension age is likely to rise by over 4 million.[13] Meanwhile, life expectancies at 65 will continue to increase. By bringing forward the rise to 66 – although starting no earlier than 2016 for men and 2020 for women – we can help ensure that the state pension provides the security in retirement that should be the right of every pensioner.

Of course, the issue of longevity is central to this and so much of the discussion around pensions. At the beginning of the 20th century a man reaching the age of 65 could expect to live for around 10 more years; for a woman, around 12 years.[14] Today a man reaching 65 could expect to live for around 21 years and a woman for 23.[15] This is a significant and serious trend which will continue to affect the pensions debate for many years to come.

In the light of this change, and the rise in the state pension age, it will be necessary to review the Default Retirement Age. Conservatives have said for some time that we want to move to a point where retirement is a process rather than an event. Flexible working practices, for example, could greatly help people approaching retirement to reduce their work hours gradually or to find new ways of working that allow them to continue in employment more comfortably up to retirement. Pensions may also have to become more flexible. I welcome the Government's decision to bring forward its review of the Default Retirement Age following the recent High Court case. More and more people will want to work beyond the Default Retirement Age, and we should encourage and support that where it is practical to do so.

Restoring the health of pensions

The debate about pensions goes far beyond just the state pension. Our occupational pensions have sadly seen considerable decline over recent years. That is why our second principle must be aiming to restore the health of workplace pensions and the pensions system.

If restoring the earnings link was one of the centrepieces of the Turner review then the others were auto-enrolment and Personal Accounts – now commonly grouped together as the '2012 reforms'. To an extent they need to be separated in our minds as we look at the right way forward from here. However, it is clear that both have provoked some concerns among employers which need to be taken seriously.

The Conservative Party has long supported the concept of auto-enrolling employees into a pension scheme, with an opt-out available. This will be an important step

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[13] PPI, *Pension Facts*, December 2009, p. 1.

[14] Salter et al, *100 Years of State Pension*, The Actuarial Profession, London, 2009, p. 217.

[15] PPI, *Pension Facts*, December 2009, p. 1.

forward. However, there is some concern that a 'big bang' launch in 2012 could create problems for companies and leave them, and employees, open to potential teething problems. I have previously called on the Government to explore whether auto-enrolment could be brought forward before 2012 on a voluntary basis for companies in order to mitigate these problems. Early, voluntary auto-enrolment could help prevent any implementation problems that might arise in 2012, would allow employers to plan properly for implementation within their own financial cycles, and of course will boost pension saving in the long run. So I hope that the Government will look into this as a matter of priority.

Conservatives also support the motives behind Personal Accounts: ensuring that low and middle earners are saving for the future with contributions from their employer. However, there are clear concerns about the way in which things are shaping up. We have long-standing concerns about the potential for employers to level down their contributions as well as the administrative costs involved and the ability of government to deliver another large-scale IT project.

The Government's latest implementation regulations have added to existing concerns that we will not reach 3 per cent employer contributions until at least 2016, six years after Lord Turner's initial target date for Personal Accounts to begin. Far from boosting saving, we could see employer contributions as low as 1 per cent for several years, a considerable reduction on average DC contribution levels. While there does need to be some degree of phasing in there was little expectation of contribution levels of 1 per cent as late as 2015. Such a slow start could undermine the credibility of the whole project and leave millions of people facing a gap in contributions that they might never make up. Not only will this not lead to improved levels of savings; it could actually reduce saving rates at the very time we need them to be increasing.

As a result, after the next election any new government will need to review the Personal Accounts / NEST project, and I can confirm that a Conservative government would do that.

In addition to the Turner reforms, recent years have seen various changes and measures that have affected our pensions landscape. The most recent of these was the changes to tax relief on pension savings announced in the last Budget. I understand the concern and anger that this has caused. The decision to make contributions to pensions taxable as income for higher rate earners was a significant one. It breaks the basic covenant that has long been accepted by all parties – that responsible saving will be rewarded and not punished; that savings will be protected not taxed several times over.

This damaging decision will hurt pension funds and further weaken our culture of saving. As we have made clear, we do not support this change, but given the dreadful state of the public finances we cannot pledge to reverse it at this point. Of all Gordon

Brown's tax rises, our priority will be to stop the one that affects the most, the increase in National Insurance for millions earning £20,000 or more.

As we consider measures to encourage pension saving, we should not give the signal that we have given up on Defined Benefit provision. It would be tempting to do so in light of the decline that has occurred. However, that would be short-sighted. Although it might prove impossible to save DB schemes as we know them, that does not mean that we should simply give up on the concept. Instead we must look at new approaches so that employees do not increasingly see all the risk placed on them.

That is why we are looking both at what action can be taken to make it easier for companies who want to retain their DB schemes and to find ways of salvaging some element of DB provision, perhaps through a different model which involves risk-sharing. So we must look seriously at hybrid solutions that combine elements of DB and DC and how the regulatory system can enable and encourage them. We are studying several pieces of regulation that are potentially making it harder for companies to retain their schemes. It is also clear that any measures that increase volatility on a balance sheet or restrict a company's ability to adapt to changing circumstances need to be reviewed very closely.

We also need to address the issue of annuities. If we want more flexibility before retirement then we must also give people more flexibility once they have retired. Conservatives naturally believe that individuals are best placed to make decisions about their life and it is right to give people more control over their incomes in retirement, so we will end the effective obligation to buy an annuity at 75.

I should also touch on public sector pensions. This is an issue that frequently attracts media attention and understandably so – the public sector pensions deficit is estimated by some to be over £1 trillion. We cannot ignore this, nor can we ignore the growing disparity between the public and private sectors. However, we must also ensure that in addressing this we do not devalue hard-working public sector workers, many of whom are paid relatively low wages. We have always said that accrued benefits must be protected, but it is clear that an incoming government will need to conduct an audit of public sector pensions in order to assess their true state. We will ask an independent Office of Budget Responsibility to conduct such an audit.

Renewing our culture of saving

However, improving the structures and regulations will not be enough if employees are not convinced of the value of saving in a pension. More than that, financial outcomes in retirement – as well as levels of financial security throughout somebody's life – are dependent on boosting levels of savings and ensuring that it pays to save. Our third priority must therefore be to renew a culture of responsible saving for the future.

The truth is that, for many, it is easier to fall into debt than to save for the future. This is particularly relevant for people on lower incomes who face financial worries every day and for whom saving seems like an impossibility. Personal debt is one of the biggest issues faced in the UK. One pre-recession estimate suggested that up to 9 million people had a serious debt problem. It found that personal debt was 'the most serious social problem facing the UK'.[16]

A key issue is the generally poor level of financial literacy and the lack of readily available, good quality financial advice. The benefits of saving in a pension or saving more generally are not realised by many people. If they do realise the benefits, they are unaware of how much they need to save to secure the retirement they expect. So improving the quality and availability of financial advice will be an important step. Research has demonstrated the direct link between the availability of financial advice and the level of an individual's savings. Nearly half of lower earning households who currently save would not have done so in the absence of financial advice.[17]

For this reason, the Conservatives have proposed a free national financial advice service to provide impartial advice online, over the telephone and in face-to-face meetings. Launching such a service will help tackle poor financial literacy and may help boost pension saving in the long term. The service will cost £50 million a year, to be paid for through a new social responsibility levy on the financial services sector. I am pleased that the Government appears to have accepted this need and have now announced similar plans of their own.

We need also to confront the reasons that people do not save enough in a pension. Sadly, too many see pension saving as a restriction of their financial freedom rather than a tool of financial liberation. We need to change this perception and explain more convincingly the value of saving and the options that are available to people. For instance, we should consider low-earners who work hard to provide for their families and barely manage to get by each week. Or recent graduates just starting out in the world of work and still paying off their student debt. They would quite understandably ask themselves why they should put money aside in a pension that they will not see for 40 years.

So we need to look at the practical measures which will ensure that pensions are working for people. One issue worth exploring is that of early access. It is clear that not being able to access your own money, even in an emergency, is hugely off-putting to many people. Many people worry that they or a member of their family might need additional resources for medical treatment or because they have been made redundant, and are concerned that they cannot access their own savings. We are looking at some

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[16] Centre for Social Justice, *Breakthrough Britain*, London, 2007.

[17] Oliver, Wyman & Company, *The future regulation of UK savings and investment*, London, 2008.

of the early access models that have been implemented in countries such as New Zealand and the USA and it is clear that this merits further consideration. Allowing some form of earlier access to a pension fund might allow many people to overcome these fears and encourage greater saving for the future. Offering people greater flexibility could be an important means of reinvigorating long-term saving and restoring our culture of saving.

Conclusion

So the challenges that we face are great, and the circumstances in which we face them difficult. It will be incumbent upon the next government not only to prevent further deterioration of our pensions system but, where possible, to reverse the damaging trends of the last decade in order to ensure better retirement outcomes in the future. The state must accept its responsibility to ensure security for all in retirement so that the unacceptably high levels of pensioner poverty can be tackled. Beyond that, we must seek to restore strength to our occupational pensions to stop the decline of recent times. We must view pension funds as precious resources for the future, not goldmines to be raided by government for tax revenue. And as well as strengthening pensions we need to make sure that people actually want to contribute to them. We need to restore a culture of saving by looking at ways to ensure people are aware of how much they should be saving, as well as looking at practical measures to encourage them to save in a pension.

Too many people today are denied the financial security in old age that should be enjoyed by all. Pensions are at the heart of the kind of society we want to be – one that saves sensibly, rewards responsible behaviour and provides for its more vulnerable citizens. The past 12 years have been ones of disruption and decline for our pensions system but with the right approach we can ensure greater strength for pensions and, ultimately, greater hope for all our citizens.