Debating Pensions

Debating Pensions: Self-Interest, Citizenship and the Common Good

Frank Field

Commentaries
David Willetts
Philip Booth
Kirk Mann
Stephen Driver

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Foreword

The monolithic structures set up in the postwar period creating state control of education, health and welfare have been crumbling for some time; and not all the king's horses nor all the king's men can put them together again. In the field of welfare the many changes in the system of state pensions have left the problems of pensioner poverty unsolved; by adding elements of means-testing they have weakened the incentive to save or work and, besides this, have added a daunting complexity and long-term uncertainty. The problems of state pension provision have been compounded by the closure of defined-benefit occupational pension schemes and by the narrowing of the field of occupational pension schemes generally, developments which have been aggravated by government policies themselves.

In this Civitas publication Frank Field MP, previously Minister for Welfare Reform and now Chairman of the Pension Reform Group, proposes a reform of the system of state pensions which he and his Group contend will remove both pensioner poverty and the disincentives to save—and the various anomalies—created by means-testing. The proposed universal protected pension, set above present means-tested limits, would consist of a universal flat-rate pension plus a universal funded defined-benefit element, financed by earnings-related contributions that, although subject to a limit, would confer the element of income-redistribution which the removal of pensioner poverty is held to require. Removing the disincentives created by means-testing and providing a more stable environment for personal and occupational pension funds would strengthen civil society.

In *Debating Pensions*, Frank Field's essay is discussed by four contributors with different viewpoints; and in his 'Response' he replies briefly to their criticisms. My own reservation would be that in the funded defined-benefit element the investment risk would still fall on the state, which would mean that political risk, which Frank Field is rightly anxious to avoid, might remain. Readers must arrive at their own verdict, but what cannot be denied is that the problem of pensions is crucial and one on which Frank Field writes with authority and heartfelt conviction.

I am particularly pleased to have been asked to write this Foreword, for it is not generally remembered that the Conservative Government of 1970-74 proposed a (defined-contribution) funded scheme and set up a Reserve Pension Board to administer it. I was a member of that Board, but after only one meeting the election of the Labour Government in 1974 swept the whole idea aside—until Frank Field arrived on the scene nearly 30 years later.

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Editor's Introduction
Squaring the Circle on Pensions

Alan Deacon

During the first half of 2002 pensions received a level of attention in both the popular media and political debate that they had not commanded for decades. Public indifference towards an issue long deemed technical and remote was replaced by widespread confusion, anxiety, and growing anger. This shift in the public mood was fuelled by newspaper headlines that predicted that many of those now in employment would find that their occupational or private pensions provided less than they had been led to expect. Indeed it began to be suggested that it may be necessary for some of them to work beyond the current state pension age if they were to secure an adequate income in retirement. At the same time, a number of individuals and think tanks generally sympathetic to New Labour began to argue that the government would have to reverse its present strategy if it were to reduce poverty amongst the present generation of pensioners.

The broader 'pensions crisis' has many facets and its causes are complex. It arises in part from the impact upon the financial services industry of falling stock markets, adverse tax changes, lower interest rates, changing expectations of inflation, and increased longevity. It is also rooted in the well-attested reluctance of many people to forego current consumption in order to save for their retirement. This reluctance is itself reinforced by their equally well-attested scepticism regarding the reliability of the financial products on offer and the commitments given by politicians. All of this exacerbates and intensifies long-standing concerns about the impact upon public and private provision of the growth in the numbers of pensioners relative to the numbers of contributors. Within this context critics of New Labour's approach to pensioner poverty have highlighted what they see as the contradiction between the government's use of means-tested benefits to boost the incomes of current pensioners and its attempts to persuade those now in work to save more for their own retirement.

The government insists that there is now such a gulf between the circumstances of the better-off pensioners and the poorest pensioners that it would be wasteful and inefficient to pay higher benefits to them all. Far better, it argues, to target help to the most needy through the minimum income guarantee (MIG) and, from 2003, the pension credit. One objection to this approach is that such means-tested benefits are not claimed by all those who are eligible to receive them. Another is that it penalises those people who have made provision for their retirement and now find that others receive through the MIG an income comparable to that which they have earned through their savings and contributions. This situation is patently unfair, and the publicity given to it reinforces the public's reluctance to save more. It was these considerations that led the Institute for Public Policy Research, a think tank generally sympathetic to New Labour, to urge the government to perform a 'pensions U-turn' and to raise the basic state pension (BSP) to the level of the MIG.[1].

A still more far-reaching proposal is that for a universal protected pension (UPP), and it is this that is set out by Frank Field in his essay in this book. The essence of Field's proposal is that those in work should be compelled to contribute to a new pension scheme. The contributions would increase with earnings up to a level corresponding to one-and-one-half times average earnings, and would be paid at a significantly higher rate than at present. In return contributors would be given a guarantee that in retirement they would receive an income higher than that provided by means-tested benefits. The funding and governance of the scheme are designed to minimise political interference and maximise the public's confidence in this guarantee. Members of the UPP scheme would thus be able to make further provision for themselves safe in the knowledge that the fruits of their savings would not be offset by the loss of benefits. The other central feature of the scheme is the degree of redistribution within it. The UPP would be paid at the same rate to all and this combination of contributions graduated to earnings and flat-rate benefits means that there would be a significant transfer from the better-off contributors to those on the lowest incomes. Further redistribution is achieved through a provision that those caring for a child under five or for a sick or disabled person be treated as if they were in paid employment. The challenge facing Field is thus to secure political support for such redistribution at a time when, in his own phase, the ‘age of the passive taxpayer is … moving peacefully to its close’.[2]

Redistribution versus Self-interest?

A central theme of Field’s writings on welfare is the need to reconcile two fundamental truths. The first is that the dominant motivation of human behaviour is self-interest. Public policy has to recognise that for most of the time most of the people will seek to improve their circumstances and those of their dependants. The task of welfare policy is thus to channel this pursuit of self-interest in ways that are conducive to the common good. This is why Field is so critical of means-tested benefits such as the MIG, the effect of which is to penalise the very behaviour that should be encouraged. Welfare claimants, however, are not the only people who seek to advance their own interests. The same assumption must be made of the electorate as a whole. Voters will not be persuaded by appeals to their altruism, but will have to be convinced that what is being proposed will be of benefit to them.

The second fundamental truth is that poverty amongst pensioners—or any other group—cannot be eliminated without redistribution—‘a word which radicals should not be afraid to use’.[3] The better-off must be persuaded to pay more in contributions (or taxes) than is necessary to fund their own pensions. If they do not, then there is no way to meet the costs of the pensions paid to the lowest earners or those such as carers who are unable to contribute themselves.

The simple, telling question that arises from this is—why should an electorate motivated by self-interest fund a scheme like the UPP? Field's response is that the voters can be persuaded on two main grounds. The first is that the scheme offers them a guarantee of an income throughout retirement well above the level of the MIG, something that only a tiny proportion could buy for themselves in the private market. The second is that a measure of redistribution is inevitable anyway if some pensioners are not to be left in penury. It is in everyone's interest for that redistribution to take the form of adequate pensions paid for by contributions rather than means-tested benefits financed out of taxation. Removing the corrosive effects of the means-test will benefit everyone in the long run.

The Commentaries

These arguments are subjected to robust challenges in the four commentaries in this book. For both David Willetts and Philip Booth the UPP enforces a degree of redistribution that is unacceptable. In Willetts's words, it is 'a highly political project resting on the state's power to compel people to pay contributions and then redistributing those contributions according to the political judgement of Frank Field'. If a private scheme were to operate like this 'it would be hauled before the Financial Services Authority'. Similarly, Philip Booth argues that there is a simple reason why the kind of guarantees provided by the UPP cannot be bought in the private market—'they cost more than people are willing to pay'. The aim of removing the means-test is laudable, but the levels of contribution required by Field's scheme would 'turn disincentives to save into disincentives to work'.

In stark contrast, Kirk Mann argues that the UPP chimes 'neatly with' an 'insidious drift away from the idea of social and collective responsibilities towards individual responsibility'. It compels employees to save but makes no comparable demands upon employers. It is redistributive only up to the ceiling of one-and-one-half times average earnings and so 'effectively excludes the highest earners from full responsibility'. Above all, Mann insists, Field displays a misplaced faith in the City and in the ability and willingness of the pensions industry to put its own house in order.

Finally, Stephen Driver claims that New Labour is correct to eschew the radicalism of Field, and that there is 'merit and coherence in the government's incremental approach to pension reform'. He challenges the assumption that the MIG and pension credit will deter saving on the grounds that, if people are as distrustful of government as Field claims, then they are unlikely to rely on these benefits being around when they reach retirement age. What New Labour offers, Driver writes, is reworking of social democracy that strikes a sensible balance between targeting extra resources on today's poor pensioners and planning for the future.

Field offers an equally robust response to these critiques. Collectively the essays in this book articulate a range of perspectives on pensions, and constitute a major contribution to the debate about a central issue of public policy.

A Universal Protected Pension: Harnessing Self-Interest to the Collective Good

Frank Field

This paper has three themes. Its main purpose is to explain the principles behind and the organisational structure to the universal protected pension—the reform proposals of the Pensions Reform Group. Why is such a reform necessary? The first section of this paper examines the shortfalls in pension provision in the UK. It is against this background that a second theme is considered, consisting of a summary of the four parts of the Labour Government's strategy to combat pensioner poverty. The final theme of the paper examines an alternative proposal aimed at introducing, for the first time in the UK since Beveridge, an adequate first-tier pension. But first, what are the main shortfalls in existing pension provision in the UK?

1. The Current Pensions Problem

There are four main problems with the current UK pensions system. They are:

- First, too many people after 40 or more years in work retire into poverty with inadequate pensions and other income. Increases in this often inadequate provision are at best linked to price increases, meaning that older pensioners are particularly likely to be poor.
- Second, the state pay-as-you-go pension schemes are untrusted, indeed the state is not trusted by the public on pensions. The record of state pensions since the war is poor. One pay-as-you-go scheme after another has offered

a good return only to be cut by a subsequent government. There is a need to protect pension entitlements for everyone with a funded scheme where entitlement is based on something akin to property rights.

- Third, inadequate pension provision has led successive governments to offer a means-tested top-up. These top-ups are now so large that they act as a serious disincentive to save—so compounding the original problem. One in three pensioners are currently in receipt of means-tested benefits. In 2003 this will jump to one in two. This means-tested benefit system is also exceptionally complex.
- Fourth, occupational pensions have been a great success but membership has now hit a glass ceiling. The proportion of employees in occupational pensions is declining, and occupational pensions are increasingly forcing employees to take the investment risk in defined-contribution arrangements.

(i) Current Problems: The Extent of Pensioner Poverty

There is a wealth of evidence to show that pensioner incomes are particularly low. The respected Households Below Average Income survey consistently records pensioners as having low incomes relative to the rest of the population. Recent research by the Department of Social Security's Research Branch found that 47 per cent of pensioners have an annual income below £5,200 per year.[1] An improvement in this situation is not imminent.

Table 1 (p. 9), showing weekly median net income of pensioners, gives an idea of how low many pensioners' incomes are. Furthermore, the table shows that over the last 20 years or so the incomes of the poorest pensioners have fallen further behind.

Pensioners' incomes are very different in composition depending on where they fall in the income spectrum. For single pensioners in the bottom income quintile, on average 91 per cent of their income is made up from benefits, with only four per cent coming from an occupational pension, and just five per cent coming from investment income. By contrast, those in the top fifth of the income scale have on average 38 per cent of income from benefits, 32 per cent from an occupational pension, and 22 per cent from investment income.[2] Clearly, occupational pensions and private pensions do not currently deliver a decent standard of living for many pensioners, who are, instead, heavily reliant on benefits.

Table 1
Weekly Median Net Income of Pensioner Units by Quintile of the Net Income Distribution, 1979–1996/7

	Bottom Fifth	**Next Fifth**	**Middle Fifth**	**Next Fifth**	**Top Fifth**
Single Pensioners					
£ p/w (1996-97)	£74	£101	£118	£149	£221
% Growth since 1979	28%	47%	52%	70%	76%
Pensioner Couples					
£ p/w (1996-97)	£136	£170	£214	£287	£470
% Growth since 1979	34%	45%	57%	65%	80%

Source: *Pensioners' Incomes Series 1999-2000*, Department of Social Security.

About 37 per cent of pensioners are dependent on means-tested benefits.[3] This is a much higher level of dependency than the rest of the population. There are a further 470,000 pensioners (4.2 per cent of all pensioners) who have a final income either below the level of basic assistance (the minimum income guarantee) or less than £20 above it, yet are disqualified from receiving it.[4] The introduction of the pension credit in 2003 will see a jump to 5.5m pensioners on means-tested benefits—50 per cent of all pensioners.[5]

(ii) Current Problems: Less Generous Occupational Pensions

Occupational pensions have been a major source of income for pensioners over the past two generations. They are the welfare success story of the last century, and the main reason why many pensioners do not live in poverty. Occupational pensions need to be nurtured.

Occupational pension coverage grew dramatically in the 1960s following the 1959 National Insurance Act that allowed contracting out from the state additional pension. The graduated state pension on offer was of such poor value that it was almost certainly better to contract out into an occupational scheme. But from the late 1960s onwards the coverage of occupational schemes started to contract. To some extent this contraction has been eased as women have taken up employment in jobs with coverage. However, there is little doubt that there is a long-term decline in the proportion of workers coverage by occupational pensions.[6]

The overall effect of this boom and gradual decline of occupational coverage is that those pensioners who have retired over the past twenty years or so have enjoyed ever-greater amounts of occupational pension. This will continue to keep occupational pension income high for those retiring over the next decade or so as many of these people would have first entered the workforce in the 1960s when coverage was at its greatest. Thereafter the outlook is much bleaker as those who entered the workforce when there was much less coverage come to face retirement.

The nature of occupational pension provision is also changing, with a marked shift towards defined-contribution schemes which are normally much less generous. Because of the increasing and open-ended burdens on pension funds—and in effect on the sponsoring employers—caused by increased longevity (and uncertainty about further increases), shorter working lives, and lower gilt yields that support pensions in payment, employers are frequently combining a switch from defined-benefit to defined-contribution with a reduction in their contribution to the scheme.[7] In making the switch to defined-contribution schemes employers are also transferring the investment risk to the individual, meaning that the second tier of retirement provision is much more uncertain.

A recent report by the Department of Social Security suggested that many in the industry had underestimated a quite dramatic shift away from defined-benefit schemes.[8] The report showed that in a period of just two years between 1996 and 1998 there was a four percentage point reduction in the proportion of firms offering pension coverage of some sort—from 38 per cent to 34 per cent—and a significant drop in the number of active members in defined-benefit occupational pension schemes run by larger companies (those with over 20 employees)—from 71 per cent of such employees in an occupational scheme to 59 per cent.

At the time of writing, most of the 137,000 or so occupational schemes are defined-benefit, but 85 per cent of those set up since 1998 are defined-contribution or a hybrid of the two types.[9] Traditional defined-benefit occupational pensions are suffering under the weight of increased longevity of members, investment risks, and government regulation.

Table 2
Occupational Pension Provision in the UK

Proportion in receipt of occupational pension income

	1995-1996	1996-1997	1997-1998	1998-1999	1999-2000
All pensioner units					
Total	58%	60%	60%	60%	59%
Single pensioners	48%	51%	50%	50%	52%
Pensioner couples	73%	74%	75%	74%	71%
Recently retired pensioner units					
Total	64%	67%	67%	66%	64%
Single pensioners	49%	52%	51%	52%	51%
Pensioner couples	73%	75%	76%	74%	71%

Source: *Pensioners' Incomes Series 1999-2000*, Department of Social Security.

Note: The term 'Recently retired pensioner units' refers to a man aged 65 to 69, a women aged 60 to 64, or a pensioner couple where the man is aged 65 to 69.

Until 1996-97, the proportion of pensioner households in receipt of an occupational pension grew steadily to 60 per cent and has since stayed at about that level.[10] Whether this is a peak in occupational pension provision remains to be seen, but there is some supporting evidence in that over the past two years there has been a fall in the proportion of *recently retired* pensioner households receiving an occupational pension, as can be seen in table 2 (p. 11).

The average amounts received from occupational pensions have risen rapidly over the past 20 years. Between 1979 and 1997 growth in average occupational pension income for pensioner households was 86 per cent—faster than for any other source of income. Table 3 (p. 13) gives further details.

Despite some convergence recently, median occupational pension payments remain low compared to average payments, suggesting that occupational pensions—and of course the earnings from which they are derived—are paid on a quite unequal basis. Occupational pension coverage is also far from universal. In summary, occupational pensions have provided an excellent form of saving for middle and higher earners, and those with relatively stable or traditional employment patterns. Further steps must be taken to preserve and nurture this sector.

The universal protected pension that is proposed later in this paper seeks to build upon the basis of occupational pensions by running alongside them. The UPP will complement occupational pensions where they have failed to deliver adequately—on universality and on redistribution.

2. The Government's Response

(i) The Minimum Income Guarantee

Faced with these challenges—of people retiring into poverty after a lifetime of work, a widespread distrust of government pension schemes, an over-reliance on means-tested provision, and a weakening of occupational schemes—the Government has made a series of reforms. How do these match up to the pensions challenges?

Table 3
Mean and Median Amounts of Occupational Pension Income Received by Those with Entitlement (July 1998 prices)

	1994-95 £ pw	1995-96 £ pw	1996-97 £ pw	1997-98 £ pw	1998-99 £ pw	% Growth 1979-1996/97
All pensioners						
• Mean amounts						
All pensioner units	89	88	92	95	97	86%
Single pensioners	62	61	65	68	70	65%
Pensioner couples	117	116	121	124	127	107%
Recently retired pensioner units						
• Mean amounts						
All pensioner units	113	120	125	130	129	100%
Single pensioners	84	81	85	88	89	90%
Pensioner couples	126	137	141	147	145	109%
All pensioners						
• Median amounts						
All pensioner units	49	48	52	55	55	126%
Single Pensioners	36	35	38	40	41	94%
Pensioner couples	74	65	73	80	81	200%
Recently retired pensioner units						
• Median amounts						
All pensioner units	72	70	78	83	82	170%
Single pensioners	52	54	58	60	56	135%
Pensioner couples	83	80	93	102	99	203%

Source: *Pensioners' Income Series 1998-99*, Department of Social Security

Table 4
Weekly Rates of the Minimum Income Guarantee and Basic State Retirement Pension

Category of benefit/pension	1999-2000 (£)	2000-01 (£)	2001-02 (£)	2002-03 (£)	2003-04 (£)
MIG single (60/65 -75 years old)	75.00	78.45	92.15	98.15	100
MIG couple (60/65 -75 years old)	116.60	121.95	140.55	149.80	154
MIG single (75-80 years old)	77.30	80.85	92.15	98.15	100
MIG couple (75-80 years old)	119.85	125.35	140.55	149.80	154
MIG single (80+ years old)	82.25	86.05	92.15	98.15	100
MIG couple (80+ years old)	125.30	131.05	140.55	149.80	154
Basic State Pension single	66.75	67.50	72.50	75.50	77
Basic State Pension couple	106.70	107.90	115.90	120.70	123

Note: In the November 2000 pre-Budget report the Government committed itself to the rates in this table from 2001, except for the 2003-04 level of basic state pension which is the Government's predicted level based on expected price inflation.

The Government rightly wants to help today's poorest pensioners. The centrepiece of this effort is the minimum income guarantee (MIG)—in effect, a higher rate of income support that is to be raised in line with average earnings. As table 4 (p. 14) shows, the MIG is paid well above the basic state pension. In April 2001 the MIG was raised by almost £14, while the basic state pension was raised by £5. The gap between the two will increase to £23 per week in 2003-04, up from £8.25 in 1999-2000.

There are serious problems with this policy. First, the MIG offers a retirement income that increases with average earnings. No other pension, public or private, can currently match this. This clearly gives an incentive to opt for the MIG and is bound to cause resentment amongst those who have savings and price-linked pensions.

Because it is a means-tested guarantee, the MIG acts as a powerful disincentive to save. At the same time, the Government is also raising expectations it cannot necessarily fulfil, because it cannot bind its successors to retain the earnings link. The Government can only guarantee that the MIG will rise in line with earnings for the rest of the current parliament. Pension provision should be all about planning based on rational expectations, but unfortunately the MIG manages simultaneously to tell people 'don't save, but don't be too sure about relying on us either'.

The minimum income guarantee and its predecessor, income support for pensioners, suffer a particularly serious flaw in that people with savings over a specified level (£6,000 in 2002-03) face withdrawal of the benefit according to a computed 'tariff income' which is effectively an assumed interest rate of about 20 per cent. If savings were above another level (£12,000 in 2002-03) then all entitlement to benefit was lost.

This arrangement means that those with small savings are worse off than those who have less savings and more benefit income. The situation is compounded by the fact that entitlement to the minimum income guarantee carries with it a passport to entitlement to other benefits such as housing benefit, council tax benefit, dental treatment, treatment by opticians, and other forms of means-tested help. The end result is not only that those people with small amounts of savings are less well-off than those on benefit, but that many of those with income from, say, an occupational pension who have a much higher initial income than the minimum income guarantee, because of the range of means-tested help available, have a lower standard of living than those on benefit.

(ii) The Pension Credit

In recognition of the disincentives to save caused by the minimum income guarantee, and the injustice felt by those who have saved, the Government announced in the March 2000 Budget that it was planning a 'pension credit'.

The credit works by topping-up to £100 the full level of basic state pension (£77 per week) in the expected year of introduction 2003, and then giving 60p per week for each £1 of income from savings, pensions (except the basic state pension), earnings, or investments. This income subsidy is added to the £100 minimum income guarantee to give a final weekly income. Because of the nature of the taper, initial income is higher than income with the credit at £135 and therefore all people above this level receive no benefit.[11] As this has proved hard enough for politicians and pensions experts to grasp, whether or not it will resonate with pensioners remains to be seen.

It is true, however, that the credit will mitigate some of the most pernicious effects of the minimum income guarantee and that the group who were previously penalised the most may now be better off than those on the MIG.

Whether the credit will tackle the disincentives to save provided by means-tested benefits is doubtful. The Government thinks it will—thereby buttressing stakeholder saving—but pensions is a long-term business and it is unlikely that the credit will be regarded by those who are some time away from retirement as a scheme that will stand the test of time.

Moreover, as the Pension Provision Group has pointed out, the Government's intention to base credit awards on actual income rather than tariff income—although undoubtedly motivated by a genuine concern with the injustices of tariff income—could make some pensioners worse off.[12] This is because the capital limits for the minimum income guarantee were raised to £6,000 and £12,000 in April 2001, meaning that for pensioners with savings below about £8,000 tariff income would be based on a such a small portion of their savings that the computed income would—even with the punitive 20 per cent or so notional interest rate—amount to less than actual income from the entire £8,000 of capital.

With around five million pensioners likely to be eligible in the first year alone, the costs of the credit are substantial. In the first year the Government estimates the costs to be £2 billion. The cost thereafter will depend on how the credit is increased. If it is increased in line with earnings while the basic state pension from 2003 is again price-indexed, then an ever larger number of pensioners will qualify for support. The effect of the increasing differential with the basic state pension will be to extend eligibility for the credit up the income scale such that by 2050 the pension credit will cost an astonishing £26 billion in 2002 price terms and cover about three quarters of all pensioners.[13]

As ever with mean-tested benefits, the high risk of fraud and error remains. The complexity of the credit will make administration difficult and increase error. In particular, the Government plans to assess income just once a year—a move that could be problematic and lead large numbers of people to have erroneous or even fraudulent claims.

In many ways the pension credit is the result of an ill-thought-out pensions strategy that simultaneously tried to encourage more savings while extending means-testing. In its favour, the credit should mitigate some of the worst examples of unfairness under the minimum income guarantee, whereby someone with a very small, but disqualifying amount of capital found themselves poorer than someone with no capital and full entitlement to the minimum income guarantee.

However the credit is itself a means-test and will generate resentment at a higher income level than did the minimum income guarantee. Whether the credit will encourage long-term saving through stakeholder has to be extremely doubtful. This is because the credit is highly complicated and is not based on property rights, meaning that an incoming Government could easily sweep it away or severely cut the benefit. The final version of the credit may indeed offer short-term respite for those penalised by the means-test. What it does not do is tackle the long-term problem of means-testing and insufficient provision for low and modest earners.

(iii) The State Second Pension

After the minimum income guarantee the second major part of the Government's reform strategy is a new pay-as-you-go pension for very low earners called the state second pension, introduced in April 2002. This new pension replaces the state earnings related pension scheme (SERPS) and is therefore compulsory for all those in work unless they are contracted out into an occupational or personal scheme such as a stakeholder pension.

The state second pension is twice as generous as SERPS to those on earnings of up to £10,000 per annum. The Government's intention is that those with earnings above this level will contract out into a pension such as a stakeholder. To this end the state second pension has an accrual rate half that of SERPS between £10,000 and about £25,000, the idea being that above £10,000 it will probably pay to contract out.

The December 1998 green paper stated that the state second pension would have three aims:

- to boost the pension entitlements of those on low incomes and carers;
- to cut the number of people who need to rely on income-related benefits in retirement;
- to help moderate earners build up better second pensions.[14]

The need for second-tier pension reform is urgent. Projected awards from SERPS are an indictment of policy in this area. The Government Actuary calculates that men on average earnings now retiring on the basic state pension and SERPS will receive a total pension equal to 36 per cent of male average earnings. This proportion is starting a steep decline, which will continue unabated such that by 2050 a man retiring on average earnings and a full basic state pension plus SERPS will receive 20 per cent of male average earnings. This is less than the basic state retirement pension *alone* provided in the late 1970s.[15]

The Government's genuine desire to help poorer workers cannot be questioned, and the reform is not without merit. It features a significant amount of redistribution and there is the overdue recognition of work done by carers, and the special difficulties disabled people have in accumulating a pension. However there are at least two causes for scepticism about the state second pension.

The first and most fundamental objection is the state's poor record in safeguarding pay-as-you-go pensions. SERPS is the latest such pension to have its value severely cut by politicians wishing to minimise future liabilities. The 'property' rights inherent in an unfunded scheme provide a less secure claim to future wealth than do the property rights inherent in a funded scheme. Although this is a general problem of pay-as-you-go pensions, there is reason to believe it may be especially acute with the state second pension.

If the rebate structure to woo people out of the state second pension into stakeholder is successful then the state second pension may end up as a pensions ghetto for the poorest and most vulnerable in society. Then, unlike with the basic state retirement pension, there will be no broad coalition of voters to uphold the claim. Unlike SERPS there will not even be a coalition of low and moderately paid people to uphold the claim.

The second cause for scepticism is that the state second pension, even if it were to survive for fifty or more years in its current form, still might not be generous enough to float people off means-tested benefits. The Government admits that even if this reform goes according to plan, the proportion of pensioners on income support will be cut to one in four by 2050 as opposed to one in three in 2050 without those reforms. If pension credit is included these figures are completely transformed to one in two pensioners on means-tested support from 2003. This weakness could easily be used as a justification for the abolition or alteration of the state second pension.

(iv) The Stakeholder Pension

The Government introduced a new stakeholder pension in April 2001. Essentially, stakeholder pensions are funded defined-contribution pensions. The main features of stakeholder are:

- stakeholder is a funded pension aimed at those on modest incomes of between £10,000 and £20,000 per annum who do not have occupational or personal cover;[16]
- stakeholder is non-compulsory in the sense that no saver will be forced to buy it;
- stakeholder is compulsory only to the extent that all employers who have five or more employees, and who do not offer an occupational pension or a personal pension to which they make contributions of at least three per cent of their employees' earnings, have to offer their employees access to a stakeholder, and offer a mechanism to pay into a stakeholder pension from an employee's earnings. No one will be compelled to take up the offer of stakeholder. Workers earning below the national insurance lower earnings limit, and those who have worked for the firm for less than three months, are not counted towards the five employees;
- employers have been able to offer access to stakeholder since April 2001 but have had to do so since October 2001. Employers must precede this offer by a period of consultation with the workforce;
- to qualify for stakeholder status a pension must meet the CAT (cost, access and terms) standards. The Government has now set out these standards with respect to stakeholder;

- the most significant part of the CAT standard for stakeholder is a limit on the charge a pension provider can levy to cover administration and basic information costs of one per cent per annum of the accumulated fund an individual has built up;
- the stakeholder CAT further stipulates that stakeholder must be flexible. Contributors must pay be able to pay as little as £20 per month in any month they wish to contribute. Providers must also ensure that savers are able to transfer their funds to another scheme without additional charges;
- one useful part of stakeholder (which may however lead to many outside the target group purchasing) is that it can be purchased by those who are not in work, up to a limit of £3,600 per year including basic rate tax relief;
- stakeholder pension schemes can be governed in one of two ways. They can either follow the industry norm in being run by boards of trustees, or they can be run by a stakeholder scheme manager who has been authorised by the Financial Services Authority;
- subject to the £3,600 per annum limit, a stakeholder pension can be contributed to by someone who is also contributing to a defined-benefit occupational scheme but only if that person has earned less than £30,000 per annum in one of the past five years and is not a controlling director;
- part of the Government's planning for stakeholder is the creation of a suitable taxation environment. As of April 2001, the tax regime for defined-contribution pensions, including stakeholder, was simplified. Employers' money purchase schemes may opt into this new tax regime;
- it is possible to contract out of the state second pension, using a stakeholder pension. The contracted out rebates are then paid into the stakeholder scheme. The Government intends that the rebates will be such that it will be financially attractive for those earnings more than £10,000 to contract out.

The aim of extending funded pensions down the income scale is an entirely laudable one. It also appears to be the case that the charging environment created by stakeholder's maximum charge of one per cent per annum of the accumulated fund has helped bring down charges for personal pensions generally.

But there are reasons to doubt whether the aim of getting those on moderate incomes into funded pensions will be achieved by stakeholder as it is currently constituted. Indeed, survey after survey from the pensions industry has shown poor take-up, and poor consistency of payments, by the target group for stakeholder. Almost all of stakeholder's problems stem from it not offering a combination of sufficient redistribution and compulsion.

Stakeholder is not compulsory for workers. This fact leaves unresolved the classic problem of moral hazard—that people may not save, confident that others will pick up the costs of their failure to do so.

Because buying a stakeholder will not be compulsory, providers will have to persuade people to buy, as they do for any other product. The aim must be for as many people as possible to make a fully informed and correct decision. The Government says there are up to five million people in the target group for stakeholder (those earning £10,000-£20,000).[17] There is good reason to believe that persuading these people to bite the bait will always be difficult. The early data from the Association of British Insurers has shown that amongst the target group there has been both disappointing take-up and low average contributions to stakeholder pensions.

Taking out a pension is fraught with difficulties, even with advice. The target group for stakeholder is no different from most other income groups in that they normally lack appropriate financial expertise. Yet with stakeholder the choice is particularly complex.

Alongside stakeholder there is now the wage-indexed version of income support for pensioners, the minimum income guarantee. As of April 2002 there has been the state second pension, and in 2004 the pension credit will see the light of day. How much each of these will be worth at various points in the future, given political uncertainty about the long term and, for individuals, earnings and contribution expectations, is difficult, even impossible, for pensions advisers, or anyone else, to foresee. Stakeholder customers will either have to gamble on employing an independent financial adviser at significant cost, or else trust their own judgement. Either course is fraught with the risk of being caught in a retirement plan that ultimately provides a poor return.

Without compulsion linked to a single product there is a need for advice. The Government has regulated for stakeholder providers to supply information and basic advice at a fee of no more than one per cent per annum of the accumulated stakeholder fund. This sounds innocuous enough, but in fact such a charge over a working life of 40 years would amount to about 20 per cent of the fund's value.[18] Because the charge is set as a percentage of the accumulated fund it is 'back-loaded' so that most of it falls when the worker is near retirement and has a large fund. This means that little of the charge is available to cover the costs of advice up-front—which is precisely when advice is most needed. It remains to be seen whether pension providers will be able to offer more advice up-front on the expectation of winning a customer for the long term. A difficulty for providers is that, because the charge is levied as a percentage of the accumulated fund, the profits come when funds are larger, later in the lifetime of a saver. Because stakeholder pensions are designed to be totally portable there is nothing stopping a saver switching to a lower-cost provider 20 or 30 years down the line. Many in the industry are deeply concerned about whether these arrangements will prove disastrous for providers. Even those who are more optimistic admit that offering stakeholder to savers with small pension pots is 'a gamble'.

While it may be possible through expensive advertising to boost the overall take up of stakeholder (although probably not the long-term commitment by the target group to saving in a stakeholder), such figures raise the spectre of the product being bought inappropriately on a considerable scale. Indeed, such is the dearth of knowledge of and intent to buy stakeholder amongst the target group that the conditions for a repeat mis-selling scandal are frighteningly propitious.

In 1988, following the 1986 Social Security Act, there was aggressive marketing of private pensions offering consumers who had never before had funded pensions the chance to do so. This was accompanied by a change in the regulatory requirements that disrupted an established pattern of savings. At the time there was a government keen to achieve its take-up goals. All these factors are again present with stakeholder. Even if the providers have learned their lesson and do not mis-sell, the complexities are such that many people without advice will mis-buy.

This situation should ring alarm bells in Whitehall, among consumer protection bodies, the financial services industry and the public.

(v) Audit of the Government's Measures

One think tank thought to be close to the Government, the Institute for Public Policy Research, believes the Government's pensions strategy is unravelling. The intentions behind the minimum income guarantee are laudable, but the Government's judgement in adopting this strategy is questionable. At a stroke it made a large number of pensioners worse-off compared with other similarly placed pensioners who could not or would not save. In an attempt to dig themselves out of this means-tested hole, the Government has introduced a second means-test called pension credit. Both the minimum income guarantee and the pension credit are linked to rises in earnings and are not sustainable in the longer run. At some stage a future government, if not this one, will break the earnings link for these two benefits. The state second pension, on the past performance of unfunded state provision, will similarly fail to last the course. Stakeholder, which has so far had the very welcome effect of reducing pension charges, is overwhelmingly bought by people outside the target group. Occupational pensions, the bedrock of UK retirement provision for four decades, are in crisis. A new approach is urgently needed.

3. Introducing an Adequate First-Tier Pension

Towards the end of my period as Minister for Welfare Reform in 1998, I was asked by the Prime Minister to draft a paper on what course pensions reform should take. In opposition I had presented Tony Blair with a copy of pension proposals costed by the Government Actuary. The approach, which aimed at universal pension coverage—but not in a state-run scheme—was to be the basis, if not the blueprint, of discussion in Government about how best to beat pensioner poverty.[19]

Soon after resigning, I brought together a group to examine the initial ideas I had put to the Prime Minister and to propose long-term reforms that would have a real chance of defeating pensioner poverty, and allow people on modest incomes to know throughout their working lives that each penny saved would be additional wealth in retirement and would simplify massively the savings framework for savers, employers, regulators and the Government.

(i) Fundamental Assumptions

The group, which became known as the Pensions Reform Group, proposed the introduction of a universal protected pension (UPP) with two marked differences from the Government's pension agenda, and indeed more generally its welfare reform strategy. First, the UPP is the only scheme on the drawing board that has as an objective the elimination of poverty in retirement. Second, because of the very large numbers of relatively lowly-paid workers in the UK, any pension scheme has to decide both the extent of redistribution and, equally important, at what stage that redistribution should take place.

The Government has chosen a model of redistribution at retirement in the form of means-tested additions to inadequate retirement incomes. The UPP is designed to hardwire that redistribution into pension entitlement. From what might appear to be an inconsequential difference the most consequential of results follow.

Prior to the Labour's return to office in 1997, the welfare debate was dominated by the phrase 'thinking the unthinkable'. This was a slogan taken up by the media to symbolise what in Government would be a fundamental change in Labour's welfare strategy. From the 1960s onwards, and maybe earlier, Labour increasingly held a view of human nature at variance with the facts. Human nature was either written out of the political script entirely, or it was cast in a totally benign role. Both stances were dangerous to the successful operation of welfare in particular and the well-being of society in general. 'Thinking the unthinkable' put into practice was to mean reconnecting Labour with its voters. In welfare this meant replacing the naïve understanding of human nature with a realistic one. The standing of self-interest in welfare reform had to mirror the pre-eminent position it holds in the life of individuals and in the affairs of nations.

Self-interest is the most powerful of human motives and therefore the one with the most potential for sustaining—or destroying—social reform. It cannot be written out of the script. Nor should that be tried. Self-interest is in both public and private life the greatest force for change. Whether the balance of such action is for good or ill depends generally on the web of social conventions built up over many centuries as well as the legal framework and the fiscal and welfare incentives and disincentives set by government.

In one of his many memorable phrases, William Temple set out what he believed to be the due importance for this most fundamental of human motives. Temple, who was briefly Archbishop of Canterbury during the war years, published a work that has come to be regarded as a classic of its kind called *Christianity and Social Order*. In this little volume Temple observed that:

> the statesman who supposes that a mass of citizens can be governed without appeal to self-interest is living in a dreamland and is a public menace. The art of government is the art of so ordering life that self-interest promotes what justice demands.[20]

It was because of this failure to read human nature appropriately, and act accordingly, that for almost three decades a growing proportion of voters thought Labour in office would be a public menace and took countervailing action to prevent this occurring. 'Thinking the unthinkable' in welfare meant devising reforms where self-interest was once again elevated to the position it deserved.

Another part of thinking the unthinkable was to assert a dynamic rather than a static conception of how human nature and welfare interact. Means-tested welfare is the most efficient means of providing welfare if delivering income to the poorest is the only consideration and the measurement of that success is an immediate one based purely on net income. But to be effective welfare has to last for more than, as the psalmist says, the twinkling of an eye. It is this interaction over time between human nature and whatever welfare provision is on offer that spells the inevitable failure of an expanding means-tested strategy.

Put bluntly, when the self-interest of individuals runs up against a large-scale means-tested form of welfare, the benefit to society of the desire for self-improvement of individuals is greatly reduced or even destroyed. Instead, self-improvement is trapped into working the system in a way that becomes self-consuming. The proposals for the universal protected pension are built on the assumption that the reform must be cast so that every encouragement is made to allow self-improvement to benefit the individual and society simultaneously.

To achieve this, redistribution has to be part of the scheme as it builds up—thereby constructing a floor under the efforts of individuals. Any such efforts are thereby rewarded. This is in stark contrast with a system that redistributes at the end of a working life to those who have failed to provide themselves with adequate pensions. Failure instead of success is now the outcome that is rewarded. And because the incentive is to fail, the cost of redistribution is likely to be substantially greater than in the pension scheme described here.

The universal protected pension will offer a protected flat rate universal pension with pensions paid on a defined-benefit basis. The UPP has as the aim of abolishing pensioner poverty by way of introducing an adequate first-tier pension. There is a debate to be had on when people should be brought into the scheme. Our simplified model is based on the scheme covering everybody reaching 25 years of age who is paying national insurance contributions, or who has primary care for a child under five years of age, or who has full-time caring responsibilities. The self-employed, and those who subsequently become self-employed, will be included in our scheme.

The pension will pay a sum of between 25 and 30 per cent of average earnings. It combines a funded scheme with the existing national insurance pay-as-you-go basic state pension. The scheme is therefore a hybrid: part funded, part pay-as-you-go. In this way the problem of 'double payment' by existing contributors arising from the discontinuation of a pay-as-you-go scheme is largely avoided. The basic state pension forms part of the hybrid scheme. The pension will be funded by an increase in the employee rate of national insurance contributions as shown in table 5.

Table 5
Required Contribution Addition to Employee National Insurance for the Universal Protected Pension

	Retirement Age at 65	Retirement Age at 70
Gross Contribution (without SERPS/S2P rebate)	9.9%	6.9%
Contribution with SERPS/S2P rebate	5.2%	2.2%

Once in payment the funded part of the scheme will be linked to earnings. On current projections there will be money in the National Insurance Fund to link the pay-as-you-go part of the scheme (i.e. the existing basic state pension) to earnings as well. Payments from the funded part of the scheme would be added to the basic state pension, so that the total pension would equal the level of entitlement earned. Once in full payment, an earnings-linked pension would ensure that pensioner poverty is not only eradicated, but that it never returns.

(ii) Benefits of the Universal Protected Pension

Because the protected pension is set considerably higher than the income support level, and linked to earnings, everyone in the scheme will be guaranteed a retirement income well above the means-tested minimum income guarantee. This will allow people to make further second-tier provision, knowing that they will not be penalised for doing so. Everything they save will increase their pension entitlement, not reduce it. The perverse incentives of the benefit system will be circumvented for many more people than looks to be the case under the Government's proposals. Pension providers and insurers will be able to sell products knowing that their client will enjoy the full benefit.

Having a first-tier pension above means-tested benefits will mean significant savings on expenditure on these benefits. In fact, figures supplied by the Government suggest that, in today's money, these savings would be at least £10 billion per year, equivalent to 4p on the basic rate of income tax, or enough to abolish income tax for pensioners entirely. This bill is rising rapidly, especially with the introduction of the pension credit.

It is true that a very small number of pensioners with particularly large housing benefit and council tax benefit entitlement will still be eligible for some of these benefits. However our scheme lifts everyone well above means-tested MIG/income support and, moreover, lifts everyone up to an income whereby, even if they did stand to receive some means-tested support from housing benefit and council tax benefit should they not save, their protected pension will make saving and overcoming these thresholds much easier, more desirable and worthwhile.

A compulsory national scheme will be able to work like a defined-benefit occupational pension, paying pensions directly from the central fund. And because the target minimum keeps pensioners off income support, a central justification for compulsory annuity purchase in the second tier—that people may otherwise fall back on state support—is removed. A revitalised first tier will allow much greater freedom for products in the second tier. Constraints should only be needed to prevent their abuse for tax purposes.

A single national scheme will have the advantages of defined-benefit schemes, in that people can know for certain how much pension they will receive, without the distortions that company schemes can introduce into the labour market by making older employees more expensive to take on and retain. Moreover because the scheme is national it will not penalise labour mobility as some defined-benefit schemes have done in the past. And with no marketing costs the scheme will be far cheaper to administer than personal pensions, or even stakeholder pensions. As we have said before, a stakeholder scheme charging one per cent of the fund's value each year cuts savings by about 20 per cent over 40 years. Our scheme has been costed by the Government Actuary to include an annual 0.5 per cent management charge. However, it should be possible to achieve a lower charge than this given the economies of scale—and this would be a key aim of the scheme's trustees.

Because the scheme is largely pre-funded, it will be better protected against political interference than a pay-as-you-go scheme. A board of trustees will exist to protect the interests of all scheme members. As people will 'own' their savings, political pressure will be maximised to prevent any Government cuts to the level of pension for existing pensioners, or alter the level of pension (as a percentage of earnings) that has already been 'bought' by a year's contributions.

For the vast majority of people a protected pension of this nature cannot be bought in the market. This is how an element of redistribution can be made politically viable. In return for this security, higher earners in the scheme will be asked to pay a graduated contribution up to the existing employee national insurance ceiling—£585 per week in 2002-03. Low earners will also get the pension without being thrown onto the means-test. Higher earners, in buying the protection for themselves in the form of an earnings-linked funded pension—while helping lower earners to buy the same, are also buying lower welfare bills in the future. This argument applies in particular to those cohorts following the early years of the scheme who will still be in work when the first pensioners start to benefit. However it also applies to those more affluent members of the first cohort in the universal protected pension, as these people would expect to pay income tax in retirement.

Included in the costings is an assumption that in the event of premature death—i.e. death before receiving payment of the pension—an individual's contributions plus return would become part of that individual's estate. This means that for the first time every worker, and every carer, will have life cover.

This model for life insurance is simplified. The Government Actuary also suggested that it would be possible to have a more sophisticated version whereby the estate of each person in the scheme would be entitled to a sum of about £100,000 should the contributor die, irrespective of how long they had been contributing. Under this option older contributors would subsidise younger contributors who died prematurely—clearly a desirable arrangement with respect to young families who are bereaved.

(iii) A Single Compulsory Scheme

The scheme extends the existing degree of compulsion—we are not advocating moving from a situation of freedom to one of compulsion. Contributions to the basic pension and to a second pension, whether state or private, are compulsory already for workers paying national insurance contributions. The new element in our proposals is that instead of contributing to an insecure state pension like SERPS, or the state second pension, contributors will be paying into a secure, good-value funded scheme. And because everyone needs a decent pension, either on its own or as the first building block of retirement planning, using compulsion to ensure that everyone has one makes sense.

Compulsion has many other attractions for pension provision. Survey after survey reports that people think very little about pensions until they are into their mid-thirties— indeed many leave it much later.[21] Unfortunately by this time very large amounts of compound returns will have been lost compared to someone who began saving ten years earlier. Our scheme brings everyone in early in their working lives and thereby generates very significant compound returns. This helps keep contribution rates down.

Compulsion is also the best way in which satisfactory redistribution can be secured. It is worth noting the contrast with stakeholder. Stakeholder has very little redistribution, indeed, as with personal pensions, higher-rate taxpayers will receive far more benefit from the Exchequer than basic-rate taxpayers—66.7p for each additional £1 invested compared to the 28.2p received for each additional £1 for the stakeholder target group (all of whom are basic-rate taxpayers). What is more the new state second pension rebates will, as with SERPS rebates, continue to benefit those who pay more national insurance contributions. Only a single scheme, which brings in higher earners, and levies moderately graduated contributions on these higher earners, can pay the pensions of the working and deserving poor.

There is no magic actuarial solution to the uncertainties of future increases in longevity, possible changes in the birth rate, and sustained changes in investment returns. Our scheme is not immune from these—no pension scheme can be. However, because we are proposing that membership will be universal, these risks can be spread throughout the population.

(iv) Funding of the Universal Protected Pension

The benefits of funded schemes have in the past been claimed as a way to magically make pensions cheaper, thereby defusing the ‘pensions time-bomb’ that is predicted to explode in the West within the next generation. Those who favour unfunded pensions insist the stock market is too risky for first-tier provision or that pay-as-you-go is much easier to administer. The issue of funding is not as clean cut as either of these views, but is absolutely central to pension reform and demands careful treatment.

Two points should be made immediately. The first is that any pension scheme, no matter how it is paid for, is a claim on future wealth. Funded provision has to be withdrawn from the capital market and converted into income on retirement. With unfunded pensions current contributors, or taxpayers, meet the pensions bill. Secondly, if as a society we want substantially larger pensions, we are going to have to pay more for them. We do not attempt to disguise that fact in this paper.

The two state pension schemes in this country are unfunded or pay-as-you-go; both SERPS and the basic state retirement pension are paid for by national insurance contributions from employers and employees. Those in work pay for today's pensions in the hope that future workers will pay their pensions. The state second pension will also be of this type.

There are strengths to unfunded pensions. The most obvious advantage is that, by avoiding investments, unfunded pensions avoid stock market risk. Unfunded pensions thereby also side-step the need for any investment decisions to be taken or the need for fund managers.

The avoidance of stock market risk should not be confused with the avoidance of all risk. The main threat to pay-as-you-go pensions is in fact political.

Whatever may be the received wisdom of the moment, we are in an age where there is great resistance to raising taxation. Despite some of the recent hype, the business cycle has very probably not been abolished, and reducing the value of pay-as-you-go pensions is one option a future Government that finds itself under financial pressure has to reduce spending or avoid the need to raise taxes or national insurance contributions. The tax-resistant culture we live in means that relying on a state pay-as-you-go pension puts at risk the pensions agreement when the economy takes a downturn and public finances are pushed into the red.

Past experience confirms this danger. Those retiring on SERPS early in this century will feel, with justification, that their pension was not quite what they thought they were contributing towards. Such a pensioner would find that his or her SERPS rights were based on their full working life rather than the best 20 years of their working life as had been the case when SERPS was set up; they would also find that much of their pension is to be calculated not on 25 per cent of income—the original agreement to which they signed up—but on some level between 24.5 per cent and 20 per cent depending on when they retire; finally, some groups of pensioners, including women, will suffer due to a series of technical changes in the Pensions Act 1995—which the Government Actuary estimates halved the value of the scheme.[22]

The changes to the entitlement rules of SERPS in the 1980s and 1990s show that although unfunded pensions avoid stock market risk, they can carry very significant political risks. It is a risky strategy indeed to assume that the behaviour of future politicians in respect of pension promises is likely to differ from the behaviour of past politicians.

Here is the crucial difference: a funded scheme is based on property rights. The scheme members 'own' the investments in assets chosen by fund managers. Experience in this country teaches us that property rights are more likely to be safeguarded and that they therefore carry much less political risk. We believe the ownership of pension capital in the form of shares in assets is a much surer claim on future income than having contributed to the pension of someone else through pay-as-you-go.

There are other forceful arguments in favour of funding. Funding opens up the possibility of investing abroad to take advantage of countries with different demographics and perhaps the potential for rapid productivity growth and a high rate of return on capital. This could be particularly beneficial when an unusually large cohort retires—such as the 'baby boomer' generation. These options are clearly not open to an unfunded scheme which is to a large extent controlled by the demographics of the domestic country. Indeed, in such circumstances the changing demographics are likely to increase pressure to reduce pay-as-you-go pensions.

(v) A Hybrid Scheme: Avoiding the Problem of 'Paying Twice'

We do not propose to abolish the basic state retirement pension. It will remain. The unfunded nature of the scheme will also be retained. The basic state pension is the only trustworthy form of British state provision yet devised: it is cheap to administer, the public finds it relatively easy to understand, it spreads risk alongside a funded element, and it is the established first tier of an individual's retirement income. In our scheme the basic pension forms the first part of the universal protected pension and the funded element forms the second part. Our aim is to get rid of poverty in old age, not the national insurance scheme.

By avoiding a complete switch away from unfunded pensions we reduce the impact of current workers 'paying twice'. Double payment arises when a pension scheme is wound down for which current contributors have paid but from which they won't benefit, while at the same time having to pay for their new scheme. A switch from a nation-wide unfunded scheme, such as national insurance, to a funded scheme would generate a huge double payment liability. This liability can be mitigated either by government borrowing or paying taxes.

Our scheme reduces these difficulties by rejecting a complete switch away from unfunded pensions. All workers and employers will continue paying national insurance contributions towards the first part of their pension guarantee. As each cohort retires they will continue to draw the basic state retirement pension. Current workers will pay larger premiums only for their own pension. There will be some additional costs to help the poorest pensioners—age-related enhancements to the basic state pension. But these measures will be time limited, i.e. up until all those aged 26 when the universal protected pension is introduced are no longer living. At that point taxpayers costs for these measures will cease.

(vi) Governance of the Universal Protected Pension

The universal protected pension will need a suitable governance structure laid out in the Act of Parliament establishing the scheme. Because it is funded, the universal protected pension will need a body to safeguard the scheme and oversee the fund managers. Our outline proposals here are for a hybrid model of elected and public trusteeship, although it must be emphasised that these are only preliminary suggestions and that further detailed discussion will look closely at the different mechanisms for ensuring a suitable governance structure.

A serious concern with the proposals we make here is the possibility of government influence on the rates of contributions of pension provision. The most infamous examples of government intervention that generated exceptional hostility were, of course, the move from earnings indexation to price indexation of the basic state pension, and the cuts to SERPS under the 1986 and 1995 Acts. Our scheme will be largely funded, and therefore inherently more secure, but the possibility of government interference based on considerations other than what is best for the members of the scheme must be countered. Although a constitution allowing the government extensive powers in these respects might be preferred by some people as it would ensure democratic control, the post-war history of government involvement in pension provision is one of continual upheaval and promises reneged upon by incoming administrations eager to cut costs.

The aim must to be create a stable method of governance, and we believe that such a method can be found in a form of trusteeship. We propose that the universal protected pension will have a board of trustees, some of whom could be democratically elected, and some of whom could be appointed.

From stakeholder's inception in the December 1998 Green Paper *Partnership in Pensions* to employers having to offer stakeholder to employees in October 2001 is a period of almost three years. We anticipate that with a more radical reform such as the universal protected pension there will be a national consultation exercise on all aspects of the reform, including governance.

Under our simplified model, members are brought into the scheme as they turn 25. Our view is that, if some of the trustees were eventually to be directly elected, then during the first few years of the scheme's operation it would be sensible for trustees to be appointed as the contributors at that time would have little money in the scheme, and, crucially, because the electorate in the first few years is going to be relatively small, the arguments are weighted against direct election of public trustees.

There is a strong case to be made for ensuring that some or all of the trustees are experts. The case for expert trustees has recently been argued by the Myners review of institutional investment. The investment of pension funds, like monetary policy, is a specialised task. The Bank of England Monetary Policy Committee has shown that a group of expert appointees can operate in an effective and independent way. However, we do think that members who 'own' the investments should have a greater say than is the case with the Monetary Policy Committee where the Chancellor of the day chooses the experts. One option here would be to have the trustees part elected and part appointed by government. However, to a certain extent, this system would leave intact problems of insufficient expertise, unsuitable but charismatic trustees, and inappropriate government influence.

Another option to be considered during the follow-up to the report by the Pensions Reform Group is that a large board of governors could nominate trustees with appropriate financial expertise. The nominations could then be put to the members of the scheme who would approve or reject the candidate.

Because it is desirable to curtail the influence of the government in running the pension, the trustees will be invested with quite considerable powers. These will also be established in the Act and will include:

- the power to appoint and dismiss fund managers and decide on the number of fund managers the scheme requires;
- the setting of investment strategy;
- the power to make changes in contribution rates.

With these powers go other statutory duties. The Act will lay down that, in accepting appointment as a trustee, a person is accepting a responsibility to deliver the commitment of a funded pension equal to between 25 to 30 per cent of full-time average earnings minus the basic state pension. As we have said elsewhere in the paper, after 2040 there are sufficient ongoing surpluses in the national insurance fund to re-link the basic state pension to earnings. It will be the responsibility of the trustees to make the remainder of the guarantee up, be it slightly more or less than 19 per cent.

Clearly, with a specified target to reach there must be checks on whether the performance of the fund is satisfactory. We propose that the Government Actuary's Department will carry out a valuation of the fund every three years or so and produce a report to parliament. The report will detail how the fund (and its various components) has performed. The report will be debated in parliament and trustees will be required to formally respond to the report detailing, for example, why a surplus or deficit exists, and, in the case of a deficit, what will done to rebalance the fund and how long they expect it to take. Trustees will also have funds to appoint other qualified actuaries to report on the scheme.

The management of the pension scheme must also be subject to scrutiny, to ensure, for example, that the administration is being conducted efficiently and with due probity. We also propose therefore that every two years or so the National Audit Office will produce a report on these aspects on the scheme. The Committee of Public Accounts, or another designated select committee, should also have the task of scrutinising those running the scheme.

On a more day-to-day level, trustees will meet regularly to discuss the management of the fund. The minutes of these meetings will have to be made public in the same fashion as the Bank of England's Monetary Policy Committee. The Act will also allow for ad hoc meetings of the trustees. In such cases the minutes should also be published.

As well as elections we would like to further enhance accountability with a mechanism whereby members of the scheme can express their views to the trustees who will then be required to respond. Although it would be impractical to publish all correspondence we suggest that the trustees could produce an annual report containing a synopsis of the issues raised by members, and their responses to those concerns.

We believe that if the right governance structure can be found then the universal protected pension will constitute a significant strengthening of civil society. Both the main political parties made statements in the last parliament that strengthening civil society was something they wished to do. This fund will be a body separate from the state which, because of its eventual size and importance to the entire working population, will have both significant economic and political influence, and should be well protected against the potential predations of the state.

Statists, who see the state as the legitimate controller of all large-scale collective activities, or political pessimists, who believe civil society is doomed, will argue against these proposals. But those on both the Left and Right who recognise that the shelf-life of the centralised state in Western democracies has been and gone, and who also believe that the market cannot best provide every service, will see these proposals as a golden opportunity to allow civil society to re-assert itself.

We make no apology for seeking to keep government at arm's length from the running of the fund. The record of the state in this area is not a good one and has all too often led to dashed expectations. The number of pensioners living in poverty both today and in the past is the legacy of government interference in the contribution and entitlement rates to both first- and second-tier pensions.

However, because we are trying to offer a protected pension, the government must have some role. The role will, in effect, be 'lender of last resort'. Should the fund suffer from a serious shock—for example from war, epidemic or global economic collapse—it may be necessary for the state to guarantee that the appropriate pensions will be paid through lending to the fund. Provisions for a subvention from the Treasury will exist in the Act—as they do currently for the National Insurance Fund. Furthermore, in the event of such a serious collapse, emergency action by the state is required across a wide range of activities.

The state will also have a role in collecting contributions and paying pensions. The Contributions Agency currently collects national insurance contributions. It does so efficiently (NIRS 2 aside). The additional contributions required for the universal protected pension will be collected by the Contributions Agency in the same way. The funds for investment will then be immediately transferred to the fund managers.

Retaining the Contributions Agency for the collection of all contributions minimises upheaval and costs. This arrangement also ensures that there is no access to employment and income details for trustees or fund managers. In contrast to some of the government's reforms—such as the pension credit—there will be no further compromise of privacy with the universal protected pension.

The initial arrangements for the payment of pensions and death-in-service benefits will be for the Benefits Agency to make payments. However it is unrealistic to expect that over 40 years the way in which people receive money will not change considerably, therefore we propose that this provision will be reviewed by the trustees who could make recommendations to the government to change this by statutory instrument.

(vii) A Revitalised Second Tier: Occupational Pensions

We have seen how occupational pension schemes are changing with respect to the fall in membership and the shift away from defined-benefit schemes. It is clear that occupational pensions are unlikely to play the same role in this century as they did in the previous one. Many more people will not be offered access to a good occupational scheme. Universal protected pension will bring such people into a good value pension.

Nevertheless, occupational schemes do still have a very important role to play. Our aim is for the universal protected pension to be a first tier on which people can build with confidence. An occupational pension will for many be the best value second tier. In this section we discuss both the impact of the universal protected pension on occupational pensions and what simplifications can be made for employers to think running a pension scheme is worthwhile.

(viii) An Improved Role for Occupational Pensions

The advent of the universal protected pension will help develop occupational pensions. Currently, occupational pensions have two roles: first, they seek to make good an inadequate state pension; second, they aim to provide a good second tier of pension provision. With the universal protected pension, the first role will no longer be necessary. Instead we hope occupational pensions will concentrate on an advanced role as the level of provision that takes people from having modest means in retirement to having an enjoyable retirement. With poverty and most means-testing in retirement abolished, saving in an occupational pension will not have to be weighed against means-tests—as it is increasingly under the present set-up. Employers and employees will know that each pound saved will be additional money in retirement. The contrast with the current situation is stark. At present companies with funds that have performed well often exclude those on means-tests from bonuses knowing that the pensioners would only lose the gain in lost benefit.

Under the universal protected pension, contracting out will be ended for all workers in the new scheme. This will apply both for SERPS and for the state second pension. Contracting out will, of course, still exist along with other SERPS or state second pension arrangements for older workers not in the scheme, but once the universal protected pension is up and running the days of employers having to pick their way through the details of contracting out regulations will be numbered.

This will relieve employers of a great burden and constitutes a major simplification for them. At present many employers find satisfying the reference scheme tests for SERPS time-consuming and requiring considerable expertise. Such costs also serve to dissuade employers from starting occupational schemes, particularly smaller employers who are less able to cope with the financial burden and, unsurprisingly, are less likely to run a scheme for their workers.[23]

Over the past few years concern has started to be felt among employers that the massively enhanced means-tested benefits, in the form of the minimum income guarantee, have made occupational pensions less worthwhile to run for lower-paid employees. Occupational schemes are not cheap to administer, indeed they require a high level of expertise. Nor are occupational schemes bound by legislation to accept all grades of employees into a scheme—indeed this decision is largely left up to the employer. The substantial reduction in means-testing that will filter through from the universal protected pension should increase the number of employers willing to make provision for employees once the disincentive effect that creates the ‘savings trap’ is abolished.

(ix) Follow-up to the Report by the Pensions Reform Group

The PRG has been seeking views on its proposals from all organisations or individuals with a serious interest in the pensions debate. For too long consumers have had too little say on the availability and type of pension products available. The hope is that this proposal will help stimulate a serious debate on long-term pension reform that is designed to make planning for retirement easier for everyone—including those on low incomes. With this in mind we planned a series of seminars looking at particular aspects of this paper. The key areas were:

- investment of funds, macroeconomic implications and the governance of the scheme;
- occupational pensions and the universal protected pension;
- compulsion and redistribution.

The ideas presented in this essay were part of the October 2001 report by the Pensions Reform Group: *Universal Pensions, Modernising Pensions for the Millennium*. This report was very much a consultation document and these ideas should be seen in that context. The report's commitment to a rigorous follow-up process with three similar groups looking at key aspects of the reforms was fulfilled between December 2001 and June 2002, during which the groups engaged in exceptionally lively and vigorous critical discussions of the proposals. The result was a significantly improved report, published in July 2002: *The Universal Protected Pension: The Follow-Up Report*. In this report key aspects of the proposals, including the governance arrangements and the costs of the universal protected pension, were refined. However the fundamental idea, of a more generous first-tier pension for all, remained intact. How the proposals were developed is discussed in more detail in the final section of this volume.

Appendix:
Membership of the Pension Reform Group

Kate Barker	Member while Chief Economist of the Confederation of British Industry
Professor Alan Deacon	Professor of Social Policy, University of Leeds
Frank Field MP (chair)	Chairman, Pensions Reform Group
Howard Flight MP	
Ben Forsyth	Secretary to the Pensions Reform Group
Peter Gray	Chairman, Welfare Reform Unit, Hertford College Oxford, Formerly of the Chartered Insurance Institute
Carolyn Hayman	Director, Foyer Federation
Simon Linnett	Managing Director, NM Rothschild & Sons
Alison O'Connell	Director, Pensions Policy Institute
Paul Ormerod	Volterra Consulting
Matthew Owen	Morgan Stanley
Tom Ross OBE	Principal, Aon Consulting
Lord Vinson of Roddam Dene	
Steve Webb MP	Liberal Democrat Work and Pensions Spokesman

Commentaries

Frank Field's Superfund: Misusing the Power of the State

David Willetts

We all love Frank Field. He is one of the most valued and respected Members of Parliament on either side of the House. We Conservatives particularly value him because he is a High Anglican, Euro-sceptic, who passionately condemns the corrosive effects on behaviour and values of means-tested welfare. But Labour, if they had any sense, would value him as well because he is a true Christian socialist. He believes in redistribution and he is not afraid of using the power of government to try to pursue his moral agenda. He is one of the few Labour MPs who still values the roots of the Labour movement in nineteenth-century friendly societies and organised working-class self-help.

There is a caricature of politics in which Conservatives are the party of the individual and Labour are the party of the state. The liveliest intellectual exchanges now occur as we debate how to sustain and enhance everything that stands in between the individual and the state. Collective action need not be state action. The future for my party lies in what I have called civic conservatism and what Oliver Letwin has more recently called the neighbourly society. Conservatives should value all the institutions that stand between the individual and the state and which create such a rich civil society. This is the intellectual battleground of contemporary politics and Frank Field has made a notable contribution to it.

These political generalisations may seem a long way removed from pensions. But actually pension provision in this country has been a classic example of how one can construct arrangements that are collective without being controlled by the state. Occupational pensions go right back to railway workers in the late nineteenth century and they slowly spread during the first half of the twentieth century. But the single person who did most to ensure Britain could enjoy occupational pensions on the scale we now enjoy them was John Boyd-Carpenter. He rejected the advice of his officials and the conventional wisdom of the time to say that the graduated pension should not be compulsory and universal. Instead he allowed companies to contract out if they had provision that at least matched the guaranteed minimum. That was the basis on which occupational pensions expanded so massively over the next 40 years.

British occupational pensions were a powerful device for ensuring people enjoyed a decent income in their retirement. The implicit contract between successive governments and employers was that occupational pensions were an important part of retirement provision. That contract seems to be coming to an end as both industry and government push it to its limits.

There are many reasons for the closure of occupational pensions schemes. Some of the reasons are outside the control of any government—demographic changes, changes in the labour market, and the end of the long bull market in equities. But some of the changes are a direct consequence of government actions, which have broken one side of the contract. Four changes in particular stand out.

First, there is the increase in taxation. In his 1997 Budget Gordon Brown notoriously removed the 20 per cent credit on dividends to pension funds. It is probably the most damaging of all Labour's stealth taxes. The effects at the time were disguised by the bull market. Indeed the Prime Minister explicitly used rising equity prices as a defence of the measure. But now the boot is on the other foot. Markets may go up and down but this tax hit is a continuing and unavoidable new cost on pensions. In five years the cost of lost dividend tax relief has reached £25 billion and this rises by £5 billion a year. The value of pension funds may have fallen by about £80 billion from their peak, but they are still above their value just a year before the peak. As a comparison, longevity, one of the great good news stories of the last 20 years, is adding about £2 billion a year to the cost of pension funds.

Second, the burden of regulation is getting worse. The burdens on trustees and the costs of running a pension scheme have become too high. Some of the regulations go back to the 1995 Pension Act passed after the Maxwell affair. But this Government has added further regulations of its own. The regulations on pension splitting on divorce, for example, run to well over 100 pages—more than the annual number of cases handled by the advice. That is why there must be a radical simplification of regulations on pensions.

Third, there is more means-testing. It rests on a well-intentioned attempt to attack pensioner poverty today. But the trouble with the means-testing is that take-up is low as pensioners are defeated by the complexity of the minimum income guarantee and put off by the stigma of means-tested benefits. The new pension credit will take means-testing further up the income scale with more than half of all pensioners facing rates of benefit withdrawal of 40 per cent or more, at least as high as the higher rate of tax. And for many of these pensioners the marginal rate could be a lot higher because of the way in which the savings disregard works.

In 1979, 57 per cent of pensioners were receiving means-tested benefits. By 1995, this was down to 38 per cent. The House of Commons Library estimates that the proportion of pensioners on means-tests will be back up to 57 per cent by 2003. As a result, many people fear that, if they do build up a modest pension, they will be penalised by losing benefits, either pound for pound or at least at a rate of withdrawal as steep as the higher rate of income tax. We do not wish to see ever more pensioners dependent on means-tests.

The point that Frank Field has always stressed and the Government has always denied is that these sorts of means-tests can shape future behaviour. If people feel that modest amounts of savings are going to lead to loss of benefits, that will reduce their incentive to save for the future. Frank

Field's distinctive contribution to the British debate on social security is to remind us of the corrosive effect of means-testing on incentives to work and save. It is one of the tragedies of this Labour Government that, having given Frank office as the Minister for Welfare Reform, they have ended up doing exactly the opposite of what he wanted. They have delivered the biggest increase in means-testing since the spread of national assistance during the great depression of the 1930s.

Then, fourthly, there are stakeholder pensions. These are really a variant of personal pensions. There are people for whom they may prove attractive, especially after we got the Government to concede concurrency, so it is possible to have a stakeholder pension alongside a conventional occupational pension. But the question is whether stakeholder pensions are going to reach the people in the group at whom they are supposed to be targeted. The Government's target group is five million people earning £10,000-£20,000 a year who are not already members of an occupational pension scheme. In the first year, 750,000 stakeholder pensions were sold, of which I estimate only 100,000 reached the target group. The annual premiums on these were approximately £85 million, which is less than 0.2 per cent of the Government's own figures for contributions to all forms of pensions. Frank Field gives an ironic cheer to this because he fears that if people in the target group did take out a pension there would be a serious risk of mis-selling. The crucial question is how much you need to build up in a stakeholder pension to deliver a flow of income that is sufficient to float you off the most severe parts of the Government's new means-test. That's the $64,000 question—and the answer could well be at least $64,000. That is why Frank is right to warn of the dangers of mis-selling stakeholder pensions.

All governments make mistakes and the world of pensions policy is no exception. The trouble with these four policy mistakes is that they have a combined effect that is far greater than the impact of any one of them on their own. The combined impact is to drive people out of funded pensions and onto dependence on means-tested benefits instead.

We have got used, in our country, to patting ourselves on the back because we have more funded pension savings than other European countries. But such optimism now looks dangerously out of touch. It is not made any better by serious mistakes in the statistics which I have uncovered over the past few months. Until recently, ministers claimed that the total annual contributions to our pension funds were running at £86 billion. Recently, the Government has reduced this figure hugely and now estimates that only £43 billion is being contributed each year. Ministers believe their own good news, but meanwhile pension provision suffers.

The new pensions challenge that Britain faces, therefore, is to tackle the savings gap of £27 billion per annum. This is the gap between the amount that people need to save in order to enjoy a relatively prosperous retirement and the amount they are actually saving. Millions of people are currently heading for a nasty shock when they retire as their income will be far lower than they expect. And in a modern democracy people will not accept widespread poverty in their retirement. They will vote for parties that offer them yet more benefits to make up for the funded pension savings that they do not have. So we will get into a vicious spiral of yet more means-tested state benefits and yet more penalties for people who have built up their own funded pension savings. This is the spiral in which we are now trapped and from which we have to escape.

We all want to see more funded pensions. The Government says its strategic objective is to move from 60 per cent of pensioners' incomes coming from the state and 40 per cent from the private sector to the reverse, with 60 per cent of pensioners' incomes coming from funding and 40 per cent from the state. That is an admirable strategic objective and I warmly endorse it. The trouble is that the Government's policies are inconsistent with its strategy. In fact they are taking us in the opposite direction, as Frank Field's essay so clearly demonstrates.

The proposal by the Pensions Reform Group is a bold attempt to break out of this trap. They have grasped the crucial point that the only way forward is to build up more genuine funded pension savings. It is a question of how we register claims on future resources, and as a free-marketeer I would much rather those claims were registered via private contracts than via the state's power to tax. They are right when they say that it is far better for people to have pensions that rest on genuine private contracts rather than on the promises of politicians. This is in the best interests of generations of pensioners. It means that they get at least some protection from the vagaries of politics. It means there is a direct link between saving now and prosperity later. And of course if markets perform in line with their long-term average there is a prospect of a far better return than from a mature pay-as-you go pension scheme. That is why in the last two elections we Conservatives have put forward the option of a funded alternative to the basic state pension. And it is why I start with a basic sympathy for what the Pensions Reform Group is trying to do.

But unfortunately their scheme doesn't work. It is trying to straddle all the important dilemmas between state provision and private provision. Ultimately this hybrid, as in the natural world, proves to be sterile. It claims to have all the advantages of a government-backed guaranteed compulsory scheme whilst at the same time having the flexibility and reliability of pension payments resting on genuine funds rather than politicians' promises. This double act ultimately can't work.

Frank Field believes in redistribution just as much as the most ambitious means-tester. But he thinks there is a far better way of distributing wealth than means-testing. He wants to do it via national insurance, or, in this case compulsory pension contributions. He thinks that redistribution is acceptable provided it is hidden behind the mysteries of the national insurance fund or its new funded equivalent. So in his model the state collects compulsory contributions from workers to put into a fund. He believes people would be more willing to pay these contributions than if they were just taxes because these are contributions that are going into a real fund to buy real assets that would pay their pension. But the money that goes into the fund is then redistributed, and, while the contributions increase with your income, the money you get out is the same for everyone. There is no relationship between the contributions that you make into the funded pension and the money that you get out when you retire. Although the rhetoric surrounding the proposals is all about the virtues of independent funded contracts free from political interference, the reality of the scheme is very different. It is a highly political project resting on the state's power to compel people to pay contributions in and then redistributing those contributions according to the political judgement of Frank Field. If a genuine pension scheme tried to operate on this basis it would be hauled before the Financial Services Authority and the courts for extracting money from its contributors under false pretences. People who earn more will be contributing far more into this scheme than they can ever expect to get out. The crucial omission in the paper is any calculation of the scale of this redistribution. The absence of such information is a bad sign. It suggests that he knows that if people were to see how much they could be paying in and how little they get back in return they might not be so keen on his scheme after all.

Frank Field's approach is very different from that of his hero—and mine—William Beveridge. Beveridge envisaged a fixed payment to the National Insurance Fund earning a fixed benefit. At one point in the Beveridge Report he calls it a 'poll tax' because he thought if people were going to get the same benefit out they should put the same amount in. The trouble with Beveridge's model was that he could never get the figures to add up. The maximum acceptable contribution would never generate a big enough pension to float people off means-tested benefits. The solution was to increase the income into the fund by making contributions earnings-related. But if people were making earnings-related contributions it always seemed essential that there should be some earnings-related benefits for them at the end of the day. That has been a common feature of all the different models of a top-up state pension until Frank Field's scheme.

The scheme proposed by the Pensions Reform Group is in effect, therefore, a highly political project for extracting money from people during their working lives in order to redistribute it later on. It is a political artefact. The compulsory contributions and the large-scale redistribution inevitably make it a state system.

The proposal is not a proper, privately funded pension scheme. The returns do not match those that many of the contributors would expect from a private fund. They are instead politically determined just as the obligation to pay contributions in the first place is a political matter. Let us look at it instead, then, from the other side. Let Frank concede it is a state scheme but with the added bonus of being funded instead of pay-as-you-go. There are many people who believe that this is what Beveridge intended, though it is not the actual proposal in his report. Many people think that if only the state scheme were funded it would be far better. But a state scheme does not need to be funded. If the state is offering to pay people a pension in the future the ultimate guarantee on which it rests is the state's power to tax. Private pensions need to own assets to secure an income in the future but the state doesn't because it can tax us instead. The state does not need to own shares in British industry in order to extract an income from it.

If the state, or indeed the Pensions Reform Group's hybrid pension scheme, did try to buy shares in British industry it would soon find itself owning most of British industry. Frank Field would have delivered what Tony Benn could only dream of.

The temptations for political interference would be enormous. If the money going into the fund was money compulsorily extracted as a result of a vote in the House of Commons it would be very difficult for ministers and politicians to stand back and say they had no view about how the money was spent and what the money was spent on. What sort of ethical investment policy would the fund have? As it would presumably have been the biggest single shareholder in Railtrack, how would it have responded to Stephen Byers' coup last year? However elaborate the governance arrangements, it is difficult to see how the fund could be protected from such political interference.

Even giving it the benefit of the doubt and assuming that protection from politicians were possible, this would still not be the end of the problem. Even if it were scrupulously independent it would still represent the most extraordinary concentration of power over British industry. The managers of the fund would determine the outcome of every takeover bid. Their fund's votes would determine the remuneration and terms of employment of every senior director in British industry. Surely one of the things we have learnt from Austrian economics is the importance of dispersal of information and power in a modern economy. This would take us in exactly the opposite direction.

The advocates of the scheme then offer ingenious attempts to try to fragment it. They say it could be put into the hands of different managers with different remits. But however much they try to do this there comes a point when the fund becomes a single body because it pays out a single pension regardless of the performance of the individual funds.

The only way to achieve real dispersal of decision-taking and power is to have genuinely different funds with people able to choose into which fund they invest their savings. Then their pension would depend on the performance of their funds. People with funds that performed well would have a better pension than people with funds that performed less well. That is what competition and choice is all about. But in order to do that there would have to be some link between the money you put in and the pension you get out. But that cuts across the fundamental design feature of the scheme, namely providing a basic state pension for everyone, not different pensions for different people depending on the amount they put in and the performance of their fund.

There are other problems too. The scheme would also have a massive effect on our existing pension arrangements, both private and state. The essay is surprisingly cavalier about this impact, but it is a fundamental problem. It could well undermine existing private funded provision.

Imagine, despite the critique I offered earlier on, that Frank Field's claims for his scheme are true, or at least widely believed. People think they are getting a genuinely funded pension that is going to be worth quite a lot compared to average earnings. This will surely reduce considerably the incentives for employees or employers to run their own funded occupational schemes. One of the reasons why Britain has built up bigger pension fund assets than many other advanced Western countries is because of the brave decision of John Boyd-Carpenter when the first attempt at a state second pension was being developed in the late 1950s. But there is no provision for contracting out in Frank Field's model.

The Pension Provision Group's report provides a full account of the problems in the existing pensions system. These can be summed up as too much means-testing, too few incentives to save and insufficient support for funded pensions. And, as the report identifies, the Government's reforms are doing nothing to solve these problems: the minimum income guarantee and the pension credit are extending means-testing; stakeholder pensions are not reaching their target group; and the abolition of the credit on dividends to pension funds has encouraged the closure of many occupational schemes.

Unfortunately, the scale of the problem has been obscured by the Government's willingness to accept incorrect statistics on both the value of pension funds and the level of pension contributions. The Pension Reform Group has avoided such complacency, but its proposed solution has numerous conceptual problems. It involves redistributing compulsory pension contributions on a massive, but concealed, scale. It gives enormous and unprecedented power to a small number of pension fund trustees. And, by forcing people to pool their contributions, it stops them from making independent decisions about where to invest their retirement savings.

Pension Provision: Liberalism or Corporatism?

Philip Booth

Introduction

In many respects, the Pension Reform Group proposals[1] involve a significant expansion of the role of the state in pension provision. This expansion comes under a number of guises. There would be more compulsory provision; there would be more redistribution in a scheme which, in effect, divorces contributions from benefits except at the cohort level; there would be government underwriting of a pension promise that cannot be guaranteed by the performance of the fund; a particular governance structure would be determined that involves, in effect, contracted-out management of funds for the state; flexibility in the form in which pension incomes could accrue would be removed and replaced with the benefit structure required by the state scheme; and the retirement age would be determined by the state in respect of a much greater proportion of pension benefits than is currently the case. On the other hand, the Pension Reform Group proposals would provide many people with an invested pension for the first time and the investment would take place in the private sector.

There are many countries that could benefit from adopting the Pension Reform Group proposals. These include those countries for which private pension schemes are merely 'complementary' to an over-arching, all-embracing, unfunded state scheme.[2] This essay argues that, given the UK's starting point in pension provision, the Pension Reform Group proposals would be a step backwards. Whilst it is argued that the problems the Pension Reform Group identifies with the current pension system are all too real, some of those problems should be tackled 'head on'. Others can be alleviated more effectively in other ways. Also, it is contended that some of the problems to which the Pension Reform Group proposals will lead are as serious as the problems that they will solve.

Before considering the detailed economic issues, we consider the historical context of the Pension Reform Group proposals. The arguments being conducted today are very similar to those that were conducted during the debate about the Beveridge report and the subsequent legislation. We then look at the some of the problems identified by the Pension Reform Group and ask whether more compulsory pension provision, of the form proposed by the Pension Reform Group, is the solution to those problems. We then examine particular aspects of the Pension Reform Group's proposals and ask if there is a better way to achieve the stated objectives.

It should be noted that this essay is critical of the Pension Reform Group proposals, although constructively so. It should not be assumed that the author believes that their proposals do not have great merit. They are well formulated, well thought through and totally consistent. They address many of the problems in pension provision today but take a particular perspective. They are straightforward and based on firm principles. Unlike many government proposals that have been impenetrable in their complexity,[3] the Pension Reform Group proposals make reasoned argument possible and I am pleased to have the opportunity to take part in the debate.

The Historical Context

The historical development of state pensions and their interaction with the private sector is discussed *inter alia* in Hannah, Hills *et al*, Blake, Department of Social Security, Feldstein and Seldon.[4] Until the beginning of the nineteenth century, support in old age would have come from private sources, for example from the family, from continuing work or through the poor law (effectively means-tested benefits paid at subsistence level). From 1909, a small means-tested, non-contributory pension was paid to those aged over 70. This had characteristics closer to today's minimum income guarantee (MIG) than to today's state pension. In 1911, a contributory national insurance scheme was set up. This excluded pension provision but did provide an income to those under the age of 70 who were unemployed or incapacitated. The means-tested benefit would then be available over the age of 70. The 1925 Pensions Act extended the contributory national insurance principle to old-age pensions. If a state pension is regarded as an income from the state, the qualification for which is solely determined by old age and a contribution record, this Act represented the beginning of formal state pensions in the UK. Whilst the Treasury subsidised the pension, its finance was grounded in the insurance principle, with contributions being a flat amount to provide a flat-rate pension, rather than contributions being graduated with earnings, as the contributions for the basic state pension are today. The contributory state pension, introduced in the 1925 Act, existed alongside other forms of welfare provision, provided both in the private sector and by the state.

The next major reforms took place in the 1946 National Insurance Act that followed the Beveridge report. A good discussion of the historical background to the Beveridge Report, including of the nature of the representations made to Beveridge, appears in Hills.[5] One interesting aspect is the fact that exactly the same issues are raised in the debates leading up to the Beveridge Report as are raised today by the Pension Reform Group. Specifically, these issues are:

- Should the state pension be above subsistence level or below it?
- Are universal state pensions above subsistence level affordable?
- What are the effects on incentives to work of universal state pensions?
- Should the system be contributory and should contributions be linked to earnings?

- Should benefits be linked to earnings?
- Should the scheme be funded by the investment of contributions of today's working population to provide pensions for that same group when they retire?
- What would be the influence of demographic developments on the scheme if pensions were paid to today's pensioners from the contributions of today's workers?
- How should state and private pensions interact?

In the event, the legislation implemented a universal flat-rate pension, at subsistence level, financed on the contributory principle, without pre-funding. Contributions were to be flat rate and the pension paid immediately at a rate of 26*s* for a single person and 42*s* for a couple. This meant that nobody who had a basic state pension should have required national assistance in old age.[6] As the Pension Reform Group notes, this is quite different from the situation we see now, where the basic state pension is set below the minimum income that is provided from social security payments. A further important aspect of the system was that by not linking benefits to an individual's earnings, it enabled people to make private provision for any level of pension that they wished to receive over and above subsistence level.

Developments in State Pensions Post Beveridge

There have been two major reforms of state pensions between the National Insurance Act (1946) and the current time. The first was the development of a system of earning-related pensions. The second was the system of contracting out of earnings-related pensions. In addition to that, the basic state pension system has evolved to pay benefits lower than the subsistence levels envisaged by Beveridge, thus leading to the extensive means-testing of benefits paid by the state in retirement: the problem identified by the Pension Reform Group. During that evolution of the state pension system, the original link between the flat-rate basic state pension and the flat-rate contribution has been lost.

The problems that were perceived with the proposals implemented in the 1946 National Insurance Act are discussed in Hannah.[7] Two of the principles on which the Beveridge proposals had been based were the absence of means-testing and contributions that were related to the benefits that were to be received (i.e. flat-rate contributions for flat-rate benefits). These principles were well intentioned but quickly led to political difficulties. Non-means-tested pensions were costly, particularly if they were to rise in line with earnings. Also flat-rate contributions were seen as regressive. There was a limit to the extent that flat-rate contributions could be raised without imposing significant hardship on those with low earnings. Thus the system was both expensive and contributions were constrained by political necessity.

This was a problem with the whole of the national insurance system, not just with state pensions. There were possible solutions to the problem, all of which led to other practical difficulties. They involve means-testing benefits or making contributions earnings related (effectively making national insurance contributions more closely integrated into the objectives of the tax system). This 'solution' leads to disincentives to earn and breaks the insurance principle. The problems so created have been a particular concern of Frank Field and are effectively articulated in Lawlor.[8]

The first break with the Beveridge principle was as soon as 1948 when means-tested supplementary pensions were introduced because non-means-tested pensions were quickly seen as inadequate for those who had high living costs (such as high rents). Contributions then became more closely related to earnings. One school of thought was that, if contributions were to be related to earnings (to ensure that the system was not too 'regressive'), an earnings-related state pension scheme should also be introduced. Titmuss developed such a plan that would involve earnings-related contributions and earnings-related benefits. There would be implicit income redistribution within the scheme, as benefits would not relate directly to contributions. Most continental European countries operate such state schemes. However, the incumbent Conservative government implemented much less sweeping reforms. Graduated National Insurance contributions were introduced in the 1959

National Insurance Act and this was combined with an extremely small earnings-related element to the pension. The contributory principle was now broken and, once broken in principle, it would be eroded beyond all recognition over time. Companies with occupational schemes were allowed to 'contract-out' of the new graduated pension and pay only the national insurance contribution for the basic pension.

Future attempts to reform state pensions were thwarted by changes of government at general elections (specifically in 1970 and 1974) until Barbara Castle introduced a formal state earnings related pensions scheme (SERPS) in the Social Security Act of 1975, which came into effect in 1978. It is this scheme that evolved into the current SERPS/S2P scheme. The system of contracting out for occupational schemes was further developed at this time but only applied to defined-benefit schemes. Further reforms took place in the 1985 Social Security Act and the 1986 Social Security Act,[9] when defined-benefit schemes were compelled to introduce better benefits for early leavers and the principle of contracting out was extended to defined-contribution schemes and to personal pensions. This meant that any individual could contract out of SERPS by joining an occupational defined-benefit scheme, occupational defined-contribution scheme or, if neither of these two options existed within the employee's firm or if the individual chose not to join a company scheme, by taking out an appropriate personal pension scheme. The 1986 Social Security Act and the 1995 Pensions Act also reduced the benefits paid by the state earnings related pension scheme.

The other development, which had a continual and significant effect on overall state pension provision, was the linking of the basic state pension to prices in 1979. This linking was done for reasons of fiscal prudence and so that 'available resources' could be 'targeted' on means-tested benefits rather than used to increase a basic state pension that would be received by pensioners across the income spectrum. This language was used by successive Conservative governments[10] and is also used by the current government.[11] Linking the basic state pension increases to retail price increases effectively increases means-testing in retirement as the level of the basic state pension gradually falls further below the level of income that is paid to those in receipt of means-tested benefits (which, typically, have been increased above the rate of increase of RPI).

The Pension Reform Group's proposals take us back to the Beveridge debate and the questions it raised. The Pension Reform Group believes that pensions should be above subsistence level; that contributions should be pro-rata of earnings; that pensions should be flat rate; and that part of the pension, at least, should be funded. In terms of the redistributive effects, they differ from the immediate post-Beveridge settlement in that the latter required flat-rate contributions for a flat-rate pension. The Beveridge solution failed because it was politically unacceptable amongst the low paid (hence the pension level gradually declined). The Pension Reform Group solution brings with it the following problems:

- graduated contributions but a flat-rate pension might be unacceptable amongst those above (say) median earnings;
- the link between contribution and pension accrual is broken and history suggests that once this is broken the whole insurance nature of the scheme breaks down (the Pension Reform Group believes that its governance structures are strong enough to deal with this problem);
- the de-coupling of pensions from benefits accrued, in effect, leads to a higher marginal rate of tax on middle-earners. The redistribution that currently takes place through the use of means-tested benefits takes place in another form. This leads to different types of incentive problems;
- the system will be expensive because of the target pension being above means-testing limits.

In addition to this we have all the problems of an over-arching, compulsory, state-designed scheme reducing choice, innovation and flexibility. These arguments alone do not demonstrate that the Pension Reform Group solution is worse than the status quo. However, we see from the historical context that we have had this debate before and chosen to take other courses of action from that proposed by the Pension Reform Group. There are arguments against the Pension Reform Group proposals that have been discussed in the historical debate, to which the Pension Reform Group does not refer.

Pensioner Poverty, Taxation and Means-testing

The disincentives for self-provision caused by recent extensions of means-testing are discussed a number of times in the Pension Reform Group proposals. There have been a number of policies developed over the last 20 years that have led to a situation whereby it is very difficult for those on moderate earnings to earn sufficient pension entitlement to steer clear of means-tested benefits. *Inter alia*, these have been:

- the linking of the basic state pension (BSP) to prices rather than earnings;
- the cutting back of state earnings related pension scheme (SERPS) benefits;
- increasing means-tested benefits in retirement above the rate of increase in prices;
- increased tax on pension funds (with the 1997 budget effectively removing the tax-free status of pension funds in respect of most of their investments);

The Pension Reform Group is right to point out that economic decisions depend on expectations as well as the information that exists about the situation today. Thus two further measures have served to seriously exacerbate the incentives problem:

- the development of formal uprating of the main means-tested benefit (now called minimum income guarantee) in line with national average wage increases;
- the development of the pension credit designed to take means-testing even further up the income scale.

These two coincide with the formal linking (for the indefinite future) of the basic state pension to price increases and further reductions in SERPS (now S2P or state second pension) benefits.

The minimum compulsory pension provision in the UK is made up of both the basic state pension and SERPS/S2P (henceforth S2P). The incentives problem arises if the minimum compulsory provision for many people is below the level of income at which means-tested benefits are provided. There is then a disincentive to provide for one's own retirement because of the potential loss of means-tested benefits in retirement. However, the position that exists for people retiring now is different from that which exists for people entering the labour market now who will retire in (say) 40 years' time. Only a small proportion of the former group will have a significant compulsory earnings related pension. Fewer than five per cent of those retiring with SERPS in 1999 received a SERPS pension between 76 per cent and 100 per cent of the maximum: this reflects the fact that the scheme has not been in operation for a full generation.

Today's Problem

Before the pension credit is introduced in 2003, somebody retiring on basic state pension receives a 100 per cent withdrawal rate of benefit if they received any income between the basic state pension level and the MIG level. Assuming that the same individual received housing and council tax benefit, they would then be subject to a 91 per cent benefit withdrawal rate until their housing and council tax benefit entitlement had been removed.

It would be reasonable to assume that the combination of housing and council tax benefit and the excess of MIG over the basic state pension could amount to about £70 a week (or more), equivalent to over £3,600 per year. The individual would receive a withdrawal of benefit rate of between 100 per cent and 91 per cent in respect of any private income they generate until £3,600 per year had been generated. This would cost a male aged 65 about £70,000 in the annuity market, if the income purchased were price-index-linked. Even that would only take the individual over the means-testing barrier for one year as MIG is projected to be linked to wages. Thus the extent of means-tested benefits has grown so rapidly in recent years that those who wish to be independent of the state have to pay out £70,000 (roughly the value of a median house outside the South East of England) before any benefit is received. Clearly, those on higher incomes will buy the 'entry ticket to independence' because of the benefits after they have escaped from means-testing. For those on limited incomes, independence is unachievable and all saving is wasted.

The introduction of the pension credit pushes more people into this means-testing trap. It does mean that those on very low incomes will gain some benefit from their savings. However, ignoring any taxation, a 40 per cent benefit withdrawal will occur until the individual is in receipt of £135 per week. Because of housing and council tax benefit a 91 per cent benefit withdrawal rate may well arise above the pension credit level. To take an individual clear of pension credit may well involve buying an annuity costing over £100,000 if the only other income is a basic state pension (and the means-tested benefits, being linked to wages, would soon overtake the individual's income again). The lost benefit from small savings would be smaller but the benefit trap is longer and will begin to affect (literally) the majority of pensioners.

Tomorrow's Problem

Over time, one aspect of this situation will ease. People will retire with greater compulsory pension provision. This will involve a combination of the following: SERPS/S2P; annuities purchased with personal/stakeholder pension vehicles where contributions are those in respect of contracted-out rebates; and benefits from contracted-out occupational schemes. It might be thought that this would address the means-testing problem.

If all benefits remained the same in real terms, compulsory pension provision would be sufficient to take an individual out of much of the means-testing morass as the S2P scheme matures. However, it is government policy to link means-tested benefits to wages. State second pension will also be broadly linked to average national earnings increases before retirement but then to prices after retirement. Relative to earnings, the BSP will fall, as it will only be linked to prices. This means that the gap between the total of S2P and BSP and means-tested benefit levels narrows sharply as the first full generation retires. Again, many people will be on means-tested benefits within a few years of retirement; those without a full contribution history may well retire on means-tested benefits and, within a few years of the scheme maturing, the same problems that exist today will reappear. Cooper[12] describes the new pension and means-tested benefit arrangements as having 'built-in obsolescence': a most curious feature for a system around which individuals are supposed to take long-term financial decisions. The problems are analysed in detail in a report for the DTI by Booth *et al*.[13]

Thus the Pension Reform Group is correct. Means-testing is likely to cause huge disincentives to save. Recent government policy initiatives do not deal either with the short-term problems or the long-term problems and have created a system of incredible complexity.

The Pension Reform Group Proposals

There are four aspects of the Pension Reform Group proposals that I would like to consider in detail:

- the proposed increased level of compulsory pension provision;
- the proposed increase in redistribution within the pension system;
- the salary-linked guarantee;
- the governance structures.

More Compulsion and More Redistribution

The government has moved the means-tested benefits system to a position whereby very many individuals are better off (or not much worse off) doing nothing than saving or working in retirement. It has also created a benefit structure for the post-65s that provides much higher benefits and reduced work incentives after age 65 than before 65. Responding to this by increasing compulsory pension provision is an attempt to make individuals poorer during their working lives to address the problems created by means-testing in retirement. There are many economic reasons why this policy could create serious welfare losses:

- Those who are most susceptible to the moral hazard problem are those on low to median incomes. Thus, to address the specific moral hazard problem, compulsory pension provision should be a fixed amount such that, once this fixed level of provision has been made, any individual, regardless of their level of earnings, should be above the maximum income at which means-tested benefits are paid. Those who would see the greatest proportionate increase in their pension provision would be the lower paid who may already be on means-tested benefits in work. If such means-tested benefits were increased to help the low paid meet their compulsory pension contributions, means-tested benefits in retirement would simply be replaced by means-tested benefits in work. The Pension Reform Group circumvents this problem by creating more income redistribution within the system. However, this simply replaces disincentives of means-tested benefits with disincentives of higher taxes (the Pension Reform Group describes these taxes as contributions; however, as the contributions are not related to benefits they have the characteristics of taxes).
- Most individuals and families have significant debt during their early-mid working lives (mortgage, bank loans and so on). It would be difficult to argue that greater compulsory pension provision is a sensible financial decision for such people. They would, in effect, be borrowing from one institution and lending to (or saving with) another (in this case administered by the state with some contracting-out of functions), with considerable transaction costs through interest spreads, product charges and so on. The extra compulsory pension provision would, in effect, be making pension mis-selling compulsory.

- A second-best economic position, caused by means-tested benefits altering the price of gross pension per unit net (of benefit) pension received, can always be corrected more effectively using the price mechanism than by using compulsion. The price mechanism can involve the provision of tax breaks or subsidies for pension provision. The current tax system, in effect, provides a subsidy for those who are most likely to be susceptible to moral hazard as those who are not taxpayers still receive 'tax relief' on pension contributions, thus reducing the disincentives to save caused by means-tested benefit provision.
- Compulsory pension provision would lead savers to substitute pension savings for other savings. Thus replacing flexible vehicles that can meet their needs with less flexible vehicles. This may well create a welfare loss particularly for those with impaired health who may not expect to live sufficiently long to receive a pension or who would receive a pension for a shorter than average time.
- Pension savers could simply increase their financial liabilities and plan to repay those liabilities with their pension assets. For example, they could choose to continue their mortgage into retirement and repay their mortgage using their pension. Again this leads to savers incurring the intermediation costs of both borrowing and saving. The only way the government could prevent this from happening would be to considerably increase control of all financial decisions taken by individuals.
- Individuals may prefer to be supported in old age from the proceeds of working beyond traditional retirement age, from the income or capital from non-financial assets (for example by letting property or 'downsizing') or, in many cultures, through extended family networks. The Pension Reform Group proposals involve the extension of the concept of the 'retirement age' despite the ever-increasing demand for greater flexibility.

The current system, to which the Pension Reform Group objects, involves finding people who are poor and giving money to them and then finding people who are less poor and taking money from them. The Pension Reform Group does not propose a reduction in redistribution (indeed, on the contrary, it proposes an increase in redistribution). It simply proposes a different mechanism to find poor people and give them an income financed by other people who are slightly less poor, who work harder or who save more. Disincentives are not reduced by such a mechanism: they are changed in form.

The Pension Reform Group suggests that 'the Government is not offering sufficient redistribution through the state second pension and stakeholder'.[14] When looking at the amount of redistribution, we should also include the basic state pension, of course. In fact, the redistribution is huge. The basic state pension is financed by an average national insurance contribution of around 3.5 per cent of earnings between lower and upper earnings limits, yet it is a flat-rate benefit. S2P will be financed by an average contribution of about five per cent of earnings between the lower and upper earnings limits. In the case of S2P, the redistributive effects are complex but will be more straightforward after stage two of the reforms when S2P becomes flat rate. Earnings between the lower earnings limit and the lower earnings threshold will incur an average national insurance cost of about ten per cent of salary but individuals will receive no more benefit than if they did not earn anything at all. Those on earnings above the lower earnings threshold who contract out will continue to receive rebates on all their earnings (up to the upper earnings limit). The system is incoherent and complex but, nevertheless, there is considerable income redistribution within the scheme.

The total cost of UPP for an individual on annual earnings of £27,820 is £196.91 per month. In addition to this there is a notional cost of 3.5 per cent of earnings for the basic state pension. This is a total of about 12 per cent of salary. There is no analysis by the Pension Reform Group of the labour-market consequences of what is, in effect, a marginal tax rate to finance redistribution within the UPP scheme of 12 per cent. For some (for example senior nurses and teachers) this scheme would leave them to be considerably over pensioned when current arrangements are taken into account and for others (for example those in stable employment and in a defined-benefit occupational scheme) there would be substitution of private pension provision by state provision. But for all, the Pension Reform Group scheme would turn disincentives to save into disincentives to work. The contributions proposed are very high, yet no marginal benefit is received in respect of marginal contributions. The development of the Pension Reform Group scheme would therefore have the same effect on the labour market as an increase in marginal tax rates of 8.5 per cent from the current 3.5 per cent required for redistribution in the BSP to 12 per cent.

The Pension Guarantee

UPP is designed to increase in line with earnings. This not only applies to the accrued pension before retirement but to the pension in payment after retirement. This is a guarantee that, according to the Pension Reform Group, 'cannot be bought in the market'. The government would be the guarantor of last resort. This curious line of reasoning leads one to invoke Mrs Thatcher's observation that 'society' cannot pay for goods and services, only individuals and families can. More formally, Bastiat[15] describes how it is impossible for an abstraction (the state) to provide goods and services. The state has two hands, the rough one for taking (to finance provision of goods and services) and the smooth one for giving goods and services and, because of the porous and absorbent nature of its hands, the state will always give less than it takes. Thus the observation by the Pension Reform Group that the pension guarantee is something 'only the state can guarantee' is strange. If it cannot be bought in the market, how can the state provide it? The answer is because, unlike the market, the state is able to extract money (or extract backing for soft loans) from future generations of taxpayers to finance unsustainable promises made to earlier generations. The private sector cannot do that: such an action undertaken by the private sector could be described, again in the words of Bastiat, as 'plunder'. In a sense the proposal is that the state becomes a giant Equitable. The Equitable provided investors with a financial option. They could take their cash lump sum and either buy an annuity in the open market or have it converted into an annuity by the Equitable at a fixed rate. As annuity prices rose, more investors would take the second option and the Equitable would make losses, as it was not possible for the Equitable to purchase investments that matched that option. In the same way, the Group suggest guaranteeing a pension linked to salaries that cannot be matched by the underlying investments. If investment performance is poor and salaries rise quickly the state will have to meet this liability. Future generations of taxpayers are the guarantors. At least those who were the equity holders (with-profit policyholders) in the Equitable had a choice about whether or not to join.

There is clearly a demographic risk attached to the unfunded part of the Pension Reform Group's scheme. There is an investment risk attached to the invested part. There is a good reason why salary-linked guarantees cannot be bought in the market: they cost more than people are willing to pay. Moving that cost to the state (as guarantor of last resort) merely moves that cost to another group of people (taxpayers in general): it does not solve the problem that salary-linked guarantees are expensive. The Pension Reform Group also suggests that the UPP solves the annuity purchase problem because an annuity does not have to be purchased. This is sophistry. The scheme provides an annuity. It implicitly purchases an annuity from itself. If real interest rates fall (as they have), if life expectancy rises (as it has) the cost to the fund of providing the annuity income increases, just as it does in a private scheme. If, as a result of the capital/labour ratio rising as the population age-profile changes, salaries increase faster and real investment returns fall (see, for example Miles,[16] for some very sophisticated modelling of this effect), there will be further costs to the scheme. This will happen at the same time as labour market participation is reduced owing to the high tax rates necessary to fund the scheme.

Governance

My final comments on the Pension Reform Group scheme relate to its governance. Here, I draw the same conclusion as I drew about the proposals more generally. If this scheme of governance were to be adopted, for example, in the process of moving towards funding for the PAYGO schemes of many countries in the European Union, it would be a huge step forward. However, the market in the UK, supported by the legislative framework, has developed a number of different ways of providing pension governance that help disperse power and create choice. For example, occupational schemes are generally written under trust, personal schemes can be bought from mutual or proprietary insurance companies. The Treasury has been looking into a further range of governance structures.

It is unclear why half of the trustees in the Pension Reform Group scheme need to be appointed by the government. Analogies with the Monetary Policy Committee (MPC) are not appropriate. The MPC manage monetary policy on behalf of the government and a nationalised central bank. The government sets the inflation target. It is then a matter for central government to determine the institutional structures that will best meet its objectives. An inflation rule and operational independence for the whole MPC (both government and Bank of England appointees) seems to be an effective and credible way of meeting their objectives. The pension proposals are different. The funds are being managed for the contributors not for the government. If the Pension Reform Group scheme is adopted, all the trustees should be elected or appointed through a process determined by the members (at the same time there should be no government guarantee of the pension). There is a general danger in the proposals of too much concentration of investment power. However, with state-appointed trustees, it is highly likely that the investment of the funds would be directed to meet political aims (or current political fads) and not take place in the general interest of the members.

The arguments that the costs of the scheme would be less than private sector costs are not convincing. Many of the apparent cost reductions arise because of the compulsory nature of the scheme (no marketing costs etc.) and because of apparent economies of scale. It is difficult to think of an example of a compulsory state monopoly service, involving the elimination of competition, that has led to lower costs and better service provision than would exist under competition in the private sector. Much is often made of the apparent lower costs of the current state pension scheme. However, it should be understood that there are many reasons for those lower costs:

- state pension contributions are not invested;
- the state pension is compulsory and all have to join regardless of how inadequate the scheme is;
- no information is given to members;
- there is no regulation and benefits are routinely adjusted in ways that would be illegal in the private sector;
- no tax qualification costs are involved.

In almost all businesses (a few exceptions such as engineering and development of airline engines come to mind) economies of scale are illusory. Also, in the pensions business in particular, many of the costs and much of the lack of competition arises from the imposition of regulation by the government.

The Pension Reform Group makes its position very clear: 'nothing is more simple than a compulsory pension. You are a member and that is it.'[17] The problem is that nothing is more complex than the range of economic welfare preferences of different human beings. Experience in the Soviet Union (indeed, with the National Health Service) demonstrates the welfare losses from treating individuals as if they were the same. The Pension Reform Group proposals for the governance structure are better than those that currently exist for the basic state pension. However, the UPP is designed to replace much private and contracted-out provision too: their governance proposals offer less choice than is currently on offer in respect of those aspects of pension provision.

An Alternative Approach

The Pension Reform Group's proposal is an extremely worthy contribution to the debate. It very effectively draws out the important issues so that those with different philosophical positions can debate the proposals. This is not happening with regard to reforms being undertaken by the government. There are other countries that could adopt the Pension Reform Group proposals and, as a result, take a major step forward. It is also the case that the Pension Reform Group's analysis of the problem we face in our pensions system is accurate and its solution is wholly consistent with its analysis of the problem. However, there are alternative ways forward that would avoid many of the problems of the Pension Reform Group proposals.

As the Pension Reform Group argues, moral hazard in our pension system has arisen on a huge scale because of the developing relationship between compulsory pension provision and the level of means-tested benefits. Pensioners are retiring who have had no incentive to save (or, indeed, carry on working). Future pensioners, despite having more compulsory pension provision (SERPS followed by S2P) will be in no better position, relative to those on means-tested benefits, because of the prospective significant increases in means-tested benefits. These problems are compounded by the budget decisions of 1997. Prospective pensioners with defined-contribution pensions can expect their pension to be reduced by between 7 per cent and 12 per cent because of the change in the tax status of UK equities in pension funds in the 1997 budget.[18]

Continuing to increase means-tested benefits in retirement beyond those that are paid during working life and responding by increasing compulsory pension provision to alleviate the consequent moral hazard will lead to a significantly raised tax burden and consequent disincentives to work (and save). The problem that the Pension Reform Group identifies as existing in retirement will be transferred to people of working age. A different approach could be taken. There is space to summarise only that approach in this essay.[19]

- From the current time, all increases in means-tested benefits should be limited to increases in the general level of prices. Discretionary increases could then be given, if it were regarded as appropriate, taking into account a broad range of issues. The proposed 'one-off' increases in MIG and proposed future increases in line with national average earnings should not take place;

- S2P and the basic state pension should be merged into one flat-rate pension. This would comprise the minimum compulsory provision. Under all reasonable projections, this would lead to a greater pension than the level of means-tested benefits for anybody with a full contribution record, given the above proposed change to MIG;
- the compulsory pension provision, as defined above, would be indexed to an index between national average earnings and price increases before retirement, and the annuity to be received in retirement would be indexed to prices;
- the pension credit should not be introduced and winter-fuel benefits and free television licenses should be abolished. This money could either be used to reduce the general level of taxes or, possibly, to provide for a one-off increase to the basic state pension that would close the gap between the basic state pension and means-tested benefits;
- the taxation position of pensions should be reviewed. The most logical option would be to restore the tax credit on dividends but remove the tax-free lump sum. An alternative would be to retain the current system but either require recipients of the tax-free lump sum to annuitise it, if they had insured annuities less than means-tested benefit levels, or refuse to pay means-tested benefits for a given period after retirement to people who had not annuitised their tax-free lump sum;
- individuals should be allowed to contract out, in a variety of ways, from all aspects of the state pension scheme. However, it would not be desirable to see individuals currently contracted out of SERPS/ S2P contracting back in because they wanted to receive the equivalent of a basic state pension. People should therefore be allowed to contract out of 0, 50 or 100 per cent of the revised state

pension scheme described above. Rebates should be actuarially neutral and reviewed more frequently than quinquenially.

There should be significant simplification of the various tax and regulatory regimes along the lines described in Booth with Arthur.[20]

A scheme with a governance structure similar to that described by the Pension Reform Group could be set up to receive contracted-out rebates. However, it should do so on a competitive basis and have to provide the same standards of service, information provision and so on as private providers.

The state pension age should be reviewed regularly so that the actuarial cost of state pensions does not increase as a result of increases in longevity.

These proposals provide greater freedom of choice than the Pension Reform Group proposals and would lead to a further development of the pluralism that has been a characteristic of UK pension provision since the nineteenth century. They attempt to address the same issues as the Pension Reform Group proposals but without the creation of corporatist structures and without the attempt to redistribute income in a way that is difficult to justify.

Conclusion

In conclusion, I see two major problems with the Pension Reform Group proposals. The old may be, on average, poorer than the young. However, this does not, of itself, provide a reason for the state to underwrite a minimum income for the old poor that is higher than that it underwrites for the young poor. The working young, many of whom have seen their living standards increase only slowly in recent decades because of the fall in the relative market value of manual labour and because of higher taxes, would have to pay for the proposed extension of means-tested benefits to the old through higher taxes and then have to pay higher pension contributions too. This creates labour market disincentives. The second problem is that the further erosion of the link between contributions and benefits, as proposed by the Pension Reform Group, together with the proposed governance structure and government guarantees provides a recipe for political interference.

The first of these problems can be addressed by looking at the whole retirement income question, rather than just looking at pensions whilst accepting the current and future proposed levels of means-tested benefits. The second problem can be addressed by allowing people to contract out of all state pension provision with actuarially neutral rebates. In effect, this would make a scaled-down version of the Pension Reform Group's scheme voluntary, if people can demonstrate they have made appropriate provision. This way the liberal pensions' settlement that has been established in the UK would not only prevail but be reinforced.

‘Faith in the City’: Absolving Employers and Protecting Vested Interests

Kirk Mann

Introduction

Neither Frank Field’s record as an advocate of the deserving poor, nor the merits of his analysis of the flaws in the current pension system, should distract attention from the weaknesses of his latest proposals for reform. The focus of this essay is on the assumptions that underpin the proposed universal protected pension (UPP). In short it will be argued that Field has a peculiar faith in ‘the City’, a misplaced faith in the pensions experts, an agnostic and myopic view of occupational pensions, a faith in his preferred form of retirement saving that presumes he knows what is in people’s best interests, and a dogmatic faith in his top-down model of social reform. In contrast he has no faith in those he claims he wants to help with these proposals—they must be forced to comply. Rather than offering anything radical or new, these proposals for compulsory retirement saving are, at best, benignly authoritarian measures. At their worst they free employers from their responsibilities and further restrict the rights of employees.

Saving is Morally ‘Good’

Field follows in a long line of well-intentioned social reformers who have bemoaned the fact that poorer people are less likely to save and more inclined to consume. The thrifty self-reliant sections of the ‘respectable’ working class and the prudence of the middle classes (facilitated by access to pension schemes that are subsidised by employers and the tax system), has often been contrasted with those sections of the working classes who simply want to 'spend, spend, spend'. If only the poor would defer gratification, spend their money more wisely, and save for the future, then the state could deal with the small minority who are unable, as opposed to unwilling, to do so. Consequently Field believes that the current pension system 'leaves unresolved the classic problem of moral hazard—that people may not save, confident that others will pick up the costs of their failure to do so' (p. 22). In contrast, it is presumed that compulsory saving will 'allow self-improvement to benefit the individual and society simultaneously' (p. 27). This is justified by an interesting reading of Christian ethics that appears to elevate self-interest above a concern for others. However, the narrowness of Field's approach stands in marked contrast to other Christian scholars who have managed to acknowledge human frailty, incompetence and even greed, without constructing welfare reforms with these to the fore.[1] Retirees are undoubtedly as adept at playing the welfare system as any other social group, but whether those sections of society that 'fail to save' are cunningly exploiting the system is debatable. Even the thrifty souls Field approves of rarely plan for their retirement before they are middle aged and relatively few of them will know exactly what they have accrued prior to their retirement.[2] It seems hard to believe, therefore, that significant numbers of the poorest pensioners are so well-informed that they can plot their way through the benefit maze. Bearing in mind that retirement planning involves a 30-40 year time lag, it might be better to offer these mischievous individuals jobs as benefit advisers, social policy lecturers and civil servants. Who else could so accurately have predicted retirement policy over the last 20 years, let alone the last 40?

Instead we might usefully consider the situation that confronts those who 'fail to save'. For example, many working-class women who got married in the 1940s and 50s and cared for their children and spouse, thereby complying with the moral order of the day, are currently among the poorest pensioners. They placed their faith in 'the universal welfare state' and failed to save. Their counterparts today are asked to place their faith in another 'universal' scheme but this time it will force them to save from their meagre earnings. Others will have been deterred from saving by the complexity and confusion surrounding current provisions, combined with the private pensions mis-selling fiasco, the Equitable Life debacle, and the Maxwell scandal. The poor performance of fund managers when compared to other investment possibilities, the incomprehensible efforts at communicating information on the part of the pensions industry, and the impossibility of comparing pension products are further deterrent factors. As the UPP proposals admit, simplification and accountability have to be objectives for any pensions reform. If the pensions industry were able to put its own house in order, something that these proposals do little to address, more people might be inclined to save. Others will not, and they will prefer to enjoy the fruits of their labours while they are still fit enough to do so. This is the group that Field finds so morally hazardous because having spent their earnings (but having paid NI, PAYE, SERPS and VAT) they still expect a retirement income. However, human nature is unlikely to be transformed by the UPP, and the mischievous freeloader is unlikely to change their moral outlook, but it may encourage new ways of circumventing the legislation. For example, increasing deductions from employees may promote the hidden economy, as it increases the incentives for cash-in-hand work. Self-interest in this case may 'objectively' be short-sighted but the low-paid, temporary and casual workers, who are the least likely at present to have private or occupational pensions, may simply disagree. Some mischievous individuals may squander their money, as Field would see it. Others will feel their moral responsibilities are ranked differently and elevate the immediate needs of their partner, parents or children above their own longer-term self-interest. The point is that compulsory saving for retirement tries to impose a specific form of moral, as well as economic regulation on the individual.[3] Field makes no bones about this but in his pursuit of mischief he may inadvertently drive more people toward more elaborate ways of pursuing their interests, both economic and moral, beyond the state's gaze and grasp.

Only Pensioners Benefit from Pensions

A fairly standard question to ask of any reform proposal is: who benefits and who loses out?

Clearly, retirement pensions, of all kinds, are a benefit to the recipient but only the most short-sighted observer could fail to see the role they also play in the finance markets, in employer's labour market strategies, and in wider processes of economic restructuring—a fact acknowledged by the OECD,[4] the present Government[5] and key sectors of finance capital in 'the City'.[6] Yet throughout the UPP proposals it is assumed that retirement is a drain on resources for employers and a benefit for employees. This ignores both the history of retirement policy and the part pension funds play in employers labour market and investment strategies. Employers were to the fore in pressing for a state pension a century ago and have consistently used the state pension age as a basis for 'restructuring' their labour force ever since. Of course many employees have also welcomed the fact that they could exit at a specified point without being regarded as undeserving. Nevertheless, the state pension age has been a useful marker for many employers in establishing a widely accepted idea that there is an age at which employees ought to exit paid work.[7] It needs to be recalled that in all the industrial nations at the beginning of the twentieth century retirement pensions were a response to social and structural changes that were beyond the control of individual employees. Changes such as an aging population, the modernisation of the labour and manufacturing processes that displaced many older 'skilled' workers, and labour market restructuring that witnessed companies relocating. This in turn prompted concerns from the mutual and friendly societies over the increasing demands on their funds and from poor law guardians who were struggling to distinguish the respectable (deserving) society men from the (undeserving) roughs.

Current debates over pension reform, including proposals for a UPP, are replaying many of these themes but with no mention of the benefits to employers that a fixed age of retirement bestows, or the subsidy (the state pension) they effectively get for their age-discriminatory employment practices. In addition to having a socially accepted basis for putting pressure on older workers to leave—you are close to the time for retirement, make way for new blood, and so on—occupational pension funds have often been used to ease out older workers with ‘top ups’, enhancements and ‘golden handshakes’ for executives.[8] Thus ‘early retirement’ and ‘voluntary redundancy’ have allowed employers to shed labour smoothly—i.e. without generating resentment from those employees they wish to retain. It is rarely acknowledged that the industrial shake-out in the UK in the 1980s was often facilitated by occupational pension funds.

The benefits of the present pension system are also enjoyed by ‘the City’ with the crucial part played by pension funds overlooked in headlines about ‘the pensions crisis’.[9] In 1963 pension fund assets were estimated to be worth seven per cent of all UK equities; by the mid-1990s, 30-35 per cent of total capital assets. The Myners Review, undertaken on behalf of the British government, stated that: ‘UK institutional investors own more than £1,500 billion of assets—over half the quoted equity markets’.[10] Worldwide it is estimated that pension fund assets amount to 43 per cent of the planet’s GDP![11] These phenomenal savings are the backbone of the finance markets. And yet, while fund managers ‘will fight like crazy’ to win a contract,[12] they have been consistently criticised for their passivity, herd mentality, conservatism and under-performance once they have fund control.[13] Even Tony Blair[14] and the fund managers journal[15] have berated them, but Field asks nothing of these institutional freeloaders.

Responsibilities Must Be Imposed on Individuals, Not on Employers

Between 1979 and 1994 employees saw their national insurance contributions increase by 68 per cent.[16] However, reductions in employer contributions introduced by Labour have cut the annual income to the NI fund by £1 billion.[17] Simultaneously, employers have complained that the minimum funding requirements for occupational (defined-benefit) schemes are too onerous. They are increasingly reluctant to make any contributions, preferring, as Field notes, to have employee-funded defined-contribution schemes. It should be recalled that in the 1980s and early 1990s pensions experts were predicting huge fund surpluses and many employers gave themselves contribution freezes. It seems employers are quick to duck their responsibilities and to pass these on to their employees.

The proposals for a UPP chime neatly with this insidious drift away from the idea of social and collective responsibilities toward individual responsibility. Compulsory saving for employees, particularly when there is no requirement for employers to contribute and no age-discrimination legislation, amounts to compelling low-paid workers to pay for poor employment practices that benefit low-paying employers. Individuals are expected to make provisions for circumstances over which they have little or no control. However, retirement is not the only candidate for such individuating measures. Health and medical services could be funded by an additional levy. Education, at all ages and stages, would benefit from additional resources that could be raised if money were available from a contributory fund. Similarly, long-term care, transport, and virtually any other public and welfare service, might all make a case for additional resources from dedicated funds and contributions. And why stop there when we know that poorer people often spend their money on unnecessary and frivolous items?

The scope for both consumption and saving to be entirely prescribed by a benign authoritarian state is very great, and would probably improve the diet and welfare of the poorest if enacted.

Even redistribution is to be between employees, and neither employers nor 'the City' are to share in this responsibility. As Field notes '...any pension scheme has to decide both the extent of redistribution and, equally important, at what stage that redistribution should take place' (p. 25). Even more important is the question of who the redistribution should be between. The UPP assumes redistribution between scheme members and that, despite graduated contributions, the highest earners should be exempt once they hit the current national insurance ceiling. Thus redistribution is relatively progressive but only within the scheme. The ceiling effectively excludes the highest earners from full responsibility and is, therefore, not universal and not genuinely redistributive. Although it is acknowledged that constraints may be necessary to prevent second-tier schemes being abused for tax purposes, the tax privileges currently enjoyed by the richest members of private and occupational pension schemes will apparently continue—privileges that presently increase with income and are blatantly regressive.

Faith in Property, Consumers and Experts

'No rights without responsibilities' has been a recurring theme of the Blair government, and retirement as a citizenship right, fixed by age and underpinned by a universal benefit, is under threat[18]—a threat that Field uses to make his reforms appear a more attractive option.[19] The idea that a Labour government ought to be protecting citizenship rights and the most vulnerable in society is apparently no longer worthy of consideration. Property and consumer rights are seen as more reliable and easier to defend than citizenship rights. There is certainly ample evidence to suggest that the state has been an unreliable pension provider that has reneged on previous commitments and has, in effect, mis-sold pension products (e.g. SERPS). Whether property and consumer rights will address the needs of the poorest is less clear. It is also worth noting that, whatever the fate of the UPP, the state would retain very considerable powers over the retirement rights of everyone. Changes to the tax liabilities of retirees, with penalties for retiring before 65 (or later), might well be used in future. We need only recall the fate of MIRAS (mortgage income tax relief at source) whereby fiscal subsidies were scrapped once they had done the job of enticing owner occupiers. What the state giveth the state may taketh away. Rather than threatening to curtail retirement rights it might have been hoped that Field would defend them.

By diminishing the rights of citizens and enhancing those of consumers, the stick driving people towards the private market takes on a sharper point. Extending meaningful choices to the poorest can only occur if welfare provisions exist to cushion the effects of the wrong choices. The fear is that talk of choice and moral responsibility ignores the obstacles the poorest sections of society confront in trying to address these. Moreover obligations and responsibilities are being imposed on those who rely on public and informal welfare that do not apply to the more privileged forms of welfare, i.e. fiscal and occupational. Consumer choice looks set to become the privilege of the comfortable majority, with compulsion for the poor.[20]

Simultaneously, the drift toward a consumer society, with welfare a consumer item, contains the seeds for new social and political agendas to emerge. Although he has previously identified 'the drive towards greater individual consumer sovereignty'[21] as a major influence on both politicians and welfare service providers, it is unclear whether Field is aware of the potential conflicts that may arise over the UPP funds as a consequence. One possibility is that consumers will press for more rights, more information and more accountability. Harrison[22] has observed how the structures of organised consumption can generate claims and entitlements related to forms of savings and accumulation. He suggests that these will in turn promote calls for more accountability and transparency from the grassroots and their representatives. If pensioners become active consumers, exercising rights, then the decisions of both market providers and government are likely to be closely scrutinised.

Thus consumers might pose some difficult questions about the investment decisions of the funds. The UPP funds would undoubtedly attract considerable attention from, on the one hand, those who want to extend ethical investment issues and, on the other, people who want to maximise investment opportunities. The prospect of a succession of legal challenges, with property rights, consumer rights and human rights claiming primacy is very real.

There are already pension providers who claim to be ethical, avoiding the arms trade, environmentally damaging developments and so on. In the past consumer boycotts and pressure from shareholders have persuaded numerous companies to change their activities. However, if the state is compelling people to save for their retirement, even more accountability can be anticipated. The UPP funds might be scrutinised very closely and any whiff of unethical investment, let alone dip in fortunes, will surely attract attention. Furthermore, and as the Goode Report[23] acknowledged, saving for a pension is not like other forms of saving or consumption. Thus many people will save for Christmas or a holiday but, unlike Christmas, retirement comes but once a lifetime. Even ardent advocates of the free play of market forces accept pensions are very different to other consumer items and that information and knowledge are vital.[24] The unpredictability of the market and the long-term nature of pensions means that individuals are poorly placed to make informed judgements. Even pension experts regularly misread the market or miscalculate their liabilities (e.g. Equitable Life). Consequently, individual consumers are unable to learn from the previous year in order to save more or spend less. Nor is it necessarily the case that trustees, actuaries and other experts know best. For example, property prices in the South East of England have risen much faster than the returns of pension funds in the last decade. Rather than being forced to pay into a pension fund, people might have been better off if they had purchased a slightly more expensive home, an asset that will appreciate, and be appreciated, while they live in it. Furthermore, what right of redress, or compensation, will consumer citizens have if the funds perform badly?

Will the fund managers be sued, as they might if a car or washing machine failed to perform?

Is the power of the state only to be used to compel the poor to conform, or will there be clearly defined and stinging penalties for those who fail to deliver, while seeking to profit, from the UPP funds?

A faith in consumer rights also informs the proposals for the governance of the UPP funds. There is, quite properly, a concern with preventing political influence or interference with the scheme by government. However, the possibility of the funds becoming highly politicised still exists. For some people, any investments in developing nations that return the profits to highly developed nations are unjustified. The anti-globalisation movement, and a host of social movements such as Greenpeace, the anti-tobacco lobby, animal rights groups, etc., have already begun campaigning over ethical investment issues. The requirement that pension funds produce a statement of investment principles (SIPs) is likely to fuel such campaigns.

On the other hand, there are undoubtedly consumer citizens who would want to vigorously pursue their own self-interest by investing in any unethical venture that promises a good return. If the funds were invested in, for example, the sex industry in Thailand, or companies known to employ child labour, they may generate very good returns for scheme members. Field would probably wish to ensure that trustees establish ethical guidelines that prevent such contentious investments, but in placing his faith in self-interest he fails to acknowledge the potential this has for promoting amoral individualism. The potential for the UPP funds to become political footballs, with the possibility of conscientious objectors refusing to pay their UPP because it is unethically invested, while others press for the highest investment returns irrespective of any ethical considerations, is very real.

Faith in a 'Top-Down' Process of Reform

The UPP proposals also follow a very traditional 'top down' approach to social reform, in line with Field's faith in the Fabian strategy. Like the Webbs a century ago, he has to seek out key civil servants, opinion formers and intellectuals to ensure his proposals make it onto the political agenda. This may explain the spate of media reports and newspaper articles in February 2002 with alarmist and misleading headlines.[25] The readers of this publication should be aware, therefore, that this too should be seen as part of the same opinion framing project. Field has, in his own dour fashion, worked hard to 'spin' the need for reform with limited resources. This 'top-down' strategy is predicated on the idea that the mobilisation of élite opinion is the driving force for social reform. Thus Field also has a peculiar faith in the captains of industry, pensions experts, and the financial institutions of the City. He has little or no faith in trade unions, pensioner lobby groups, or the poorest sections of society. This is most apparent from the membership of the Pensions Reform Group think tank. Despite the key role played by trade unions in promoting occupational pensions—the great welfare success story of the twentieth century—there is no place for them in the Pensions Reform Group or in the UPP scheme. He sees no need to engage with current workers, carers, or pensioners, let alone the young people who will be most affected. There must be many 18-23-year-olds, the 'Thatcher generation', wondering precisely what dreadful sins their fathers committed in order for them to be visited by a succession of cuts, fees and charges since they were born. There was no possibility of dissenting voices being raised, nor even a focus group of affected service users that 'New Labour' are so fond of, prior to Field issuing his tablets of stone. Instead, the City of London, employers, pensions industry experts and a token academic are laughably portrayed as a 'broad-based' group.

As Fiona Williams has argued,[26] social policy has to recognise and listen to the dissident voices of marginalised and excluded groups, it cannot simply presume that one form of welfare 'fits all', or that the excluded speak with one voice. The consequences of ignoring this advice can be illustrated by considering the part that other faiths might play in our diverse society. Historically, welfare and religion have been inextricably, but ambiguously, linked. For example, in the nineteenth century, Papal edicts, religious belief and discrimination combined to exclude many Catholics and Irish migrants from the benefits of friendly society membership.[27] And if religious beliefs are offended by compelling membership of the UPP—because, for example, they may depend on usury (profits from money lending)—some minority ethnic communities today may well approach retirement rather differently to the ethnic majority. Thus, Nesbitt and Neary identified cultural values among Pakistani and Bangladeshi men in Oldham that emphasised traditional patterns of inter-generational support, rather than formal pension rights, as the mechanism to provide welfare for retirees.[28] However, compulsory pension saving might undermine these traditional and informal commitments to welfare within specific communities. On the other hand, Pakistani and Bangladeshi women are less likely to be members of a private or occupational pension scheme than any other ethnic or social group. They might welcome the opportunity to break with traditions that commit them to providing informal welfare across generations, but they may not. The point is that a top-down approach to social reform will rarely be sensitive to such questions. Indeed, any review of social policy would see that it is littered with well intentioned, but misplaced, frequently universal, 'normalising' solutions.[29] It may be that asking questions about the significance of religious and cultural values will produce answers that emphasise similarity and shared attitudes. The failure to consider such questions, however, shows little regard for the views of those who will be most affected.

Moreover, the failure to listen to voices that might pose uncomfortable questions is not merely an oversight, it is an inherent feature of the Fabian tradition. Recognising that successful welfare measures might be promoted by social movements from 'below' is hard to reconcile with a 'top-down' strategy. To acknowledge, for example, the part played by level headed trade unionists in the third quarter of the twentieth century, who pressed and persuaded employers to extend their occupational pension schemes, would require Field to give some credit to folk of a different faith. And if trade unionists and other political and social movements have been responsible for success in the past, on what basis are they to be excluded today?

An Unthinkable Alternative?

This is not the place to set out an alternative in any detail. A few observations and unthinkable thoughts should, however, indicate the possibilities. Occupational pension (defined-benefit/final salary) schemes have been remarkably successful and rather than abandon them they need to be extended and developed. Instead of compelling individuals to save, all employers could be made to do so, as they have been in Australia since 1992 with the introduction of the Superannuation Guarantee Charge (SGC).[30] Compelling all employers to make a minimum contribution based on a proportion of earnings has extended the privileges of occupational welfare to all in the paid labour market.[31] It has also ensured a level playing field for employers who are all compelled to accept they have social responsibilities. This is an option explicitly rejected by the PRG but, apart from the influence of employers and 'the City' on the group's thinking, it is hard to understand why. As Field acknowledges, most large-scale employers have schemes in place and they are still the best pension packages available. Admittedly occupational schemes do not resolve many of the problems identified above. Most significantly, occupational pension schemes fail to address the needs of carers and others who, for various reasons, have a tenuous relationship to the paid labour market. They are also regressive, providing more tax relief to higher earners and the least benefits for the low paid. Many schemes in the UK have also been poorly managed, permitting contribution freezes during stock market booms only to confront funding problems when the market slowed down. It is also true that the massive restructuring of the labour market and the loss of many jobs that were covered by good occupational pension schemes, increasing proportions of the workforce employed in part-time work or on fixed-term contracts, and the drift to US-style defined-contribution schemes, all combine to undermine final salary/defined-benefit schemes. However, many of the obstacles could be addressed and the decline could easily be halted, if there was a genuine political will. Thus it should not be beyond the wit of the experts to develop a fund for carers, or to extend the privileges of occupational welfare to all. Indeed, simply providing additional fiscal privileges, with progressive redistribution a clear aim, to existing funds in support of such reforms might revitalise occupational schemes generally. At present 'good' employers who retain their final salary schemes have to compete with others who refuse to accept they have any social responsibilities. Legislation protecting employees from age discrimination might also enable older workers to continue to make pension savings, or other provisions—a need that they will be more aware of as they approach retirement.

Of course some employers, particularly smaller ones and those with low paid, temporary and 'flexible' employees will howl with indignation. Similar complaints were heard from employers regarding the minimum wage in the UK and were voiced in Australia in 1991/2 when the SGC was proposed.[32] In the event, neither a minimum wage nor the SGC generated mass unemployment.

Unfortunately this type of thinking is likely to be dismissed as typical of old Labour, but it should be recalled that the SGC was promoted by Paul Keating, arguably one of the most abrasive and successful advocates of 'modernising' Labour politics. The SGC is not perfect, although most critics feel it has not gone far enough in promoting redistribution, or in addressing the needs of carers and groups excluded from the paid labour market. Nevertheless, it demonstrates the very narrow and predictable limits within which virtually all British Labour politicians now think about social reform. There are, though, no simple solutions to the problems confronted by the pension system, not even if the unthinkable—a system akin to the SGC—were to be adopted.

Conclusion

Like some renegade from Cromwell's (Blair's ?) New Model Army, Frank Field insists that, rather than consuming, the peasantry should be saving. So if you are under 25 you should stop dancing and plan for your retirement—always assuming of course that the right to retirement is not scrapped. Had the proposal for a UPP been premised on compulsory contributions for employers, as is the case in Australia, with employees free to contribute as well, these proposals might be more warmly embraced. As they appear here, they reflect the concerns of employers, vested interests in the finance markets and a 'rethinking' of policy that is constrained by its obsession with the mischievous few, rather than extending the privileges of occupational pensions to all.

The funding of retirement pensions and even the cherished idea of a retirement age are likely to see some intense political contests in the near future. To be fair to Field, his proposals are far from being the worst.[33] However, if, as Minns claims,[34] pension funds are part of a new 'Cold War in Welfare', in which the interests of finance capital are promoted and the welfare needs of individuals undermined, Field aligns himself with 'the City'. It is an approach to retirement funding, rights and responsibilities that few of those he intends to 'help' will find attractive.

Instead of moralising to the poorest, and turning to compulsion when it fails, he might usefully recall the following 'test' he set for a future Labour government:

> So too with private pension provision. Here will be a test for a Blair government in showing that it is not only capable of standing up to vested interests on its own side, but to vested interests wherever they reside. The commitment of the government should be to protect the individual against the corporate vested interest whenever there is a conflict.[35]

Thus far both 'New Labour' and Field appear to be failing this rather tepid test.

Frank Field's Fifteen Minutes

Stephen Driver

The Rise and Fall of Stakeholding

Back in the mid-1990s, 'stakeholding' had its 15 minutes of fame as the new Big Idea in British politics. Tony Blair lauded the concept in a speech to business leaders in Singapore. The journalist Will Hutton had an improbable best seller with *The State We're In*, a book that put stakeholders—employees as well as employers—on the same footing as shareholders in his critique of Anglo-American capitalism. Frank Field made stakeholding the key to his analysis of contemporary social policy and the move away from universal insurance schemes to means-tested benefits. For Field, radical welfare reform demanded new institutions, owned and controlled by stakeholders—pensioners, employees and so on—to provide long-term solutions to the problems of poverty and welfare dependency. As we can see from Field's chapter in this volume, this stakeholder model remains at the core of his ideas for welfare reform—and of his critique of the Labour government's social policies.

Stakeholding's spot in the political limelight was short-lived. Before long, Blair's advisors—always more influential than the gurus, Field among them, David Willetts[1] said he had—were back-tracking. Stakeholding smacked of big government. It looked too much like the European model of political economy, which in the second half of the 1990s was not delivering the goods, certainly when measured against the success of the US economy. This reinforced the North Atlantic policy drift that had set in with Bill Clinton's victory in the 1992 presidential elections. The driving force behind Labour's domestic policy agenda, Gordon Brown, borrowed heavily from US welfare reforms, such as tax credits for poor working families. Indeed, the Labour government has gone a long way to delivering on the Democratic welfare reform agenda as set out by Clinton's policy advisor David Ellwood.[2] Before long, the Continental European and Far Eastern flavours that Hutton and to a lesser extent Field had given stakeholding were lost. Instead, a leaner, more individualist notion of stakeholding emerged in New Labour's political lexicon. Gone were the collective social institutions that Hutton and Field imagined would reform British society. Stakeholding became equated with social inclusion: with having a stake in society principally by working.

Field the Post-Thatcherite

Still, Field was given a job in Tony Blair's first government in 1997. As the political commentator Andrew Rawnsley suggests, the Prime Minister liked the idea of Frank Field: here was a man who had taken on the Left politically and intellectually. But did Blair fully understand the implications of Field's ideas?[3] Central to these was an engagement with the New Right. Field understood and even sympathised with Conservative concerns over welfare dependency. This did not endear him to everyone in the Labour Party. When the Conservative Social Security Secretary Peter Lilley unveiled plans before the 1997 election for a compulsory privately funded scheme to replace the basic state pension, Field had more in common with the Tory front bench than his own.

Field's solutions for the welfare state were thoroughly post-Thatcherite. Social policy, Field argued, should be designed to make the forces of self-interest—those very same forces that Margaret Thatcher had appealed to—work to the general good: 'The growth of individualism is not going to be arrested by talk of rebuilding community. Welfare has to be shaped so that individual wishes can simultaneously promote new senses of community', wrote Field.[4] In Julian Le Grand's terms,[5] Labour had to ditch knights for knaves: individuals are motivated by self-interest not altruism. Field's assumptions about human motivation, as we can see in the opening chapter, remain central to his current ideas on pension reform.

If Field went against the altruistic assumptions of post-war social democracy, so his views on equality were another reason for the Left to want to lynch him—and another for Blair to admire him. Field's treason was that he didn't think that redistribution between classes was the main goal for welfare reform. In characteristically forthright terms, Field argued in the mid-1990s:

> There is no general groundswell amongst middle-class groups for the redistribution of wealth to the poor, particularly in the aftermath of the Thatcher years. Politicians who maintain otherwise are a public menace distracting from the real task'.[6]

What was that task? Dealing with poverty, welfare dependency and helping people to look after themselves. To the Labour modernisers around Blair, this was music to their ears. Indeed, 'a hand-up not a hand-out' has become one of the main themes of government social policy.

The Problem with Means-testing

At the core of Field's critique of welfare dependency was the means-tested benefit. As is well demonstrated in this volume, the number claiming a means-tested benefit has climbed over the past 20 years. Labour's pension policies are adding to this number. For Field, the problem with these benefits is not only that they lock individuals and families in a poverty trap, but they have a morally damaging impact on their behaviour: 'Means-tests penalise all those human attributes—such as hard work, work being adequately rewarded, savings, honesty—which underpin a free, let alone civilised society', Field argued in 1995.[7] Again, the same argument underpins his current proposals: 'when the self-interest of individuals runs up against a large-scale means-tested form of welfare, the benefit to society of the desire for self-improvement of individuals is greatly reduced' (p. 27).

But did Blair—and more importantly Field's Nemesis Gordon Brown—buy this vision of stakeholder welfare as an alternative to the extension of means-tested benefits?

Labour and the Welfare State

For much of the 1980s, Labour's defence of the welfare state had been traditionally of the Left: the way of dealing with poverty was to increase welfare payments. It promised to restore the link between benefit levels and earnings that had been cut by the Conservatives. The Policy Review set up by party leader Neil Kinnock in 1987 suggested a more limited role for the state in public policy and placed greater emphasis on individual freedom. Still, Labour went into the 1992 general election promising to increase pensions and child benefit and to fund these increases by raising the top rate of tax and middle-income national insurance contributions. Not surprisingly, the Conservatives jumped on this apparent throw-back to Old Labour, labelling John Smith's shadow budget 'Labour's tax bomb-shell'—and for Labour, the election was lost.

'The language of priorities is the religion of socialism', Aneurin Bevan told the Labour Party conference in 1949. Gordon Brown made it his religion in 1990s. Labour's priority was to prove its economic competency. This wasn't easy. Labour was the party of tax-and-spend. The public believed it. The City of London believed it. The Labour Party itself believed it. But it didn't win elections anymore. Brown set about making Labour bank manager-friendly.

Despite his politically disastrous proposals in 1992, John Smith had already done much to trim Labour's commitments to tax-and-spend. Smith also set up the Commission on Social Justice in December 1992 to review social policy for the Labour Party. The Commission's final report was deeply critical of the growth in the number claiming means-tested benefits. Like Field, the report argued that: 'a modern social security system should be built upon the foundation of social insurance'.[8] On pensions, the Commission favoured universal second pensions with a minimum pensioner guarantee to top-up existing pension provision to the level of the guarantee. In this way, the Commission believed, a government would be laying the basis for saving for future pensioners; and offering an alternative to means-tested income support for poor pensioners today: the minimum pensioner guarantee would only test for pension income plus earnings of a 'substantial' size. Field at the time was part of a commission chaired by Lord Dahrendorf and sponsored by the Liberal Democrats that argued for compulsory earning-related second-tier pensions.

The Conservative mishandling of Britain's membership of the Economic Exchange Rate Mechanism in 1992 gave Labour the chance to prove that it, not the Tories, could be trusted with the nation's finances. It was a chance that Labour didn't blow. Blair and Brown spent the mid-90s convincing the voters that a Labour government would be fiscally prudent. In May 1996, Labour's then shadow social security minister Chris Smith said the unthinkable: 'High social security spending is a sign of failure, not a sign of success'.[9] Blair and Brown went on record attacking the big government assumptions of post-war social democracy. A New Labour government would be different from an Old Labour government because it would find new ways of bringing together the public, private and voluntary sectors in 'partnerships' to do things that previously had simply been provided by government. To Field, who had bemoaned Fabian Labour's antipathy to mutual societies and to its statist approach to social policy, New Labour must have seemed like it was talking his language.

In the spring of 1997, Labour fought an election promising not to raise income tax rates and to stick to Conservative spending limits for the first two years in government. This time it was the Tories who were blown out of the water. But was the stage set for Frank Field's Finest Hour—or just for an all-too-brief 15 minutes in government?

'Frank, We're Going To Reform Welfare'

When Tony Blair offered Field a job in government in May 1997 with the remark: 'Frank, we're going to reform welfare'[10] the political outsider must have had some expectation that his vision of stakeholder welfare would get a hearing. Certainly supporters on the Left and Right hoped it would. But while Field was shown to a small room in the political attic—number two to Harriet Harman in the old Department of Social Security—Gordon Brown slipped his feet under the mother of all policy-making desks at HM Treasury. Field may have been given the rather grand title of Minster for Welfare Reform—and charged to 'think the unthinkable'—but it quickly became apparent that the only person who was going to reform the welfare state was Brown. Indeed, once the Chancellor had handed over monetary policy to the Bank of England, it seemed that social policy was the only thing Brown was interested in. The 1998 green paper *A New Contract for Welfare* was to have been Field's opportunity to set the direction for future policy-making. Instead, Brown's fingerprints were all over it. Its dominating theme was welfare to work, not the building of stakeholder institutions. The discrepancy between Field's views on welfare reform and the government's became even more apparent as the Institute of Economic Affairs re-issued Field's *Stakeholder Welfare*. This is what Frank really thought. He was to have no Finest Hour.

Labour's 1998 pension green paper *Partnerships in Pensions* gave further proof that Field's view of welfare reform had failed to win the day. Field wanted compulsory second pensions along the lines set out in *Stakeholder Welfare*. The green paper proposed a voluntary system of stakeholder pensions for middle-income earners; a new state second pension replacing SERPS for those on low incomes and those in caring roles; the continuation of the basic state pension; and a minimum income guarantee.[11] These proposals formed the basis for subsequent government policy on pensions. In response to concerns that the minimum income guarantee (MIG) would undermine incentives to save for retirement, the Pension Credit was unveiled in 2000 to reward those who had made some provision for their retirement.

What Field Thinks is Wrong with Labour's Pension Policy

So what is Frank Field's problem with the government's pension policies? The short answer is the extension of means-tested benefits and the failure to establish an adequate and long-term system of social insurance. Gordon Brown's hegemony over domestic policy has reinforced the institutional dominance of the Treasury in British public administration. As a result, Field argues, the Labour government's strategy would discourage long-term saving. While Field acknowledges that 'the government rightly wants to help today's poorest pensioners' (p. 15), the MIG is flawed: it 'acts as a powerful disincentive to save' (p. 15). The pension credit is just as bad: it is too complex, will encourage fraud, is unlikely to deal with disincentives to save and 'is the result of an ill-thought out pensions strategy that simultaneously tried to encourage more savings while extending means-testing' (p. 17). Field is not unsympathetic to the government's proposals for a second state pension, but thinks it likely that it will become a 'pensions ghetto', set at too low a level to get people off means-tested benefits. Finally, the stakeholder pension is 'laudable' in its aims, but doomed to failure because it is not compulsory and 'people may not save, confident that others will pick up the costs of their failure to do so' (p. 22).

And where the government has ducked radical reform, so Field offers a 'bold solution': a universal protected pension (UPP) that would operate like a national occupational pension, with pensions paid on a defined basis. Combined with the retained basic pension, Field's UPP would provide benefits 'well above the level of the means-tested minimum income guarantee'. In the long-run, the UPP 'would ensure that pensioner poverty is not only eradicated, but that it never returns' (p. 29).

Others share Field's concerns with Labour's pension policies. The centre-left Institute for Public Policy Research described the government's strategy as 'unravelling'.[12] The MIG undermines incentives to save; the pension credit is costly, complex and extends means-testing; and the stakeholder pension may not reach its target audience. Above all, there is general uncertainty about what the state should provide and what individuals are responsible for. Contributors to this volume draw the line differently. But does the government's approach have any merit?

Why Labour's Pension Policies Make Sense

The debate between Field and the government can be seen as one between the 'incremental policy options' (as the IPPR put it) of the government and the 'fundamental policy options' of Field. For Field, this incrementalism, as we have seen, is a sign of weakness: Labour has failed to be radical; its step-by-step approach is leading to one bad policy after another. The government's strategy is going nowhere. In fact, Field's proposals for a UPP are not, as Field concedes, as radical as some. The UPP is a 'hybrid scheme'—and the proposals are all the better for being such.

But there is also merit and coherence in the government's incremental approach to pension reform. To start with, Labour's policies directly address the issue of pensioner poverty today—a point Field concedes, then does little about. The UPP may eradicate pensioner poverty in the long-term, but by then today's pensioners will be dead. Gordon Brown has grasped the mantle of social democracy and offered an egalitarian policy for today's poor pensioners that targets extra resources on those most in need. Field is right to be concerned about the growth in means-testing, but MIG at a stroke has lifted all pensioners above Age Concern's £90 a week poverty line. For good measure—and rather against the logic of the MIG—the Chancellor added £5 to the basic state pension in 2001.

Many fear—the government included—that the MIG will undermine incentives to save. The pension credit—like the working families tax credit—is expensive, too complex, lacks transparency and extends the means-test. In a simplified and fully costed form, it may yet offer a means for a government committed to targeting extra resources on today's poor to overcome the disincentives to save that a means-tested incomes floor introduces. On this question, Labour must respond to what works. Moreover, whatever trade-off there is between such means-tested guarantees and incentives to save, there must be doubts as to whether the very modest level at which the MIG is set—and Field offers no hard evidence for his argument—will put people off in the longer term from providing for themselves. Indeed, if Field is right—and he surely is—that people no longer trust government to provide a cradle-to-grave service, then a policy that does something about the sorry lot of today's pensioners is not going to be the awful moral hazard that Field thinks it is.

The challenge the Government faces in its second term—and this is the important message of Field's critique—is to ensure that the MIG does not become an end in itself. The government likes to talk about ending welfare dependency, but now it must deliver on encouraging greater personal responsibility. So far take-up of the MIG has been low. There may be a case for raising the basic pension rate to the level of MIG and restoring the link with earnings. This, the Institute for Public Policy Research suggests, would deal with pensioner poverty, cut means-testing and, if combined with the phasing-out of the second state pension, simplify the pension regime enabling better individual decision-making.[13] So far, the government has resisted such a move, fearing the economic costs. Buoyant tax revenues have enabled the Chancellor to increase public spending, especially on the NHS. But tough decisions will have to be taken by 2004 to ensure the Treasury sticks to its 'golden' fiscal rules: taxes or borrowing will have to be increased—or services cut. The political pressure on the government to appear financially prudent—fundamental to New Labour's political strategy—will remain intense.

So, the government must make a success of encouraging second-tier pension provision. Field's solution is compulsion. The government's is a mix of incentives and persuasion. Both approaches have their pros and cons. Field fears that stakeholder pensions will fail to reach their target group—so individuals must be forced to take up a funded scheme. The government thinks that compulsion will add to the tax burden. In the short term, the government must ensure that people are given adequate advice—and warnings—about second-tier pension. It must also work to simplify the pension regime to ensure that individuals have a clearer understanding of what the state will provide and what they are responsible for. This is essential if there is to be an honest debate about the cost of the welfare state in the future and how these costs are to be spread.

Re-working Social Democracy—Not Thatcherism Mark 2

The Government's pension policies do make sense. Within the political and economic constraints faced by the Labour Party in the mid-1990s, Labour has put together a policy that does something for today's poor pensioners, while at the same time encouraging greater self-reliance from tomorrow's pensioners through asset-building. Few believe that the government's approach is without limitations. Labour must stand by its commitment to 'what works'.

But for a government that was billed as Thatcherism Mark 2, its policies are modestly egalitarian. While retaining entitlements to the basic state pension, the government is encouraging a shift to a regulated private sector. Its approach is interventionist not *laissez faire*. The Left attack Labour for being not egalitarian enough—and for relying on the private sector too much. The Right attack the government for being too statist and for engaging in costly and complex social engineering.

The modest element of redistribution in Labour's social policies is linked to a far greater emphasis on the targeting of welfare reforms. This raises fundamental questions about the future of social democratic social policy, in particular the balance between universal and targeted benefits. In the post-war period, social democratic social policy was committed to the universality of the welfare state: that it should be available on the same terms (free at the point of use) to everyone. Not all of the welfare state was universal, but the principle became central to the theory and practice of post-war British social democracy.

The thrust of the government's welfare reforms has been to target extra help on those in need—such as the low paid, poorer families with children and poor pensioners. A 'baseline of essentials', as one of Labour's policy advisers (and now civil servant) Geoff Mulgan once put it. Certainly, what some call 'progressive universalism' is not very universal at all. Labour's reforms target welfare on those groups in need. In this sense they are progressive. Benefits are available to everyone, so they remain in theory universal. But crucially benefits are not the same for everyone: they are means-tested. Even Frank Field has acknowledged that the middle classes should be taxed on certain universal benefits like child benefit to ensure the legitimacy of the welfare state: ‘universal does not mean standardised’, he said in a Politeia lecture in May 1998. ‘We might have to offer an *à la carte* menu rather than a fixed-price menu to make sure we all eat in the same restaurant’.[14]

In many respects, New Labour’s social policies—pensions included—offer a re-working of post-war social democratic themes. The Chancellor Gordon Brown’s famous ‘prudence with a purpose’ is clear. To be prudent is to balance the nation’s finances and keep inflation under control. The purpose is to spend the fruits of a strong economy on collective public services and welfare to the working poor, especially those with children, and to pensioners. Brown’s prudence echoes Thatcherite economic philosophy; his purpose doesn’t. And while Frank Field fears that Labour’s means-tested welfare reforms will be de-railed by knavish behaviour, Gordon Brown appears happy that individuals can do as they like—as long as they work and, he hopes, save.

Response

Frank Field

Pensions policy sits at the apex of political and economic decision-making, and the past 100 years of pensions policy are unlikely to prove a reliable guide to the first century of the new millennium. During the twentieth century an expanding workforce facilitated the easy transfer of income between generations. In the coming 100 years that same transfer process, but with pensioners expecting a more generous pension, has to be achieved on the base of a relatively declining workforce. Can productivity, a notoriously difficult index to nudge upwards in the British economy, bridge the difference? Successful pension planning therefore necessitates some of the most important and long-term decisions politicians and voters are ever called upon to make. How far politicians are able and prepared to lead this debate is one of the big tests of the quality of Britain's political class.

Life expectancy at birth over the past few decades has increased at a rate of around two years every ten years. Decisions on individual pension provision now involve an increasing number of us making saving and spending decisions over a 60-year or more span of work and retirement. For the longest established company schemes this time scale already stretches for 120 years. How can an income in retirement be delivered through either a tax-based or funded scheme to today's workers when many of those who will have to produce the wealth from which pensions are paid are not yet born? Political as well as economic judgement of the first order is required.

There are few more fundamental political and economic questions than seeking the best way of delivering this pension expectation over the long-run. The political judgement underpinning a pay-as-you-go scheme is that the future workforce—some of whom are not yet born—will pay taxes as a means of redistributing to pensioners part of the income from their labour. If a funded solution is sought, then today's workers will claim a share of future national income on the basis of what their capital earns. Both methods have advantages and drawbacks.

Will the inter-generational tax contract prove strong enough to deliver the level of pension income expected? Or is the tax revolt, so evident in the 1980s and 1990s, to become a permanent part of the political landscape in Britain? Will the equity yield over, say, the next 50 years approach that of the last half century?

One aspect of judging the best means between these two alternative ways of delivering pensions, or where the balance lies between them, is that funded provision opens up new political perspectives. As more and more equity is owned by pension savers, can a form of economic democracy be developed alongside the political democracy we now have in Britain? While this is yet to register on the political radar screen I would guess that it is likely to be a major issue in politics 10 or 15 years hence. The universal protected pension suggests a distinctive way forward on both this economic and political agenda, and it is against this background that these four contributions need to be judged.

I am grateful to each of the essayists for their critiques of the universal protected pension proposals. Kirk Mann's and Stephen Driver's essays cover different aspects of the debate and I attempt to answer separately the main issues they raise before taking together the essays of Philip Booth and David Willetts.

Kirk Mann's essay brings back unwelcome memories of the kind of politics that helped to make Labour unelectable. The set menu of criticism is rigidly adhered to. No one criticism is spared in the attack, but at the end of the exercise one wonders who can possibly be listening. The style is amusing, but at the cost of consistency. Nothing constructive is added and much misrepresentation is achieved. First the contradictions. Kirk Mann extols the value of company welfare before launching into the UPP. In doing so he appears not to realise that the UPP is in effect a company welfare scheme for the whole nation that makes provision for carers, the single reform he calls for in his paper. People on modest incomes, whom Kirk Mann dubs as peasantry, do accept compulsion. All the surveys on the stakeholder market report respondents confirming that they know they should save but will not do so until it is made compulsory. Given the income on which some people have to exist, saving enough is impossible, hence the UPP's redistributory nature. Kirk Mann does not seem to see the contradiction in his cry against the City (a euphemism for capitalism) while advocating company schemes that include groups like carers. Why is it safe for Kirk Mann to advocate more savings through company schemes, given how he condemns the financial sharks in the City? His ideas lack coherence. Nor does his criticism on the scale of redistribution in the UPP make sense. What measure of redistribution does he advocate and how does he envisage delivering this politically? Silence quickly follows his brave cry.

I see a clear distinction between the warm feeling that some respondents may feel when replying to pollsters that they would welcome tax increases and the reality of people having a choice of whether to vote to make themselves worse off so that others can be better off. A central concern of my political life has been with maximising redistribution within a political culture more and more resistant to the idea. Here self-interest has a key role to play.

Kirk Mann totally misunderstands the nature of self-interest. My opposition to the Titmuss school stems from their fundamental misreading of human nature. Kirk Mann objects to the narrowness of my reading of human nature. He is wrong here as well. He cites other writers who 'acknowledge human frailty, incompetence and even greed, without constructing welfare reform with these to the fore'. Self-interest is not an aspect of human frailty. It is an integral and totally proper part of our nature and it is not to be attacked, let alone ignored, when trying to gauge how individuals might react to reforms. One of the consequences of airbrushing human nature out of politics for so long, apart from, of course, making the Left unelectable, was that for most social policy academics human nature was a dead language. Hence Kirk Mann's slipshod equating of self-interest with greed. It is not. Greed is part of our nature. It needs to be controlled and is a fundamentally different motivation from self-interest.

To explain what is to most people obvious about self-interest, though still far from obvious to a dwindling band of academics, is not to say that this is the only motive force in human nature. Of course it is not. But it is the primary one (the human race would not be here to tell the tale if it wasn't) and one which has to be engaged if, for example, our altruistic feelings are to be harnessed effectively for policy formulation. Altruism is too weak a force on which to build policy that will last the distance, and there are few policy areas, apart from our stewardship of the environment, where the distance is longer than with pensions. Altruism alone can sometimes stimulate a public demand for change, but self-interest is the rock on which long-term policy has to be built. Hence the redistribution within the UPP is sold on the basis of self-interest and altruism in that order.

The UPP's objective is to ensure that, in an age when providing for retirement will become more difficult, poorer people gain a pension that keeps them free of poverty throughout their retirement. For this to be achieved the altruistic motive of the majority has to constantly be reinforced by their self-interest. Of course, this pension guarantee can be bought in the private market but the rates would be prohibitive except for the very rich who, of course, have least need for it. The vast majority have to see that the reform has much of direct concern to them, as well as being a comprehensive scheme including the poor. The poor's contributions are paid because it is in the self-interest of the other members to pay them, i.e. redistribution is built into the scheme and is the 'price' paid for being in a scheme that delivers a pension guarantee.

Where are the building blocks of an alternative strategy in Kirk Mann's scheme of things? He cites the Bangladeshi's excellent inter-generational care. Great. But the same school who made their careers attacking the failure of company welfare to provide universal coverage, who followed in the footsteps of those who destroyed all collective pre-1948 welfare on the basis of this same failure to deliver to everyone, now seem to see a Bangladeshi model as appropriate. Both the enormous cultural differences between the countries, and the weakness of our civil society after 50 years of nationalised welfare, ensure that the Bangladeshi model by itself is not a serious option. UPP advocates see its advent as part of a widening and strengthening of civil society against the state collectivist approach.

Neither Kirk Mann nor Stephen Driver answer one of the fundamental questions posed by any pension reform. How are claims to be made against national income not yet produced by a labour force, some of whom are not yet born? Both contributors are silent although Stephen Driver's contribution is of a different order to that of Kirk Mann. His, I think, is a defence of the Government's strategy. He could not be more right in highlighting Gordon Brown as the main driver of welfare reform in the 1997 parliament, as he intends to be of health reform in this parliament.

Stephen Driver's analysis owes much to the popular media model whereby personalities take precedence over issues. Sure, Gordon won and I lost in personal terms. But on the issues? This kind of reporting, one can hardly call it analysis, ignores how the Chancellor's domination on the home front, with the Treasury's annexation of some of the big spending departments, is a strategy not without some severe drawbacks for taxpayers. Stephen Driver's emphasis on individual players ignores this vital interplay. The Treasury has historically been on the side of those from whom it takes money, even if it does not always seem like that to the hard-pressed taxpayer. The Treasury becomes the taxpayers' friend when it carries out its role of questioning how the money it has raised is then spent by individual departments. But if the Treasury becomes in effect the spending department, whether it is on welfare reform or health, this principal task is lost. The Treasury acquires a vested interest in spending as much taxpayers' largesse as possible. Gordon Brown is in charge of the tax credit programme. Success is measured, as it was in the early days of housing benefit, simply by the numbers claiming the tax credit benefit and the money paid out. The more who claim, and the bigger the bill for taxpayers, the greater is the political acclaim for the proposals. But success cannot be measured simply by this kind of criteria. No-one now claims that the £12 billion housing benefit bill is a sign of its success. Rather, the opposite is now the accusation. The benefit pushes up rents and opens up untold chances for fraud. The debate on tax credits will follow the same trajectory. And as it does Stephen Driver's main defence of New Labour's social policy—that it works—will begin to look a little dated and be seen very much as part of the uncritical enthusiasm that accompanied Labour's triumph in 1997.

Perhaps it is worth commenting upon one or two other points made by Stephen Driver. His dichotomy between the big bang and incrementalism in New Labour's debate about welfare reform is false, and later in his essay he appears to accept this. But it does not stop him posing these alternatives as part of the punch-up between myself and Gordon Brown. It might be good chatty stuff for the newspapers but it doesn't stand up to serious consideration. The UPP is to be run alongside the bedrock of existing provision. Indeed the national insurance basic state retirement pension continues as part of the full pension guarantee. There is no big bang in the sense that everything changes. True, the UPP does not solve pensioner poverty now. That is not its purpose. Its aim is to prevent it in the future. And it does so in a way that minimises the dangers inherent in the existing means-tested approach. Indeed it begins to make sense of Gordon Brown's strategy by time-limiting the life of the minimum income guarantee and the pension credit.

Here lies the second issue. Stephen Driver views my concern over the moral hazards of means-testing as misplaced. With the MIG and pension credit making savings for the poorest 40 per cent or so of the population a no-go area, it is hardly exaggerating to emphasise the economic sense of not saving. The collapse of pension savings, with new inflows now standing at a quarter of the level of five years ago, is, I guess, in part due to the spread of means-testing.

It is the UPP proposals, which could be seamlessly developed from the current Government's reforms, that Philip Booth and David Willetts consider carefully. These are two of the most serious critiques so far made of the UPP proposals and it is to them I now turn. Philip Booth's essay ranges over a number of important issues before ending with a critique of the UPP's governance proposals. So does David Willetts' contribution, but he stresses above all else his doubts on whether the UPP scheme could ever be independent of government. This concern is of another order to the other criticisms raised by these two authors, and I shall conclude my comments therefore on this issue of independence after examining the four other major concerns of these two essayists.

The first centres on what should constitute a national insurance contribution and when does such a contribution become a tax? David Willetts' views, in particular, appear to be heavily influenced by what an insurance contract constitutes in the private market and how this concept relates to Beveridge's ideas. It is assumed by David Willetts that Beveridge had a consistent view of what constituted an insurance contract. The opposite is, of course, true. Beveridge began formulating his ideas in 1906 when he registered opposition to the contributory principle. Within a little over 12 months he converted to a new position following a visit to Germany. There he witnessed the benefits of the German social insurance scheme that proved particularly alluring, given that Beveridge at this time was an apostle of national efficiency. The German model also fitted into Beveridge's developing ideas of society as a social organism, in which powerful and vibrant organisations shielded the individual from state domination. National insurance offered the substantial advantages of gaining universal coverage, of giving members a sense of belonging to the same organisation and having a shared body of interest.

That it built on the existing friendly society and trade union traditions of insurance was an added attraction.

What Beveridge was not advocating was the simple adoption of what the private market saw as insurance, of varying rates according to the circumstances of the individual for a particular type of coverage. Contribution conditions had to be fulfilled before benefit was paid and the scheme had to pay its way. But there was a large taxpayer subvention to make up the difference between the money a flat-rate poll tax could raise and the cost of a viable scheme that severed links with insurance as was understood in the private market. Contribution conditions had to be fulfilled before benefit was paid. The scheme was also redistributive, even, to use Philip Booth's phrase, highly so. And because of the redistributive nature of the scheme some contributors could have gained a better deal in the private market. So, even at the conception of Beveridge's scheme, the link between contribution and benefits was more tenuous than David Willetts appears to accept. The UPP continues to develop the idea of national insurance, just as Beveridge developed his ideas in stages first during the years up to the First World War, then during the inter-war years, and then finally during the Second World War years themselves, and for the same reasons. Beveridge adapted his views on national insurance in order to achieve his over-riding objective. Abolition of Want was the goal. Insurance was the best means to that end and the means had to be developed so as to achieve the goal.

I do not believe the UPP contributions are any more of a tax than were national insurance contributions in 1948. More importantly, I do not believe the public would see them as a tax. In an age where it is going to be ever more difficult to raise revenue for agreed social objectives, it is a form of carelessness beyond the Lady Bracknell syndrome to throw away the advantages voters see in a national insurance type scheme. Contributions that only go into a funded pension scheme are, I judge, much more likely to be seen as simply that. Taxes are seen essentially as a confiscation of income which is then spent on whatever programme a government sees as desirable. Fortunately, what constitutes savings and what constitutes a tax is not a matter that has, or indeed can, be settled by disputation. The only referee is the taxpayer and this is a matter that can and should be directed to them for an answer.

Both Booth and Willetts also question the UPP on the grounds that, while the contributions are earnings-related, the benefit received is flat-rate and that therefore, in Willetts' words, 'There is no relationship between the contributions that go into the funded pension and the money that you get out when you retire' (p. 53). In fact there is a relationship, in that shorter contribution periods will result in a lower pension, but Willetts and Booth do correctly grasp the nature of the scheme's redistribution. This same pattern of redistribution is, as Booth acknowledges, already long-established in the form of the basic state pension. However, the idea of introducing some form of earnings-related pension in return for the earnings-related contributions is certainly not one that is inconsistent with the UPP, as long as the minimum pension is still above the poverty line and lifts people clear of means-tested benefits. The article of faith is to abolish pensioner poverty, not necessarily to deliver an identical deal for everyone. It is a development of the scheme that would be worth considering prior to implementation.

The second issue that has to be faced, given the UK's income distribution, is that ensuring a minimum adequate retirement income requires redistribution at some point, either during the working life of the recipient or after retirement. Elsewhere David Willetts accepts this is a choice that has to be made and that it has less damaging effects to redistribute earlier than to reward failure to save later. Philip Booth accepts this and argues for a working-life redistribution, as does the UPP. He argues for achieving this objective, however, in a very different way. His tax break ideas are as yet uncosted and there is no link to the UPP's objective, which is to eliminate poverty in retirement through a defined-benefit income above means-tested welfare. Such an objective brings huge rewards quite apart from the abolition of the moral hazard in the present system —and any system that redistributes to the poor during retirement. The UPP objective ensures that means-tested welfare for the retired falls away with huge savings to public expenditure. To give an idea of the size of the savings on means-tested benefits that the UPP will generate: they could pay, for example, for the abolition of income tax for pensioner households.

Indeed, when the pension credit is introduced in April 2004, expenditure on means-tested benefits for pensioners will hit £13bn per year—an increase of 40 per cent in real terms since 1997 and equivalent to 5p on the basic rate of income tax. Official forecasts suggest this bill will continue to grow quickly. Booth's critique of the cost of the UPP, although argued with all the skill for which he is justifiably renowned, fails to take into account that, once the UPP comes into payment, huge savings will accrue on expenditure on means-tested benefits.

The follow-up process to the first report on the UPP has resulted in a change to the age at which the funded element of the UPP will be paid—and correspondingly lower costs. Given the very significant continuing increases in longevity, it is not unreasonable to propose that, when the UPP comes into full payment in 40 or more years time, paying the funded element of the UPP from age 70 will be justified. This move reduces the required additional employee national insurance contribution to just two per cent. The change, it should be emphasised, does not affect the pension age for the unfunded basic state pension—that would remain at 65.

How the UPP would impact on existing pension provision is a third issue raised by these last two contributions. That the introduction of the UPP would lead to over-provision is a worry for Philip Booth. Here again I do not believe that either Philip Booth or David Willetts have the full measure of the trends in occupational pension coverage that are now well under way. It is not just the move from defined-benefit-type schemes to defined-contribution-type schemes that should concern us. Nor is it just that this transfer is generally being accompanied by a significant decrease in employer contributions that now compounds the fall in employee savings.

Most commentators see defined-contribution as the final resting place for occupational schemes. I doubt that. The defined-benefit arrangements pay considerable dividends to employers over and above the knowledge that they are the major providers of decent income for their employees in retirement. They create loyalty and, when any 'downsizing' has to take place, for example, defined-benefit schemes offer redundant employees a reasonably generous pension package. No such package is offerable under defined-contribution schemes as the investment risk is with the employee.

Moreover, the shift to defined-contribution schemes run by companies specialising in pension provision, which will also become a much more marked trend over the next five years, allows employers to wash their hands completely of any pension responsibility to the prematurely retired and retired alike. It is not unreasonable to predict that boards currently seized by the urge to cut pension costs, and so help company profitability, will return to pension provision once the defined-contribution has been successfully achieved. 'What is in it for us?' will be the cry heard from more and more company boards running in-house defined-contribution scheme. Some of the very best employers will hold out, but will most?

On present trends I very much doubt it, and so the next wave of changes will centre on outsourcing and closing what remains of company pension provision. Moreover, with the closure of most defined-benefit schemes, does anyone seriously suggest that public pension schemes will be left unscathed by taxpayers who feel with good reason that they have been cheated out of their pension promise?

The question will not be one of over-provision as Philip Booth highlights. It will be the reverse, where the gap in savings needed for retirement grows rather than diminishes. It is of course proper to consider how a UPP introduction might speed up the present trends from defined-benefit schemes. But if the scenario I have painted of a very large exodus of employers from running their own schemes is right, the introduction of something like the UPP becomes more not less urgent.

That a compulsory scheme discriminates against the sick is a fourth matter commented upon by Philip Booth. True, but any scheme, public or private, does precisely that but in different ways. The UPP however counters this by having a universal life cover as part of a plan. Over £100,000 at death has been costed into the scheme. It also has cover for carers.

The final issue I wish to consider is the one on which David Willetts majors. Despite all the rhetoric about the need to reinvent civil society, David Willetts sees the UPP only in terms of being a giant front for resurrecting a nationalisation programme undreamt of even by the Bennite Left. This criticism is not without a certain irony. David Willetts is ahead of the game as the first person on the political Right in this country to refocus on the pivotal role civil society has in underpinning our freedom. Yet David Willetts and the Conservative Party in general have yet to come forward with proposals for strengthening civil society, as opposed to telling, in the most general terms, anyone with the time to listen that this is their objective.

The UPP proposals can be read simply as a pension reform. They can also be read as a pension reform in the context of constructing much of the economic and political agenda stretching over future generations. It can also be read in both these two contexts while at the same time being an essay on civil society. Yet the apostle of civil society appears stung and immediately calls foul.

The UPP advocates are as fully aware as any group could be of the dangers of political interference and even of indirect political control. That is why they emphasise the strategic distinction between trustee and fund manager, a role confused by David Willetts, and the power fund managers already exercise that is ignored by David Willetts. Fund managers are not open to phone calls from ministers, as David Willetts appears to believe. The 'single body' he refers to is the trustees and their overall investment strategy. However the UPP constitution will mean that the trustees' role is to select fund managers and not to make decisions about takeovers on the one hand, or who will be company directors on the other. This is the already established practice in occupational schemes across the land. It also happens in the national Canada Pension Plan, for example. Indeed, the argument of excessive market control—or 'owning much of British industry' (p. 54)—ignores how much regulation there already exists to prevent investment vehicles amassing highly concentrated assets. Unit trusts and investment trusts, to take two examples, are both limited in what proportion of a company they can own or what proportion of their assets they can invest in a single company. A development of this type of regulation, perhaps with restrictions on the level of investment in UK markets, is perfectly feasible for the UPP. Even if the UPP were 50 per cent invested in UK equities, it would, at a maximum, own about ten per cent of the equity market. The fund would be very large, but would be invested globally. It would be fragmented amongst many different fund managers, who would also be managing other assets. The counter-factual is an ever-smaller number of fund managers with more power. Any sustained and significant increase in the UK's funded pension provision (a Labour and Conservative Party target) is likely to mean that pension funds own more of the economy. It is a fallacy to believe that because, for example, personal pensions are at a purchase level individualised, that this significantly weakens the market power of, say, a Prudential or Legal & General fund manager.

The UPP is also an essay on redrawing the boundary between government and non-government activities or, if you wish to call it so, an essay on civil society. Prior to the nationalisation of welfare in 1948, collective provision, which was far more extensive than the statists would concede or perhaps comprehended, was delivered by non-government bodies. While government is responsible to the electorate, it is responsible over huge areas of policies. Voting against the government because of its failure in one area, say pensions, is a most risky business, particularly if the voter thinks that on most other grounds the government has done tolerably well and the opposition is unlikely to acquit itself in a comparable fashion. Here the re-invention of civil society adds to democratic control. The members of the UPP have a single issue before them when considering the stewardship of trustees. Performance is centred on how well the trustees are delivering. In no way could trustees behave as governments have to state pension schemes. Dr Johnson once remarked: ‘When a man knows he is to be hanged in a fortnight, it concentrates his mind wonderfully’.

The October 2001 report by the Pensions Reform Group committed the Group to running three seminar groups subjecting the proposals to rigorous analysis and criticism.

Three seminar groups were convened to discuss the following three key aspects of the reform:

- governance and investment;
- compulsion and redistribution;
- how the proposals fit with occupational pensions;

From the outset the discussions were lively and exceptionally well-informed—perhaps unsurprising given the calibre of the participants. This is not the place for a detailed discussion of the refined proposals. For those with an interest in the continuing pensions debate, they were published in July 2002 as *The Universal Protected Pension: The Follow-Up Report*. Nevertheless, it is worth very briefly illuminating a few aspects of the evolution of these ideas.

Much of the ideas’ evolution answers the outstanding criticisms of Booth and Willetts. To give a couple of examples: refinement of the proposals led to a softening of the guarantee to deliver a specific percentage of average earnings. It was felt that the trustees would have to possess the power to alter both the contribution rate and, with a certain range, the pension. It was decided therefore that the pension would aim for 25-30 per cent of average earnings. This change will make the task of trustees easier without vitiating the scheme’s promise of freedom from poverty in retirement.

Second, the PRG had always envisaged that there might be some combination of a phasing-in of contributions and some allowance made for present consumption that is likely to be the ‘best’ use of limited income—education and training being a classic example. The new report suggests that this could be incorporated into the proposals.

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15 *National Insurance Fund Long Term Financial Estimates*, Government Actuary's Department, Cm 4406, July 1999, Figure 1.1.

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