saving for the future

Rt. Hon. Alistair Darling MP
Secretary of State
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THE SMITH INSTITUTE

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Introduction

Wilf Stevenson

The Smith Institute has been set up to look at issues which flow from the changing relationship between social values and economic imperatives, an area that was of particular interest to the late John Smith QC MP.

John Smith believed that people had a responsibility to help themselves. But he also had a passionate belief that poverty has no place in a civilised society. The Commission on Social Justice, which he set up in 1994, set out the principle that a future Labour Government must both tackle poverty and encourage savings. He would have been interested in the current pensions debate.

The Smith Institute held a series of influential seminars in the Winter of 1998/99, which focused on equality in the modern economy from a conceptual point of view. Last year, the Smith Institute held a successful series of seminars that focused on equality in action. During this, it became clear that while the main drivers for reducing inequality were work and education, the gradient of these ladders of opportunity was lowered in certain socio-economic groups, particularly those in low pay employment, or on welfare. The Institute's current programme therefore includes a series of seminars examining the public policies that underpin an approach to equality for the low paid.

Most countries are faced with problems of inadequate pension provision, arising from differential saving patterns and demographic shifts. Experience suggests that although regulatory and statutory measures are complex, governments have a key role to play in facilitating change. The Institute is therefore pleased to be publishing this monograph by the Secretary of State

for Social Security, which sets out the Government's strategy for reforming both state and funded pensions, and maps what has been achieved during this parliament and the plans for the next few years.

The monograph is, however, not only a contribution to the debate about appropriate pension provision in the UK; it is also a timeous contribution to the one-day US/UK Pensions Summit (entitled *Learning Pensions Lessons from across the Atlantic – Building on Success*) which the Institute (with the support of Prudential plc) is holding in February 2001.

Foreword

Since 1997 the pensions landscape has changed dramatically. This pamphlet sets out our strategy for reforming both state and funded pensions, to ensure that every pensioner shares fairly in our rising prosperity. It sets out what we have already achieved this parliament and how we now seek to build on this over the next few years.

Our objective is to ensure that everyone has a decent income in retirement, whilst keeping the system affordable for the long term. But this can only be achieved by rejecting the old approach that relied on universal state provision, and the views of those on the right, who would privatise our pensions system. Instead, we are building a new partnership between state and private pensions.

John Smith believed in the virtues of thrift: people had a responsibility to help themselves. But he also shared a passionate belief that poverty has no place in a civilised society. The Commission on Social Justice, which he set up in 1994, set out the principle that a Labour Government must both tackle poverty and encourage savings. And we have shown, in this parliament, that we can achieve both these objectives.

When we came into office, our first priority – quite rightly – was to address the immediate needs of today's pensioners. Under the last government, the gap between rich and poor pensioners grew to be the largest for about 30 years. By 1997, one in six recently retired couples were retiring on £20,000 a year or more. But at the same time, many pensioners were living in poverty. That's why we were right to introduce the Minimum Income Guarantee. As a result of this, and other measures we've introduced since 1997, nearly 2 million of our poorest pensioners are at least £15 a week better off in real terms.

Over this parliament we are also helping all pensioners, by building on the Basic State Pension as the essential foundation for a secure retirement. And we are delivering extra money where it is needed, like the Winter Fuel Payments for all pensioners and free TV licences for those over 75.

But not only did the system we inherited fail to tackle poverty amongst today's pensioners, it was also failing to provide security in retirement for tomorrow's pensioners. So our second priority this parliament, was to put in place the long term reforms to enable more people to save for their retirement and to provide security for those who cannot afford to save. From April, the new Stakeholder pensions will go on sale. And next year, a new State Second Pension will start providing those on low incomes with a substantial boost to their pensions.

But the next essential step in our reforms is to remove the penalties for saving, and instead make sure that we reward saving. We inherited a benefit system that penalises those who have modest occupational pensions or savings and who find that their thrift denies them help that others receive.

Every week I meet people who have done everything that successive governments have asked them to do. They've worked hard all their lives, they've put a bit of money in a savings account, they've got a small occupational pension – and they feel their effort has been wasted. Under the current rules they get no extra help. That is what we are determined to change.

This next stage of our reforms, will mark a further step in our progress towards integrating the tax and benefits system. For working age people, we have already introduced the Working Families' Tax Credit and the Disabled Person's Tax Credit. And in Budget 2000, the Chancellor announced that we would apply similar principles to support for pensioners – by introducing a new Pension Credit from 2003.

The Pension Credit will be the most radical change to our pension system for 50 years. When introduced, it will benefit half of all pensioner households. And – for the first time – it will ensure that we reward the thrift of millions of pensioners who worked hard all their lives and who are now living on low or modest incomes.

The reforms set out in this pamphlet build on the Basic State Pension. They tackle poverty and reward thrift. And above all, they will ensure that all pensioners share fairly in our rising prosperity, whilst keeping the system affordable for the long term.

1. Summary

1.1 Strategy for reform

Our objective is to make sure that everyone has a decent income in retirement. At the same time, we must ensure that our pension system is affordable and sustainable over the long term.

Three steps are therefore necessary:

- first, we need to tackle pensioner poverty today and ensure that all pensioners share fairly in our rising prosperity;

- second, we need to prevent poverty in the future by putting in place the long term reforms to our pension system;

- third – we need to encourage and reward saving for retirement. We must ensure that it always pays to save: thrift should be rewarded, not penalised.

Fifty years after the founding of the modern welfare state, we inherited a pension system where none of these objectives were fully achieved. Whilst some pensioners were retiring on good incomes, too many were not. Indeed too many were dependent on benefits on top of their pension at, or soon after, their retirement.

At the same time, many people were heading for retirement without having built up adequate savings. In fact, if we had done nothing, by the middle of this century a third of all pensioners would have been on income support. And finally, the system actively penalised saving. Millions of people saved a little bit and found they got no advantage for it.

Over the last 50 years, successive governments have tried at various times to either tackle poverty or encourage saving.

For too long, left of centre governments have seen universal state provision as the best form of pension provision and as the remedy for pensioner poverty. But that approach could never do enough to lift the poorest pensioners out of poverty. Today, there are still those who advocate universal benefits as the best policy for pensioners – despite the fact that it has failed in the past and pensioner incomes are now more divergent than ever before.

On the other hand, governments of the right argued that measures to tackle poverty amongst today's pensioners would act as a disincentive to save for today's workers. Over the years, they let pensioner poverty grow, with no coherent strategy to address it. At the same time they were committed to an ideology which favoured privatisation in pensions, as in other parts of the welfare system.

The truth is that both approaches were flawed. Relying solely on the state would not provide people with the higher incomes they rightly want for their retirement. And a universal flat-rate pension could never do enough to address income inequality.

But relying wholly on funded pensions would mean that people on low incomes, or who are not in work, could never save enough for a decent retirement. It is only the state that can undertake the redistributive function, to give the most help where it is needed.

So the challenge for the new Labour Government was to build a new partnership between the state and funded sector, to deliver our twin objectives of tackling poverty and encouraging saving.

1.2 A new public-private partnership

This parliament, we have faced the crucial dilemma of how to reconcile the immediate needs of today's pensioners with action to promote savings, and thus prevent poverty amongst future pensioners. And we have matched these principles with action against poverty today, alongside radical reforms to encourage savings.

In 1998, we published a Green Paper on pensions[1], which set out our overall strategy for reform of both state and funded pensions. Our approach is based on renewing the partnership between the state and funded pension system, working together to ensure that everyone can achieve a decent income in retirement. The approach we set out in 1998 has been almost universally endorsed.

We considered, but rejected, two extreme alternatives:

- privatising the pension system entirely so that over time state pensions are wholly replaced by funded pensions; and

- relying on a system where the state is the dominant pension provider.

Privatisation of the UK pension system wouldn't deliver our objectives. People on low incomes or with broken work records can't afford to make sufficient contributions to produce an adequate income in retirement, after the costs of administering the fund are taking into account. That view, which was set out in our 1998 Green Paper, was widely endorsed. Privatisation was wrong then – and it's still wrong now.

On the other hand, relying on universal state provision alone would be unaffordable for the longer term, and would deny people the opportunity to make better provision for themselves and their families. And it would ignore

1 *A New Contract for Welfare: Partnership in Pensions,* December 1998, HMSO, Cm 4179.

the fact that over the last 25 years, more and more people have taken out second pensions to save towards their retirement.

Instead, we want to build on the best features of both the state and private provision. The Basic State Pension is, and will remain, the foundation for income in retirement. But in order to deliver the increased incomes that people rightly want during their retirement, a second pension is – and always has been – essential.

1.3 Encouraging saving

We believe that people who can save for their retirement have the responsibility to do so. In return, the state must: provide more help and encouragement for people to save; ensure proper protection for those savings; and make sure people see the benefit of their savings.

To enable more people to save for their retirement we have:

- established the right conditions for saving: a strong and growing economy; low inflation; higher incomes; helping to restore confidence in the pensions industry;

- built on the complementary role of both state and private pensions: both are necessary as we shall show;

- introduced new options for people to build up a good second state or funded pension – the State Second Pension and Stakeholders Pensions;

- will be providing better information for individuals on their own pension position; and

- as we move towards the Pension Credit in 2003, we've begun the process of removing the penalties for saving: by reducing the tax burden on pensioners; and by enabling pensioners who have saved to see the benefit of their thrift.

We are doing this in a partnership between the state and private sector: more rights and choices, in return for greater responsibility. But it is only by building on the partnership approach, and by making the necessary reforms, that we will continue to both improve pensioner incomes and keep the system affordable.

The next step will be to go further to ensure that not only do we remove the penalties for saving, but that for the first time we reward people for their thrift. To deliver this, we will introduce a new Pension Credit from 2003.

The new Credit will bring together our twin objectives of eradicating pensioner poverty and encouraging saving. And it will help renew the partnership between the state and the funded sector, on which the British pensions system has historically relied.

2. A Brief History of the UK Pensions System

2.1 Early development of a mixed public/private system

From the earliest days of pension provision, the UK has always had a mixed system of public responsibility and private initiative.

Funded pensions have been a feature of our pension system since the nineteenth century, and occupational pensions were firmly established by the start of the twentieth century. But most schemes were then limited to public service or white-collar workers, such as clerks and managers. Others had to rely on trade unions and friendly societies for private savings and insurance. This meant that too many people had no cover.

A state pension was first introduced under the 1908 Old Age Pensions Act; it was subject to a means test, together with a test of "moral character". It was not until the Beveridge Report in 1942, which was implemented by the post-war Labour Government, that the UK moved to a near-universal state pension, paid in return for flat-rate contributions, and supplemented by a means-tested system of support for the poorest pensioners.

But it was always intended that state and funded pensions would be complementary. Both were key to the UK system of pension provision before and after the founding of the modern welfare state. Indeed Beveridge made it very clear, in his 1942 Report, that the Basic State Pension was intended to provide a minimum standard, on top of which individuals could make provision for themselves:

"The State in organising security should not stifle incentive, opportunity, responsibility; in establishing a national minimum, it should leave room and encouragement for voluntary action by each individual to provide more than the minimum for himself and his family". [2]

2 Sir William Beveridge, *Social Insurance and Allied Services,* 1942, pp6-7

During the 1950s and 1960s, membership of occupational pension schemes grew rapidly. Successive measures were also introduced to increase the coverage of second tier state pensions, leading up to the introduction of the State Earnings Related Pension Scheme (SERPS) in 1978. This scheme paid a pension, on the basis of earnings, during the best 20 years of each person's working life. SERPS was compulsory, except for those who were able to "contract out" into an occupational pension paying an equivalent or better level of pension.

In 1974, regular uprating of state pensions was introduced (instead of raising the value on an ad hoc basis every couple of years or so). In 1974, the Labour administration decided to increase the Basic State Pension in line with prices or earnings, whichever was higher. In fact, the pension was increased in line with earnings in only 4 years, reflecting in large part the very high inflation rates of the time.

2.2 Reforms during the 1980s and early 1990s

The balance between state and funded pensions underwent significant change during the 1980s. First, the Conservative Government decided to uprate pensions in line with price inflation. This meant that second pensions and other savings would become increasingly important to maintain the living standards of pensioners.

Second, to bring the state system more in line with private pensions, the Conservative government introduced measures to cut the future value of SERPS and to halve the SERPS entitlement for those widowed after April 2000. But despite the passing of legislation in 1986, people were never properly informed about the change. Worse still, some were given misleading or incomplete information about their future position. The problems that arose from this scandal had to be cleared up by the present Government in 2000.

Third, the reforms to SERPS were accompanied by a number of reforms to improve the options available to those without access to an occupational pension, by introducing personal pensions. This was done by providing strong financial incentives, through higher rebates, for employees who contracted out into funded pensions.

In addition, the Conservative government prohibited employers from compelling employees to join their occupational pension scheme. These factors contributed to the subsequent pensions mis-selling scandal, which resulted in millions of people leaving their occupational schemes in order to take out poorer value personal pensions instead.

By 1993, in response to the problems of mis-selling, the Major government had removed the additional rebate incentive to take out private pensions. But millions of people who had lost out as a result of mis-selling remained to be compensated.

In 1995, legislation was also passed to raise the state pension age for women back to 65, to be phased in between 2010 and 2020. This change will have a significant impact on pensions planning for millions of women.

2.3 Why reform was needed

Over the past few decades, there have been fundamental changes in the economy and in our society – and the pensions system needed modernising to reflect those changes. First, the demographic trends are well known: an ageing population means, quite rightly, there is pressure to ensure that our system remains affordable for future generations.

Second, the position of women has changed dramatically. In Beveridge's day, women were expected to rely on their husbands, not just for an income during his working life, but also in retirement. As more and more women

entered the labour market, this old assumption of female dependence has broken down. Women now want – and expect – to build up a pension entitlement in their own right. At the same time, the number of divorces has increased, so we needed to review the way that pension assets are divided as part of a divorce settlement.

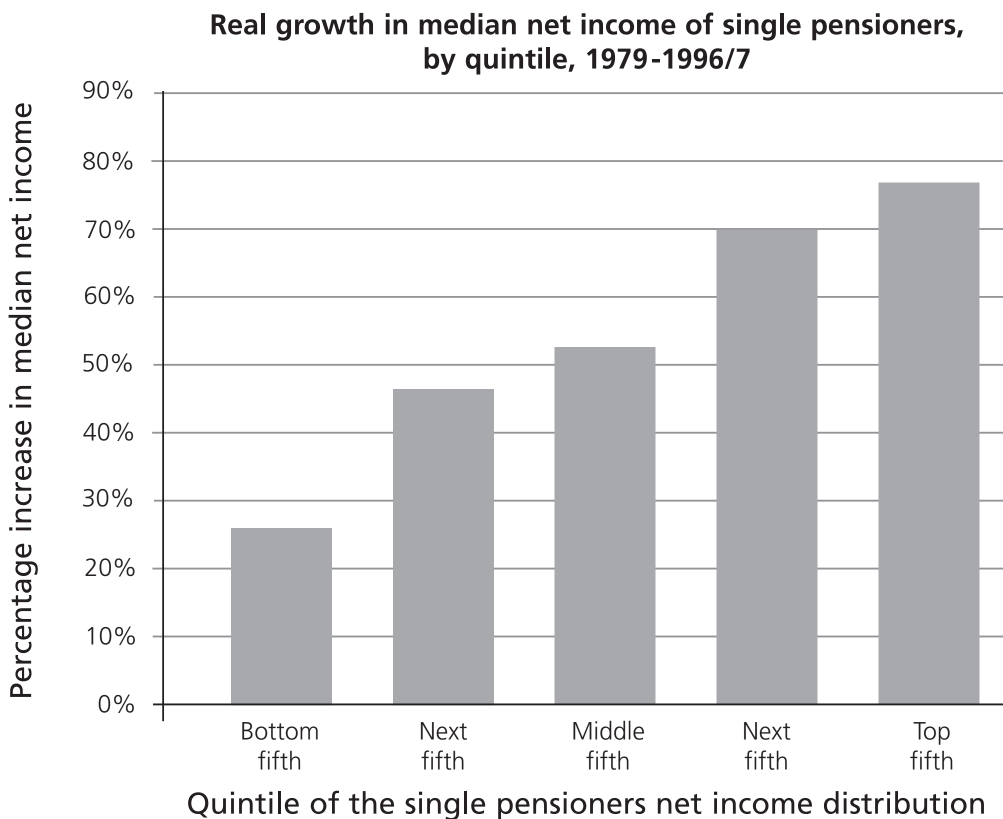
Third, there have been significant changes in the labour market. For example, the number of people working part time has risen by 40% since 1984 and the number with temporary contracts by more than a third since 1992. At the same time, the number of small firms has increased, partly due to a rise in self employment. This is important because smaller firms are less likely to offer occupational pension schemes than larger companies. All these changes have led to new demands for more flexible products, to fit better with people's employment patterns.

Fourth – and perhaps most importantly – over the past two decades, we saw a dramatic rise in pensioner inequality (this was set out in more detail in a recent DSS published paper[3]). Between 1979 and 1996/7, for both singles and couples, the incomes of the richest fifth of pensioners rose by around 80%, but over the same period the incomes of the poorest fifth grew by only 30%. This is shown in the two charts overleaf:

But the widening inequality also meant that the old approach (an across the board increase in the Basic State Pension, whether linked to prices or earnings) was inadequate. It would not do nearly enough for the poorest pensioners, nor would it do enough to reward savings. A new approach was required, to deal with the reality of pensioner incomes today.

3 The changing pattern of pensioner incomes is set out in more detail in: *The Changing Welfare State: Pensioner Incomes,* Department of Social Security Paper No. 2, March 2000.

Figure 1: Growth in inequality of pension incomes



3. Reforms during this Parliament

3.1 Tackling the problems we inherited

Our reforms address the three key problems facing us when we came into office:

- for today's pensioners – tackling pensioner poverty and ensuring that all pensioners share in our rising prosperity;

- preventing poverty in the future, by encouraging all those who can save to do so. That means creating the right economic climate, ensuring that savings are protected, and providing the appropriate savings options; and

- making sure that saving is rewarded, instead of being penalised.

In order to tackle these problems, we wanted to build on the positive aspects of the system we inherited. But at the same time we had to develop new solutions, which take into account the reality of pensioner incomes today.

3.2 Today's Pensioners: Tackling Poverty

Faced with growing pensioner poverty, our first priority – quite rightly – was to do more for those living on the lowest incomes. To start tackling the urgent problem of pensioner poverty, we introduced the Minimum Income Guarantee (MIG).

The MIG has already delivered more help, more quickly, to nearly 2 million of our poorest pensioners. When we came into office, just under 4 years ago, a single pensioner, aged 70, on income support would have received a weekly income of £68.80. From April, the same pensioner would get £92.15, so they would be nearly £18 a week better off, over and above inflation.

We wanted to ensure that all pensioners would share fairly in the rising prosperity of our country. And the action we have taken is already delivering new help to all pensioners. As we move towards the new Pension Credit in 2003, we are raising the Basic State Pension – this year and next; we're giving more help with lump-sum bills, like the Winter Fuel Payments and free TV licenses; and we are reducing the tax burden on pensioners.

Overall we are spending more than £8.5 billion extra on pensioners over the parliament, which is £5 billion more that if we had instead restored the earnings link. In 2002, the poorest pensioners will be getting five times more than an earnings link would have given them. So our reforms are delivering more help for today's pensioners, but with most help for those who need it most.

3.3 Tomorrow's Pensioners: Long Term Reforms

Our second priority was to put in place the longer term reforms to ensure that tomorrow's pensioners can retire on a decent and secure income, whilst making sure the system remains affordable and sustainable for the long term.

For many people, the mix of public and private provision in the UK system has worked well. Increasing numbers of pensioners are retiring on good incomes, largely because they have built up a good second occupational pension.

But too many people who could afford to save are not doing so. Two in five of today's workers have made no provision at all for their retirement, beyond that provided by the state.

Similarly, there are many people on low earnings, or who are out of work, who do not get the opportunity to build up a decent second pension. The State Earnings Related Pension Scheme (SERPS) has served some pensioners

well, but by its very nature it gives least help to those who need it most.

So this parliament, we have put in place the long term reforms that will enable people to build up a good second pension, both state and private.

3.4 Affordability

At the same time, we needed to ensure that our reforms were affordable, and would not pose a threat to the public finances.

Governments across the world are grappling with the implications of an ageing population, not only for their pensions systems, but across the range of health and social care. The average OECD *elderly dependency ratio* (the population aged 65+ as a proportion of the working age population) is expected to almost double between 1990 and 2030.

All too often this demographic change is described as a "time-bomb" or in other apocalyptic terms. But, in fact, the scale of the problem faced by individual countries is very different and has more to do with the structure of their pension systems than with the pace of demographic change.

Recent research[4] has shown that in some European countries, without reforms, state spending on pensions could rise to 15-20% of GDP in 2030. This is mainly due to the lack of any significant funded pension provision in those countries, and the resulting pressures on their state pension schemes.

In contrast, the UK pensions system is affordable, largely because of the historic partnership between the state and a strong funded pension sector. So that whilst the total income of pensioners will rise in years to come, this will be mainly due to rising contributions into funded pensions. State

4 Taken from the October 2000 EU Communication "The future evolution of social protection from a long term point of view: Safe and sustainable pensions".

spending on pensions is rising in real terms, but less sharply, and is predicted to fall slightly as a proportion of national income. As a result of the reforms we're making, the UK pension system will remain affordable and sustainable for the long term.

3.5 Options we rejected

The Green Paper on pensions, published in 1998[5], looked at the options put forward by those who wish to move either to fully funded pensions, or to a wholly state-run system. And we concluded that both of these extreme options would be impractical.

A completely private system would be unworkable, as people on low incomes can't afford to put aside enough for a decent income in retirement. Allowing people to opt out of the state system would also create a very large transitional funding gap – because the contributions of today's workers are needed to pay out the State Pension to today's pensioners. In our view, the public pension system remains the most efficient and effective way to enable those on low and moderate incomes to save for their retirement.

But this must be complemented by a strong funded sector. A purely state system would deny people the opportunity to build up better pensions for themselves and their families. It would also fail to recognise the changes that have taken place over the last few decades. Many people have taken out second pensions: the problem is that too many have been unable or unwilling to do so.

5 *A New Contract for Welfare: Partnership in Pensions,* December 1998, HMSO, Cm 4179.

4. Creating the right environment for saving

4.1 Why encourage savings?

The starting point for our long term reforms is to encourage people who can save for their retirement to do so. In return, the Government is responsible for: creating the right environment for saving; ensuring proper protection for those savings; and – crucially – putting in place the right incentives and making sure people see the benefit for their savings.

Savings are important to provide people with independence throughout their lives, and security if things go wrong, as well as ensuring a more comfortable retirement. For a long time, there has been concern that too many people in the UK have no, or only very low levels of savings. However, total contributions to funded pensions (occupational and personal) were around £25 billion in 1999, the highest ever level, and an increase of around 15% since 1997.

During this parliament, we have taken a number of steps to encourage people to save throughout their lifetime. These are set out in more detail in a recent Treasury publication[6] and include: extending tax incentives for saving, particularly to low-income savers, by introducing Individual Savings Accounts; and measures to tackle financial exclusion.

But the first and fundamental starting point to deliver a pro-savings culture is to get the right economic conditions.

4.2 Low inflation environment

People need to be able to save without fear that the value of their savings will be eroded by rapidly rising prices. We are committed to low inflation, reducing the national debt and giving independence to the Bank of England to set interest rates. As a result of these political decisions, we now have stable

6 The Modernisation of Britain's Tax and Benefit System, No. 7: *Helping People to Save,* November 2000.

economic growth, along with low inflation.

4.3 Raising incomes

The second change is to give more people the means to save. People will only start to put money aside for the future when they have enough income not to worry about day-to-day living. We are helping to make work pay, and to make work possible, through a combination of the New Deals, the Working Families Tax Credit, and the minimum wage. As a result, unemployment is the lowest for a generation and more people are in better paid work than ever before.

4.4 Security of investments

But it is not just about low inflation and higher incomes, it is essential that people feel their investments are secure. The Government has a clear responsibility to ensure that people can have confidence in the system, with proper regulation. Following the Maxwell Affair and the scandal of pensions mis-selling, many of those who could afford to save had lost faith in all parts of the pension system.

To help restore confidence, we have introduced a number of measures since 1997 which include:

- clearing up the scandal of pensions mis-selling by working with the industry to secure adequate compensation. To date, we have secured redress for over 400,000 people, with many more cases to be resolved;

- introducing a single financial regulator. Last year, we introduced legislation (the Financial Services and Markets Act), which brought in the new Financial Services Authority, to promote consumer confidence in financial services and to secure appropriate protection for people's savings.

But the state also has a responsibility to ensure that people can plan for their retirement in the full knowledge of the facts about their future state entitlements. This Government had to deal with the Inherited SERPS problem – where millions of people had not been told, and some had been misinformed, about a change in legislation made in 1986 – but not due to come into effect until April 2000.

We have resolved the Inherited SERPS problem by: delaying implementation of the change until 2002; ensuring that all those who have reached state pension age are fully protected; and by phasing in the changes for those nearing state pension age.

4.5 Better information

For the future, we are committed to ensuring that people are told about changes in pension policy – so they can plan for their retirement in full knowledge of their position. We want people to start planning early for their retirement. But to do so, they need accurate information about their own projected pension entitlement, and about the options available to them.

From October 2001, we are introducing Combined Pension Forecasts, to give people better information about their own position. Employers and pension providers will be able to send out statements, setting out individuals' current and projected entitlement for both state pensions and from their occupational, stakeholder or other pension investments, as well as information on the options for making further savings. Individuals will therefore have a much better idea of what they need to save, in order to meet their aspirations in retirement.

5. Providing the right vehicles for people to save

5.1 Reforming the state second pension

As well as providing better information about the choices available, we also need to create new options for saving. This parliament, we have legislated to provide new ways for people to build up a good second pension – in both the state and funded pension sectors.

For those on low or broken incomes, private pensions are not a good option, and they remain better off in state provision. For this group, we've reformed the State Earnings Related Pensions Scheme (SERPS). The main problem with SERPS was that, by its nature, it does least for those on low incomes.

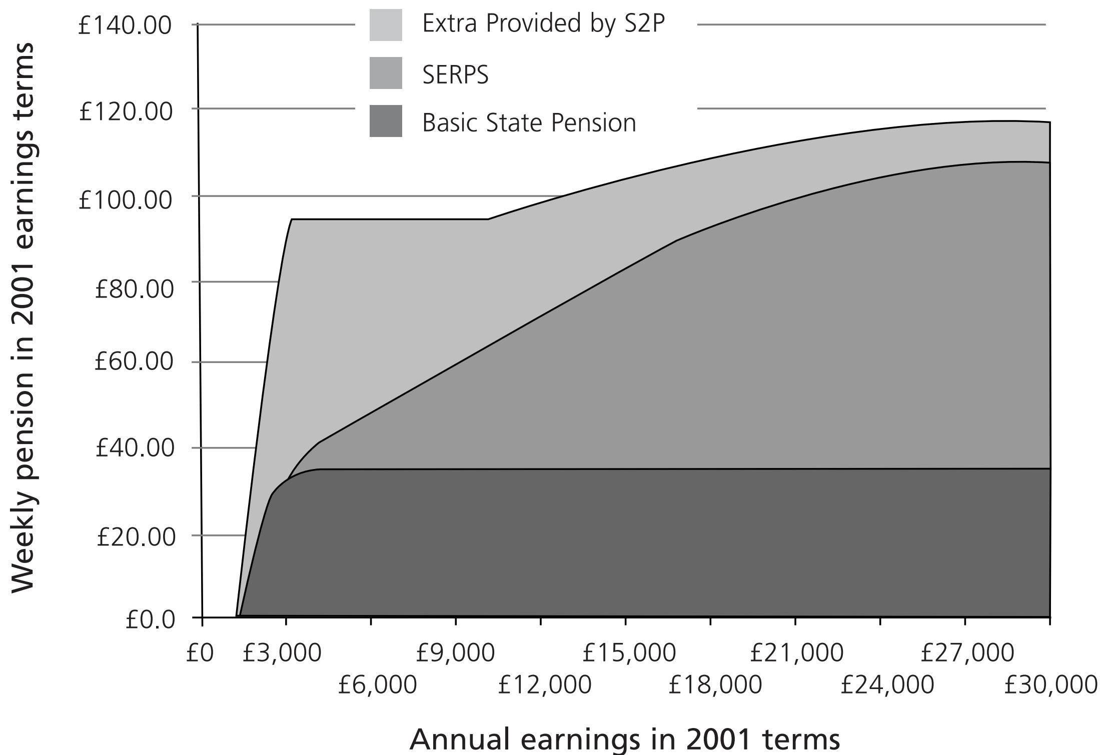
So last year we legislated for reform of SERPS, as part of the Child Support, Pensions and Social Security Act 2000. The new State Second Pension will start providing low earners with a substantial boost to their pensions from April 2002. It will give employees earning up to nearly £24,000 a year[7] a better pension than SERPS, with the most help going to those on the lowest earnings (up to around £10,000 a year).

By the time the scheme has fully matured, someone who earns £120 a week throughout their working life will be over £40 a week better off than they would have been under SERPS. The gains from the State Second Pension by the middle of the century are shown in more detail overleaf.

And for the first time, the State Second Pension will extend support to groups who have suffered in the past because their working lives have been interrupted. It will enable carers and people with a long term illness or disability who meet certain criteria to build up second pensions, even if they have earned nothing at all during the relevant year.

7 at 2000/2001 levels.

Figure 2: Effect of the State Second Pension for employees who retire in 2051



Source: Department of Social Security's LifePen model

Notes:
1. Earnings are assumed to grow 1.5 per cent faster than prices.
2. The individuals are assumed to have a full working life and their earnings are assumed to grow exactly in line with average earnings and to be worth the specified amounts relative to average earnings in 2001. These assumptions are not believed to be representative of actual individuals but are used for illustrative purposes to show the future direction of state pensions.
3. 2001 earnings terms means that amounts are deflated by earnings growth to show the movement relative to average earnings. This gives a better indication of what it will feellike to retire having earned the specified amounts.

In total, some 18 million people stand to gain from the State Second Pension: 14 million low and moderate earners, 2 million carers and 2 million disabled people. Many of these will be women, working part time, who typically have no second pension for their retirement.

5.2 Stakeholder Pensions

For those on moderate and higher incomes, the best option is a funded

pension. But for those who do not have access to a good occupational scheme, the existing options were often too inflexible or too expensive.

To meet this crucial gap in the market, we have developed the framework for Stakeholder Pensions, which will be available from 6 April 2001. First, Stakeholders had to be good value: that's why we have stipulated a maximum management fee of 1% of the fund each year. Second, they had to be flexible, so people must be able to vary their contributions and move easily between Stakeholder providers, without penalty.

And third, they had to be part of a simplified pensions structure which made mis-selling less likely, which is why we have allowed for parallel running of both Stakeholder and occupational schemes for most people. That means there is no incentive for people to opt out and therefore for providers to mis-sell.

The new Stakeholder Pensions are already revolutionising the way the pensions' industry does business. Charges on existing private pension products are being cut, even before the first stakeholder schemes go on sale this Spring.

They also reinforce the responsibility of employers to help their employees to save for retirement. All employers with more than 5 employees will have to provide access to a Stakeholder scheme, unless they already offer a good pension arrangement. And Trade Unions will be playing their part too, with many signed up to sell the new Stakeholders, often in partnership with the industry.

Stakeholder Pensions will provide many more people with a safe, flexible, and low-cost way to save for retirement.

The new rules will also allow someone to contribute up to £3,600 a year to a

Stakeholder or other private pension, even if they are not earning, and gain tax relief on this amount. This is an important step forward, in particular for women. It will allow, for example, a working man to pay into a funded Stakeholder Pension for his wife or partner, who may be taking time out of work to care for children or other relatives.

5.3 Pension Sharing on Divorce

Another important reform for women, is the introduction of the new rules on Pension Sharing on Divorce last December. Sharing pensions will allow some couples to achieve a fairer settlement of assets on divorce. This will provide a more secure pension income in retirement for those, particularly women, receiving a share of pension rights.

5.4 Next Steps

These long term reforms will ensure that more people retire on good incomes, and will help prevent pensioner poverty in the future. At the same time, they will make sure the system remains affordable for future generations. By the time our reforms are complete, we will have reversed the current ratio, so that 60% of pensioner incomes will come from funded provision and the remaining 40% from the state.

Having dealt with the immediate problems that we faced in 1997 – tackling pensioner poverty and putting in place the right vehicles to enable more people to save for their retirement – we now want to do more to encourage saving.

Therefore the next step in our reforms is to remove the penalties for saving, and instead make sure that their saving is rewarded.

6. Rewarding saving

6.1 Action this parliament to reward saving

We have already taken action to remove some of the penalties for saving in the system we inherited. These changes include:

- the introduction of the 10% income tax band in April 1999, which has benefited the 4 million pensioners paying income tax, many of whom are paying tax on the income drawn today from savings made during their working lives;

- the cut in the basic rate of income tax in April 2000 from 23% to 22%, which has increased the returns for those taxpayers who invested in a pension whilst working. Overall this reduction benefited almost 3 million older people who pay income tax;

- in the 1999 Budget we increased the pensioners' tax allowances over and above inflation, so that in 2000/01 someone over the age of 65 only pays income tax if he or she has an income over £111 a week;

- the effect of the 1999 Budget, with its introduction of the 10p tax rate and above-inflation increases in personal allowances, was to lift some 200,000 pensioners out of tax. Currently six out of ten pensioners pay no income tax at all; and

- from April 2001, we are increasing the amount of capital which people can hold and still be entitled to additional income through the Minimum Income Guarantee. We are doubling the lower capital limit, up to which full MIG support is available, from £3,000 to £6,000 and raising the upper limit – up to which some MIG support is available – from £8,000 to £12,000. As a result of these changes alone, 500,000 pensioners will gain by an average of £5 a week.

But now we want to go further. We have, to date, started to remove the penalties which the system we inherited imposed upon those who had saved. We now want to eradicate the remaining penalties and indeed positively *reward* those who save.

6.2 The Pension Credit

Last November, we published a consultation document[8] which set out our proposals for a new Pension Credit, to be introduced from 2003.

The Credit will take us a step further towards eradicating pensioner poverty. Not only will it provide more help for those on low and modest incomes, but it will also signal a clear break with the old-style means test, which is disliked by many pensioners. In the future, we will move towards a system with much simpler and less frequent assessment, along the lines of the tax system.

And for the first time, the new Credit will provide a much fairer reward for those who have saved for their retirement. If we take, for example, a pensioner with £20 of occupational pension on top of her state pension. Under the benefit current rules, she would get no extra help. As a result, she can find herself just a pound or two better off than someone who saved nothing. It is that unfairness that we are determined to change.

In summary the Pension Credit will, when it is introduced:

- guarantee a minimum income, which by 2003 will be at least £100 for single pensioners, or £154 for couples;[9]

- on top of that, the Credit will mean a cash reward for those who have saved, at a rate of 60p for every pound saved (up to an estimated maximum reward of £13.80 for single pensioners and £18.60 for couples);

8 The Pension Credit: A Consultation Paper, November 2000, HMSO, Cm 4900
9 Based on current assumptions about future growth and prices

- abolish the arbitrary capital limits and replace them with an income test, more in line with the income tax system;

- abolish the rules on "tariff income" for pensioners. So we will no longer assume that pensioners can get a ludicrous 20% return on their savings;

- move away from the weekly means-test to a system where awards are fixed over much longer time periods, thereby reducing the administrative burden on both pensioners and our staff; and

- make it easier for pensioners to claim their entitlements, by introducing a dedicated new service for pensioners. People will be able to claim over the phone; claim forms will be shorter and easier to navigate; and increasingly technology will allow us to automatically identify those pensioners who qualify for the Credit.

When it is introduced from 2003, the Credit will reward all those with weekly incomes up to around £135 for single pensioners, or around £200 for couples. It will cover 5.5 million pensioners – that is half of all pensioners households in this country. The table on the facing page shows how much people will gain, under our proposals, in the first year of the Credit.

The Pension Credit will be of particular advantage to women. On average, women have smaller occupational pensions than men. And because they are likely to live longer, they are more at risk from the falling value of their pension income over their retirement. As a result, two thirds of those who will benefit from the Credit are women.

In the same way that the Credit will deliver increases in state support at least in line with earnings growth for low and modest income pensioners, so we intend also to help those pensioners on higher incomes. For those who pay

income tax, in 2003/4 we propose to raise the pensioners' tax allowances by £240 over and above indexation, benefiting over 3 million pensioners.

Figure 3: Gains from the Pension Credit[10]

Illustrative examples for 2003/04 (£ per week)

Your income from savings, second pension or earnings	Your basic state pension	Your original income	Your Pension Credit		Your final income
			Guaranteed income top-up	Savings credit	
0.00	77.00	77.00	23.00	–	100.00
10.00	77.00	87.00	13.00	6.00	106.00
20.00	77.00	97.00	3.00	12.00	112.00
30.00	77.00	107.00	–	11.00	118.00
40.00	77.00	117.00	–	7.00	124.00
50.00	77.00	127.00	–	3.00	130.00
60.00	77.00	137.00	–	–	137.00

Source: OSS

The Pension Credit and associated changes on tax will also represent a further step towards tax and benefit integration for pensioners. Since 1997, the Government has been pursuing policies designed to bring the tax and benefits system closer together. In 1999 we introduced the Working Families' Tax Credit and the Disabled Persons' Tax Credit. A new Children's Tax Credit comes on stream in April.

For the future, the Chancellor has announced that a new system of support for families with children, accompanied by a new employment tax credit, will be introduced in 2003. The Pension Credit builds on many of the same principles: tackling poverty, promoting incentives to work and save, maximising take up and wherever possible, bringing the system of tax and benefits closer together.

10 Based on assumptions about planned increases, and future rises in prices, we expect the Basic State Pension to be £77 for a single pensioner in 2003/4.

Over time, we want to take this further by taking steps to reduce overlap between the two systems, and ultimately to merge support through the Credit and the tax system to create a single, integrated system of support for pensioners.

7. Conclusion and next steps

Since we came into office in 1997, the UK pensions system has started to look markedly different from the one we inherited. We promised to ensure that all pensioners would share fairly in the rising prosperity – and we have. And we have delivered substantial additional help to the poorest pensioners – far more than they would have got if their Basic State Pension had been linked to prices or even to earnings.

This Parliament we have also put in place longer term reforms which will protect future pensioners against poverty. More and more people will retire on a decent income, as we enable more people to save, and ensure they are rewarded for their efforts.

Over the next few years, there is a great deal more to achieve.

- First, we will continue with our commitment to end pensioner poverty;

- Second, we need to deliver the longer term reforms which have already been planned and legislated for – including the new State Second Pension; and

- Third, we will ensure that for the first time ever, pensioners are rewarded for their saving, by introducing the new Pension Credit from 2003.

Not only will the Credit help millions of today's pensioners on modest incomes, it will also complement our long term reforms by rewarding people for saving. The message is clear – whatever you can afford to put by, it will always pay to save.

The Pension Credit will be a key building block of our initial pension reforms. But we will continue to move the policy agenda forward, as we attempt to both tackle poverty and encourage saving.

Already we have started to lay the foundations of a new approach to welfare, which recognises the importance of saving – not only to protect people against poverty, but also to improve their life chances. Reforms like the new Stakeholders and the Pension Credit will ensure that people see the benefit of their savings. And we will continue to look at other ways to promote saving for retirement and other needs.

Our reforms build on the partnership between the public and private sector, in a way that is affordable and sustainable for future generations. And crucially, they allow a new Labour Government to meet the twin objectives of tackling poverty and encouraging saving. That is the only way to achieve long term security in retirement for all, not just the few.