Reasonable force

The place of compulsion in securing adequate pensions

Ben Jupp

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Contents

1 Introduction

Welfare reform, we are promised, will start to take shape over the next six months. The autumn row over benefits for single mothers showed just how controversial any changes might be. It is little wonder that Tony Blair wants to encourage voters to think first about the broad issues involved. Only when people are clear about the principles will they be willing to consider the details.

Pension reform is no exception to this pattern. Its broad principles were outlined last July: cheaper provision with 'stakeholder' pensions; retaining the basic state pension; improved financial education; a system which is affordable for the government and adaptable to people's changing patterns of work. Since then 64 specific questions on stakeholder pensions have been put out for public consultation.

Yet the big question of whether people should be *forced* to make more pension provision or simply *encouraged* to do so has rarely been mentioned by the government. Few submissions to the pensions review have been any more illuminating. Compulsion has frequently been supported or opposed, but usually with little detail about why or how a system of compulsion would work in practice.

This *Commentary* addresses both the broad principles and the details. It argues that:

- compelling everyone to save enough to fund a pension which is a proportion of their earnings is overly paternalistic and cannot be justified;

- those who can afford to should be required to save for a *minimum* pension so that they do not become an unnecessary burden on others in their old age; individuals should be free to decide whether or not to save more than the minimum.

Practically, it suggests that:

- a target minimum income for pensioners should be 40 per cent of expected average male earnings, which currently would amount to £160 per week;
- to achieve this level a basic state pension of 10 per cent of average male earnings should be guaranteed by the government, leaving individuals to fund a target minimum additional pension of 30 per cent of average full-time male earnings;
- it is reasonable to require those with over half average male lifetime earnings to save the amount required to reach this target;
- a compulsion rate of 11 per cent of current earnings should ensure that people earning over half average male lifetime earnings contribute enough to fund the target minimum pension;
- once people had saved enough to ensure the target minimum pension they could stop paying into their fund if they wished; some people would reach the target in their forties, some in their fifties, some in their sixties, a few never at all without government help;
- to ensure low levels of contribution avoidance the government will have to win people's hearts and minds about the need to save more and the need for a minimal compulsory system.

The consequence of this policy would be that:

- with current conditions about two thirds of the population would contribute enough to fully fund the target additional pension;

- the proportion should rise as more women retire at 65;
- if the government gave mothers of new born babies four years' pension contributions of £10 a week in recognition of the lower wages they are likely to earn during this period, a significantly higher proportion of the population would reach the target level.

The *Commentary* highlights additional ways in which the government could increase the proportion reaching the target level. However, the government would be foolish to make promises about pension provision which its successors may not be able or willing to keep. Such broken promises in the past have added to public confusion and lack of confidence over pensions. The target minimum additional pension should therefore remain a *target*, not a guaranteed income.

The background

Compulsory pension contributions are nothing new. We have all been required to contribute to our pension provision since the introduction of SERPS (State Earnings Related Pension Scheme) in 1978. The concept was simple. A proportion of employees' and employers' National Insurance contributions are designated for SERPS. In return the government promises to pay people a SERPS pension of 20 per cent of their average earnings if they stay in the scheme all their working lives. The government does not invest the money in a fund. It is used to pay the pensions of current workers. In effect, people are compelled to buy government IOUs for future pensions. Alternatively, people can have their contributions back as a rebate to pay into an occupational or personal pension.

Yet even with SERPS many of today's workers are heading for very low pensions. If current trends continue, the Department of Social Security estimates that by 2025 approximately 70 per cent of single pensioners will have an income equivalent to less than £150 a week and over half of couples less than £300 a week in today's prices (see Figures 1A and 1B).[1] With rising numbers of pensioners, the government is

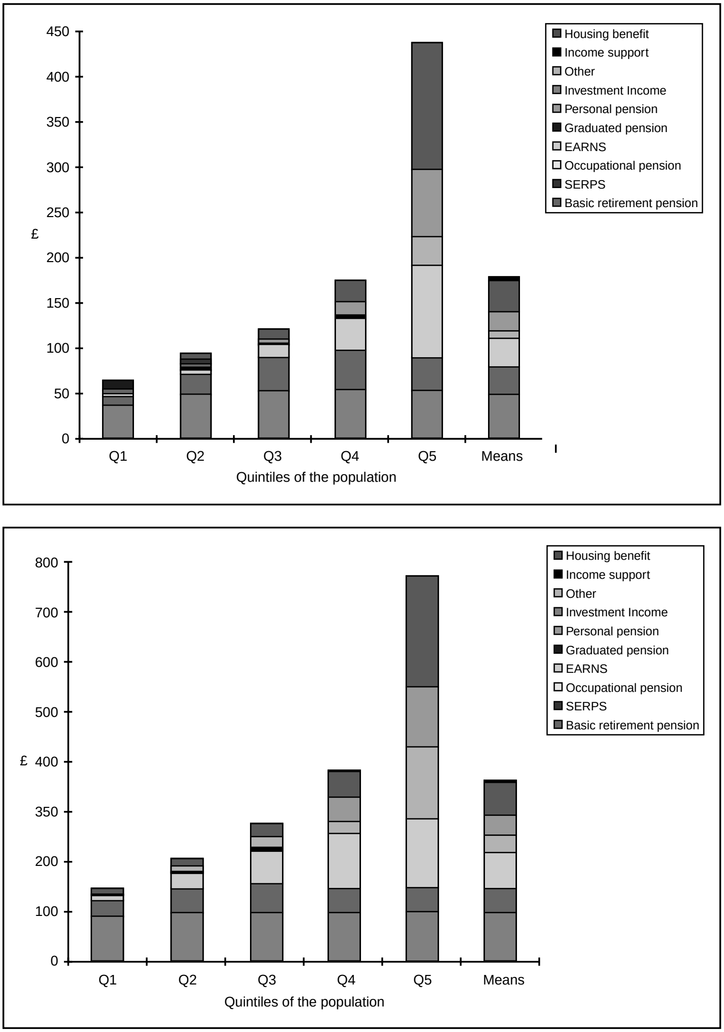

Figure 1 Estimated gross income. (a) Single pensioners 2025. (b) Pensioner couples 2025.
Source: Curry C, 1996, *PENSIM: a dynamic simulation model of pensioners' incomes*, Analytical Services Division, Department of Social Security, London.

worried that it will not be able to pay for the increasing cost of supporting those without enough resources of their own.

These two facts – low pension provision and the rising cost of supporting pensioners – have generated a host of reviews and reforms around the world. Britain is far from alone in facing these problems. Many countries across the 'greying' societies of the West are dealing with more serious projections. In the long term, similar problems will be faced by developing countries.

One increasingly common response is for countries to compel workers to save into their own retirement accounts. In Singapore, employers and employees must put 40 per cent of wages into the government-run Central Provident Fund which covers pensions and also many health, education and housing expenditures. In Chile, workers contribute 10 per cent of current earnings into a personal retirement account provided by one of 21 private insurance firms. In Australia, employers are compelled to put 6 per cent of pay into occupational schemes.

Compulsory schemes which invest people's contributions in funds (rather than write IOUs) have been praised by the World Bank. They also have powerful advocates in Britain. Frank Field, the Minister for Welfare Reform, has repeatedly supported more compulsion. The TUC, National Association of Pension Funds, Consumers' Association and many pension providers have also lined up behind compulsion.

However, detail has often been absent from people's proposals. While many talk about compulsion, few make detailed arguments about the cases for and against it, or how a compulsory scheme might actually work. Consider the TUC's submission to the current pension review. 'Second tier pensions into which employers and employees are required to contribute should be compulsory', they state.[2] But the report does not suggest a rate of compulsion or a mechanism for collecting it. The 1995 Retirement Income Inquiry by a group of independent academics, business leaders, former civil servants and representatives of unions and consumer groups investigated all aspects of pension provision. They favoured an assured pension with compulsory contributions. Their report was well argued and extensively researched. Yet as *The Economist* noted, 'on the two questions which really matter – at what level the assured pension should be set and what the ideal level of compulsion contributions is – the report fudges.'[3]

Even with influential supporters, greater compulsion is by no means certain. When New Zealand held a referendum in September 1997 on whether to introduce compulsory pensions 92 per cent of people voted against the measure. If such popular rejection occurred in Britain, compulsory pensions would be as unsustainable as the poll tax. Nor are all interest groups in Britain in favour of compulsion. One submission to the current Pension Review voiced a popular hope that 'better pension products backed by a persuasive educational campaign on the need for them might well persuade people that they had to do something about a second pension without it being necessary to constantly tell them that they *must*.'[4]

The tone of recent government comments is guarded. The most recent statement said only that 'the Government will respond on the issue of compulsion, as on all major issues raised in the Review, in due course.'[5] The lack of rigour and detail surrounding current debates about compulsion only makes their consideration more difficult. As John Denham, the Pensions Minister, recently lamented: 'There has been an awful lot of sloppy thinking about compulsion'.[6] In response, the rest of this *Commentary* assesses the case for compulsion and outlines the practical details of a fair compulsory scheme.

2 Compelling arguments

A good starting point for any government considering compulsion is to avoid it if at all possible. Practically, governments always find controlling people's behaviour very difficult. Consider the recent problems of compelling absent fathers to contribute to their children's upkeep, banning beef on the bone, or even forcing recalcitrant truants to attend school. In Australia, 2,000 legislative changes have been required to make their compulsory pension system operate effectively. Secondly, when governments try to compel people to do things for their own good they often end up making things worse for them. When governments determined the investment decisions of nationalised industries, the results were usually worse than when they became independent companies. Why should the government be any better at telling us how to invest our money? Thirdly, any compulsion necessarily decreases the individual's freedom. When one person's freedom significantly reduces another's, such restrictions are understandable. It is right to compel motorists to follow the highway code given the havoc that complete freedom on the roads could create. But the price of reduced freedom for individuals should always bias governments against compulsion.

The onus is therefore on those in favour of compulsion to make their case stand up.

Three arguments are made for compulsory pension contributions:

1. *People are short-sighted, do not think about their retirement and consequently do not save enough for it*. This line of

argument suggests that the state, with an overview of the population, is better aware of people's likely retirement needs than individuals themselves.

2. *The economy will benefit if people are forced to save.* This argument assumes that the savings will be invested in British firms and investment will lead to higher growth.
3. *Some people end up a burden on the rest of society in old age even though they could have afforded to save earlier in life.* This is not a problem if we are prepared to watch the imprudent suffer greatly in their old age. But if society feels a responsibility towards the poor, we should compel those who can afford to save to do so.

Box 1 The cases against and for compulsory pensions

Against:	For:
○ reduces people's freedom ○ difficult to enforce ○ risks forcing people to make poor investments	○ compensates for people's short-sightedness ○ increases national saving ○ reduces unnecessary burdens on others

It is worth considering each point of the case for compulsory pensions separately, for they are distinct assertions and lead to different models of compulsory pension.

1. Compensating for people's short-sightedness

People's financial short-sightedness is often, explicitly or implicitly, the major reason given for compulsion. Using economists' jargon for short-sightedness (myopia) the World Bank's pension expert neatly summed it up last year: 'A mandatory system is premised on the argument that people behave myopically and will not make adequate pension for their retirement needs under a voluntary system.[7]

Because Western governments usually end up supporting people with severe financial problems, the myopia argument is often linked to concerns that the short-sighted will be a burden on others. But these arguments are distinct and lead to different sorts of compulsion. For example, Frank Field proposes a compulsory system in which 'the aim is to give every worker a minimum pension entitlement of two thirds of previous earnings'.[8] It might be good for someone earning £50,000 to have a pension of £33,000 because it allows them to maintain a similar lifestyle. But it seems clear that high earners would not be a *burden* to the rest of us if they only managed a pension of £20,000. With an earnings related system, such as the Frank Field proposal, the state is acting primarily in what it perceives to be these individuals' best interests, not just preventing them from burdening others.

A similar argument is accepted for compulsory education. Education is good for people but when they are children they can not always see that. We also compel the mentally ill to take medication for their own good.

But there are few other precedents on which to base the 'short-sightedness' compulsion case. Societies used to compel people to do things that were supposed to be good for their souls: pray, learn scriptures, make sacrifices and so on. Perhaps the closest we get to such ideas now is in the rhetoric used by some politicians about work. The unemployed should be compelled to work not just because it reduces the burden on others, we are told, but because it will eventually provide the individual with a more fulfilling life.

Over a hundred years ago John Stuart Mill argued that 'the only purpose for which power can be rightfully exercised over any other member of a civilised community, against his will, is to prevent harm to others. His own good, either physical or moral, is not sufficient warrant.'[9] It is telling that the only groups routinely excluded from this rule today are children and the mentally ill, possibly to be joined by a new group designated by some, particularly American commentators, as 'uncivilised' – the long-term jobless. Should we add non-savers to their number?

There are grounds for thinking that some people would eventually appreciate compulsion which benevolently compensates for their short-sightedness. Forty two per cent of people say that they wish that they had considered their pension arrangements earlier.[10] One in five of those offered membership of an occupational scheme decide not to join. They will probably regret it later.

But ultimately this paternalistic argument cannot accommodate the vast range of people's needs and desires. Someone earning £50,000 might not want a pension of £33,000 – the necessary consequence of Frank Fields proposal. They might want to keep working until they die or lead a materially simple life in retirement. People's ideal pension level will also depend on factors such as whether they own other assets or have children to whom they want to leave a bequest. And people's needs are becoming more and more varied as our lifestyles and circumstances become less uniform.[11] It is increasingly difficult for the government to say what is in anyone's best interests because our interests are so different.

> In such an environment it is very hard to justify the necessary reduction in freedom which supposedly benevolent compulsion creates.

2. Increasing national saving

In some countries, most notably Australia, one of the policy goals of compulsory pensions has been to increase national saving. Compulsory saving, it is assumed, leads to higher national saving, which translates into more money for investment and ultimately greater economic growth. The case has been made in Britain, too. Lord Taverne recently argued that 'compulsory funded pensions are likely to lead to a very substantial increase in saving'. He concluded that 'the positive economic side effect of a rise in the UK's historically low saving rate clearly strengthens the case for compulsion'.[12]

Past experience suggests that the argument is compelling. In Switzerland, the national saving rate rose from 6 to 8.5 per cent in the decade after funded pensions became mandatory. The entire increase occurred in pension funds and related institutions. Chile, with its mandatory pension system, has a saving rate of 26 per cent of GDP, compared to a Latin American average of 15 per cent.

Countries with high saving rates also tend to have high investment and economic growth. In many Southeast Asian countries saving rates are at least double those in Western economies. Some economists believe these rates contributed to the remarkably high rates of economic growth in the region over the past twenty years.

The consultancy firm London Economics predicts that about £7 billion of extra savings would be generated each year in Britain if we had a funded pension system with a mandatory 10 per cent contribution rate.[13]

But there are two problems with this argument. First, additional net saving may be quite limited. A 1997 World Bank research paper claims that 'mandatory saving may not increase total private saving if individuals find ways to offset them against other voluntary saving or accumulated assets. With perfect capital markets, private saving will not increase at all, since people will simply borrow against their mandatory pension saving.'[14] In other words, people may put more into a pension but pay for this simply by borrowing. Just such a scenario appears to be happening in Australia. According to one expert, 'The increasing debt secured against housing has allowed Australian households to *reduce* their saving to 3 per cent of disposable income, the lowest in the OECD, despite [rising] compulsory superannuation.'[15] It may only be those with few assets against which to borrow who are forced to reduce their spending if a compulsory system is introduced.

The second, and stronger, attack on the increased national saving argument is that higher saving may not lead to higher investment in the British economy. Pension funds can be invested anywhere. The recent stock market falls in East Asian economics serve to remind prudent fund managers that the safest strategy is never to invest all pension scheme resources in a single country or region. They are no more likely to put all their investments in Britain than anywhere else. Conversely, British companies can borrow money from people around the world. They no longer have to rely on how much the British save.

Even if high levels of saving in Britain lower the cost of investment now (because the more spare money which is available the cheaper it is to borrow), if Britain joins in European Monetary Union our rates of saving will have practically no impact on the new European interest rates. If these rates are influenced by saving at all it will be by the total European level.

Given these uncertainties about the impact of compulsory saving on the wider economy, it is wrong to conclude that the government should force people to save for macroeconomic reasons.

3. Reducing the burden on others

If the government was paternalistic about car insurance it would make fully comprehensive insurance mandatory. It is nearly always the best insurance to have. But only third party insurance is mandatory, so that if you crash into someone else's car and cannot afford to pay the innocent party is not burdened. If people want to risk losing their own car the government leaves them to face the consequences.

The distinction between third party and fully comprehensive insurance is pertinent to the debate about compulsion. The 'third party' pension is the *minimum* pension which ensures that people do not burden others in their old age. The 'fully comprehensive' pension aims to replace a *proportion* of people's working income so that they continue to enjoy a similar standard of living in retirement. The proportion of working income needed as a pension to sustain a similar standard of living in retirement is usually assumed to be less than 100 per cent of a person's final salary and is often half or two thirds of it. Pensioners do not have some employment-related expenses such as work clothes and travel. If they are home owners they may have little or no mortgage.

While the case for a compulsory 'earnings proportional' pension is based on the assumption that it is in people's best interests, the argument for a minimum pension is that society would otherwise be forced to support many people in their retirement. If people on reasonable incomes do not save while they work they will almost inevitably ask others to support them in old age. Unless society is prepared to see such people destitute, the government will be forced to support them. The Retirement Income Inquiry, mentioned earlier, supported compulsion for this reason. It concluded that 'without sufficient second tier pensions, the cost to the taxpayer of providing an adequate minimum income could prove excessive. … Provided this objective is met, we do not consider that people should be forced to save some further amount in order to secure any particular replacement ratio; the choice between more income during working years or in retirement then becomes a matter for individual decision.'[16]

The basic pension was originally planned as a kind of third party insurance. It aimed to provide the necessary minimum. But most people recognise that the basic pension is no longer enough to meet pensioners' basic needs. At £62.45 a week, it is currently lower than income support at £68.80 a week. A million and a half pensioners receive income support. A further 1.5 million have incomes which exceed income support levels but are so low that they receive housing benefit and/or council tax benefit. These meanstested benefits to pensioners cost the government nearly £9 billion a year. Other support for pensioners, from free prescriptions to the extra £20 for fuel bills this year, reflects the government's fears that the vast majority have not got enough income to meet their basic needs.

If those who can afford to save for a sensible minimum pension cannot be encouraged to do so, then the case for compulsion is strong. Of course, this depends on which definitions of affordability and adequate minimum retirement incomes are used. The government certainly believes that a lot of people are heading for inadequate pensions at the moment; over 8 million people are at such risk on their estimates. As Figures 1A and 1B show, if current trends continue then a large proportion of pensioners will have very low incomes in 2025. More worryingly, many people do not seem to be sufficiently induced to save more by the prospect of an inadequate pension. Fifty-nine per cent now agree that it is unlikely that there will be a state pension when they retire but few have voluntarily increased their saving as a result.[17] In a recent survey only half of respondents who said that they thought they should be saving for their old age were actually doing so.[18]

Although more can undoubtedly be done to encourage people to increase their saving voluntarily,[19] we have to conclude from these figures that many people who could save enough for a reasonable minimum will not do so unless compelled.

In conclusion, the case for mandatory minimum pension provision is compelling but enforcing high levels of saving for people's own benefit or that of the economy is unsustainable. Furthermore, the evidence that people might simply increase borrowing to compensate for compulsory pension contributions serves as a warning: compulsion could simply transfer the underlying problem of poor financial decision making from low pensions to high indebtedness.

Achieving a non-paternalistic minimum scheme

So how could the government ensure that people who can afford to will provide themselves with a minimum pension without paternalistically forcing them to save above this minimum? Requiring people to save a proportion of their salary for the whole of their career does not do the job. Inevitably, the better off are compelled to end up with a pension well above the minimum needed to avoid burdening others.

Like most social issues, the challenge is not new but the solution needs to be. In writing his 1942 blueprint for the welfare state, William Beveridge was mindful to ensure that National Insurance benefits met people's basic needs rather than paternalistically replacing a proportion of their earnings. His prescription was flat rate benefits funded by flat rate contributions. If his principles were strictly applied today to the basic pension then every worker would contribute a flat rate of about £9 each week in order to receive a weekly basic pension of £62 when a pensioner. People would not be forced to save more than the flat rate of £9. But flat rates hit the poor hardest. The flat rate is a greater *proportion* of a small income than a large one, even though the total amount contributed is the same.

Evolving from the Beveridge ideal, the current National Insurance system has some of these flat rate features. It has an upper limit of earnings above which people do not pay contributions (currently about £24,000). So a high earner, say on £50,000, pays the same amount in total as someone earning £24,000. This reduces the compulsion on the high earner to save more than they need, reducing the paternalism. For this reason the Retirement Income Inquiry, among others, argued that an upper earnings limit should be a feature of any new compulsory system.

But an upper earnings limit is a poor way of collecting contributions from people whose earnings vary a lot over their lifetime. Take the extreme illustration of a professional footballer. Imagine he earns £100,000 a year for ten years and then retires. With an upper earnings limit he contributes only on the first £24,000 of his earnings. Imagine that his old school friend goes into a regular job and earns £25,000 for 40 years. This friend makes maximum contributions for four times as long as the footballer, even though they both earned £1 million in total. If the system was designed for 40 years of contributions the footballer would pay only a quarter of full lifetime contributions.

Few of us will have earnings profiles as extremely variable as the footballer but increasing numbers of us are likely to have times of high earning and times of low earning. Nearly a quarter of graduates have a spell of unemployment during their twenties.[20] People also increasingly take time out to study, travel, retire early and so on. Only three quarters of men aged 55 to 59 are in the labour force. Nine out of ten were in 1980.[21] Like the footballer, they are unlikely to make full contributions to a scheme with an upper earnings limit, even though their total lifetime income may be high.

An alternative is to have no upper earnings limit but a *lifetime target level* for pension provision. With a lifetime target system people are compelled to save a set proportion of all their earnings until they had saved enough to fund a minimum pension. Let us imagine that the lifetime minimum retirement saving was £50,000 and that the contribution rate was 10 per cent. Our footballer would be forced to save £10,000 every year. He would have reached the minimum after five years and would not be compelled to pay any more. His friend would contribute £2,500 every year and stop after twenty years. They would both contribute the same amount over their lifetime – the only difference would be when they could stop paying.[22]

The lifetime target system is a much fairer way of making sure that those who can afford to fund a minimum pension *over their lifetime* do so. The government would set the minimum pension fund size – enough to pay for the minimum retirement pension. Once someone's 'pension pot' had exceeded this minimum size additional contributions would be voluntary. They would not be forced to have a pension higher than the minimum.

People might reach the minimum level in their forties, fifties or sixties. Contributing more than the compulsory rate would simply mean that people reached the minimum fund size quicker. Some people would have insufficient lifetime earnings ever to reach the minimum level. But some people are never going to have a large enough lifetime income to afford an adequate pension, however contributions are organised.

Once people had reached the minimum level they could decide how much more to save. But although further contributions would be voluntary, the system should lead people to make more appropriate, often higher, pension provision than today. To gain exemption from compulsion, people would have to get an independent assessment of their pension entitlements from an accredited advisor. Crucially, an individual would then be confronted by just how much, or little, they had saved. Deciding to stop saving would require an explicit decision that the minimum pension would be enough to fund one's desired retirement lifestyle. Most people would probably conclude that it would not. With our current system people are rarely confronted so explicitly with the facts of retirement income until they are ready, or forced, to retire – when it is too late. The process of opting-out of voluntary contributions should therefore help stimulate better long-term financial planning.

3 The detail

Compulsory saving to ensure a minimum pension with voluntary contributions thereafter seems justifiable in principle. To examine how such a system could operate successfully in practice, this section answers a series of questions.

1. Who should be subject to compulsion: employers or workers?
2. What is a suitable compulsory minimum pension?
3. What is a suitable rate of compulsion to achieve this minimum?
4. What should the government do about those people who have insufficient lifetime earnings to affordably fund the minimum pension?

Having answered these questions, the final section identifies what the government would need to do in order make the scheme work.

1. Who should be subject to compulsion: employers or workers?

Many people suggest that employers and employees should split compulsory pension contributions. At first glance it seems a simple, fair approach. A recent survey also found that it would be popular. Eighty-three per cent of respondents stated that employee contributions should be matched by employers.[23]

However, placing compulsion on employers would make it preferential for them to employ people who had already reached the minimum target. Say the mandatory employer contribution was 5 per cent of pay. It would be 5 per cent cheaper to employ someone who no longer had to contribute. This problem is not confined to lifetime target schemes. A similar problem would occur even if the scheme had an upper earnings limits rather than a lifetime cut-off. It would be cheaper to give extra work to an employee already earning over the upper earnings limit than to a employee earning below this amount. Generally, it would be more expensive to employ two part-time workers rather than one full-time worker.

As with many of the nitty gritty issues around compulsion, there are no soft options. If employers were compelled to contribute either the system would have to paternalistically require contributions throughout people's working lives or it would distort the labour market. Given our rejection of paternalism and the dangers of distorting the labour market in favour of those who have already earned a lot, we must conclude that employer contributions should be voluntary.

Compulsion on workers should, however, stimulate more employers to contribute voluntarily. Voluntary employer contributions would reduce the burden on their workers. At the moment many people do not fully realise the advantage that membership of an occupational pension scheme offers. But with a compulsory scheme the costs of working for an organisation without an occupational scheme would be obvious – one's take-home pay would be less. To attract good staff those companies without occupational schemes would probably have to compensate by paying higher gross wages. If the current tax regime continued, paying pension contributions would cost the employers less than paying higher wages.

Finally, there is also a good pragmatic reason why contributions by the employer should be voluntary. For the employee, compulsory contributions are a form of personal saving because all of the money is going into their pot. But for employers it would simply be seen as a tax, for they will never get money back.

On balance then it is better for compulsion to apply to employees, not employers.

2. What is a suitable minimum pension?

Calculating a sensible minimum retirement income has bedevilled those, such as Age Concern, who have tried. Different pensioners have such different needs. For example, some have large housing costs while others have completely bought a home.

The typical (median) single pensioner currently has a weekly income of about £100. Couples typically share £185. As we have already noted, one of the reasons for the pensions review is that so many pensioners do not have adequate incomes.

In considering a minimum sustainable retirement income we should assume that it is cheaper being a pensioner now than it will be in 30 years. Given the UK's relatively small pensioner population, the government and organisations can afford to offer pensioners many concessions – cheap travel, free prescriptions, cheap entrance to leisure facilities and so on. But when there is one pensioner for every 2.4 workers (as projected for 2030) such concessions will be harder to fund. More long-term care and health costs may even be charged to pensioners. And with the richest pensioners expected to become more and more wealthy in the coming decades, justifying universal benefits to pensioners will be increasingly difficult.

Pensioners in the future may also need to spend more on services. Pensioners already tend to spend a disproportionate amount of their money on services, such as help around the home. While technological developments reduce the cost of goods over time, the cost of services – mainly labour – is expected to rise in real terms. More importantly, many pensioners may require more paid help than today. Traditionally people have relied on children for much support. But in the future more pensioners will be childless. Forty per cent of women born in the mid-1960s are still childless. Probably a quarter will remain so.

One principle for a minimum income is that it should equal the full-time minimum wage. Assuming a minimum wage of £4 an hour, the minimum weekly income should be £160, 40 per cent of average male full-time pay. Forty per cent of average male full-time earnings was also the original target income when SERPS was developed. The original SERPS system was designed to give anyone who had earned average wages for twenty years of their life a SERPS pension of 20 per cent of average wages. This supplemented a basic pension of 20 per cent of average wages.

Over the past 20 years changes in legislation have eroded the value of SERPS and the basic state pension compared to earnings. Given expected rising costs of living in retirement, 40 per cent of average earnings is a good minimum adequate income to aim for again. Forty per cent of average male earnings (about £160 a week, £8000 a year today) is an ambitious target. Only about a quarter of single pensioners currently receive this income. But if we want provide most pensioners with an adequate income, it is the correct level to aim for.

A second clear principle is that it is better to set target pension entitlements as a proportion of earnings, rather than to establish a monetary value and increase it at the rate of inflation, because earnings tend to rise faster than prices. For example, if a sum equal to 20 per cent of average male earnings had been indexed to prices in 1950 it would now only be worth £26 per week.[24] It is impossible to guarantee an earnings-linked pension once people have actually bought a pension annuity; such annuities are simply not sold. But a pension system could aim to provide people with at least 40 per cent of average male earnings at the start of their retirement and then up-grade their pension in line with prices.

How much of this 40 per cent will be met by the basic state pension?

The basic state pension is currently worth 16 per cent of average male earnings. Under existing government policy it is forecast to fall to 7 per cent of average wages by 2050 because its rate is increased in line with prices, not earnings. As we noted above, earnings tend to increase slightly faster than prices.

The government has promised to keep the basic pension as the foundation of pension provision. But they are not committed to upgrading it in the line with earnings. Given the extra tax burden which keeping the basic pension in line with earnings would create, we should assume that it will only keep pace with prices for the moment. A realistic scenario is that the government will peg the basic pension to prices for the next few years but never let it to fall below 10 per cent of average male earnings.

On this assumption, the target for a minimum additional pension will be 30 per cent of earnings. Today this is £120, but it will rise with earnings. We will therefore call this pension the '30% pension'. Contributions could be made into any authorised occupational, stakeholder or personal pension scheme.

3. What is a suitable rate of compulsion?

The suitable rate of compulsion must be a trade-off between competing financial, political, ethical and practical pressures. There is no single right answer.

If the rate of compulsion was very high most people would save enough during their lives to ensure a '30% pension'. But a high rate would act as a disincentive to work and encourage people to try and evade payment, just as high taxes do now. In Germany, the rate of compulsory pension contributions is 21 per cent of wages, having risen steeply in the last few years. But false declarations of earnings have risen with it. The black economy in Germany is estimated to have increased from 6 per cent to 15 per cent of gross domestic product over the past twenty years. A high rate would also dramatically reduce some people's take home pay. In particular, it would hit poor workers without an existing occupational scheme.

Two useful principles can help us make the decision.

1. People should not have to fund a pension which is higher than their average earnings over their working life. We should not expect someone earning less than 30 per cent of average male earnings during their working life to contribute so much that they fund a second pension of 30 per cent average male earnings. To do so would simply replace poverty during people's retirement with poverty during their working life.
2. Most people should reach the 30% target pension without government help. The aim of compulsion is to ensure that people are not a burden on others in their old age. If most people fail to save enough when working to ensure an adequate minimum pension, the elderly are likely to be a burden on the younger generation of workers.

Let us consider the implications of the first principle.

People with low lifetime earnings would have to contribute a high proportion of these earnings if they were to ensure a 30% target pension. Table 1 shows how much people with different levels of lifetime earnings would probably have to contribute in order to fund the minimum pension.

We have already noted that it would be unfair and illogical to ask people with total lifetime earning of only 25 per cent of the average to fully pay for a pension of 30 per cent average earnings. The same argument applies to people with a lifetime earning of 33 per cent of the average. Table 1 shows that these people would have to contribute 17.5 per cent of their earnings in order to fund the 30% pension. After contributing 17.5 per cent into a pension scheme, their average net income over their working life would be less than the 30% pension.

People earning 40 per cent of male lifetime earnings would satisfy the principle of earning more than their pension. However, even for these people retirement would probably be a time of greater affluence than their working life. For they would also receive the basic state pension in retirement. It would therefore be difficult to justify the

Table 1 Contribution rates needed to reach the 30% target pension for a selected range of lifetime earnings[25]

Lifetime earnings*	Approx. rate of contributions needed to pay for the minimum 30% pension
Twice Av. male lifetime earnings	2.5%
Av. Male lifetime earnings	5.0%
75% Av. male lifetime earnings	7.0%
67% Av. male lifetime earnings	8.0%
50% Av. male lifetime earnings	11.0%
40% Av. male lifetime earnings	14.0%
33% Av. male lifetime earnings	17.5%
25% Av. male lifetime earnings	25%

* Assumes that all lifetime earnings follow the current average age-specific earnings profile and work for 40 years, between the ages of twenty and 60 (the average age-specific earnings profile is taken from the *New Earnings Survey*). Rates of contribution have been calculated using Government Actuary assumptions.[26] A lower earnings limit of £20 per week is assumed with no upper earnings limit. Pensions would be paid from 65.

14 per cent contribution rate that would ensure that these people saved enough to fund a minimum pension.

So the first principle suggests that the rate of compulsion should be lower than 14 per cent.

What about the second principle?

To predict who would reach the 30% target with a given rate of compulsion we would have to know how much people will earn over their lifetimes. Unfortunately, so much could change during the next 40 years that such predictions are impossible. But experts have calculated the hypothetical lifetime earnings of a population living and working all their lives under a given set of economic and demographic circumstances. Jane Falkingham and John Hills from the LSE have modelled earnings profiles for people entering the workforce in 1985 assuming that they spent the whole of their lives in the demographic and economic conditions of 1985.[27] We do not expect these conditions

Table 2 A modelled distribution of lifetime earnings[28]

Lifetime earnings	% population with higher lifetime earnings*
Twice Av. male lifetime earnings	3%
Av. male lifetime earnings	22%
75% Av. male lifetime earnings	38%
67% Av. male lifetime earnings	48%
50% Av. male lifetime earnings	66%
40% Av. male lifetime earnings	74%
33% Av. male lifetime earnings	82%
25% Av. male lifetime earnings	87%

* Approximate figures.

to prevail during the next decades but their model at least gives us a baseline against which to consider future changes.

For example, the model shows that if people lived all their lives in the conditions of 1985 we would expect 87 per cent to earn at least a quarter male lifetime earnings. We would expect only 48 per cent to earn more than two thirds of lifetime average male earnings.[29]

Table 3 combines the two sets of calculations and shows the trade-off between level of compulsion, and how many people would reach the target.

The second principle – that the majority of people should fund a target pension without help – thus suggests that contributions should be over 8 per cent if economic and social conditions remain approximately as they were in the mid-1980s.

These are necessarily rough estimates. But they are the best baseline we have. *They suggest that a compulsion rate of approximately 11 per cent is appropriate. At this rate most people should meet the target*

Table 3 The trade-off between rate of compulsion and proportion of the population reaching the target 30% pension (Tables 1 and 2 combined)

Level of contribution	Proportion of population reaching the 30% target.*	Who would reach the target? Those earning…
2.5%	3%	Twice Av. male lifetime earnings
5.0%	22%	Av. male lifetime earnings
7.0%	38%	75% Av. male lifetime earnings
8.0%	48%	67% Av. male lifetime earnings
11.0%	66%	50% Av. male lifetime earnings
14.0%	74%	40% Av. male lifetime earnings
17.5%	82%	33% Av. male lifetime earnings
25.0%	87%	25% Av. male lifetime earnings

* Approximate figures.

pension without government support but no one should end up funding a pension income higher than their average earnings over their working life.

4. What should the government do about those people who do not reach the minimum target income?

On our assumptions, about a third of people will not reach the target minimum secondtier pension of 30 per cent average national wages. So after the basic pension is added these people will not achieve the suggested adequate income of 40 per cent.

Considerably higher or lower proportions of the population could make this target. If people's investments grow faster than our calculations assume then more people will meet it. If they grow more slowly, fewer will. The increasing length of time that women are spending in work could mean that many more of them earn above half average male lifetime earnings. Likewise if the government's Welfare-to-Work programme is successful more people will achieve higher lifetime earnings. Conversely, higher levels of long-term unemployment or more people stuck in low paid jobs would lower the proportion reaching the target. On balance, given the changes in the economic and social conditions since 1985 and our current forecasts of these conditions in the future, the proportion reaching the target will probably increase slightly, primarily due to the increase in the state retirement age for women from 60 to 65 after 2010.

Whatever happens in the future, some people will not reach the target without government help. In this section we consider the three options for supporting them.

A. Top-up people's funds at the end of their working lives

The Chilean compulsory pension system has a minimum pension guarantee. People who have contributed for twenty years but fail to save enough to reach the minimum level by retirement receive a government top-up. If such a top-up system were established in Britain nearly everyone would receive the defined adequate retirement income. But as Appendix 1 indicates, it would be very expensive. The burden on everyone else would probably be higher than it is with means-tested benefits for pensioners today, although most pensioners would be a lot better-off than now. The cost could increase greatly if investments performed very poorly or if many more people spend much of their life out of work.

A second problem would be that the prospect of these top-ups might discourage voluntary saving above the compulsory rate. If someone contributed an extra few thousand pounds into the scheme but failed to meet the target, they would be no better off than those who made no extra contributions. Everyone would be topped up until they reached the target. People could therefore be put off making additional contributions before they reached the target.

A solution would be to establish three tiers of pension scheme. The first tier would be the basic pension. The second would be the mandatory scheme requiring contributions at a set rate until the minimum target was reached. Those never reaching the target could be topped up. The third tier would take all voluntary contributions so that people did not lose their entitlement to a top-up of the second tier. Such a three-tier system would, however, be difficult to integrate with our current mixture of occupational schemes, personal pensions and SERPS.

Even if additional savings could be separated from mandatory savings, a top-up system would encourage false reporting of earnings. Because top-ups would be guaranteed, people would benefit from minimising their contributions to second tier pensions and using their money for other purposes.

B. Make contributions on behalf of low earners

The government could pay contributions on behalf of anyone not working or those earning below a low pay threshold. If the government contributions were high enough, nearly everyone would reach the target even if they had long periods out of work.

This would avoid discouraging additional savings and contribution evasion, for there would be no top-up at the end. Yet it would also be extremely expensive. Further, it would benefit many people who earn little for some of their life but have sufficient overall lifetime earnings to meet the target level independently – negating the rationale for a lifetime target system in the first place.

A better method would be to give additional contributions only to those people particularly at risk of failing to reach the target without them, or to whom society deemed entitled to such contributions regardless of their lifetime earnings. The best example is women with young children. Most people who fail to achieve half average male lifetime earnings are women who have taken a number of years out of the labour market to bring up children. Traditionally, society has also recognised that people bringing up children are entitled to financial support because they often have to reduce their own earning to do so. If women were given £10 a week extra contributions for four years after the birth of each child then far more people would meet the 30% target. These additional contributions, up-rated in line with average earnings, should fund an additional pension of about 2 per cent of average earnings. The annual cost would be about £1.8 billion today and rise in line with earnings.

The government could also make contributions to people once their total *lifetime* length of unemployment exceeded four years.

People who occasionally dip into unemployment would not receive any additional lifetime support. Such people often also jump up into higher paid jobs and have lifetime earnings of over half the national average. In contrast, most people with recurrent long spells of unemployment are likely to remain in a pattern of low lifetime earnings and would not to reach the 30% target without government help. A similar scheme could be run for the long-term disabled.

C. Rely on income support

The government could make no new commitments. The poorest pensioners would still receive income support at approximately today's level. The means test would also exclude people who had considerable private savings of their own or those with affluent spouses. If everyone contributed 11 per cent of their earnings into a compulsory pension, very few people would rely on income support. For even if a substantial minority failed to meet the 30% target pension, nearly everyone would save enough for an additional pension of at least 10 per cent average male earnings. Together with the basic pension this would lift them above the income support level.

This approach would be the least expensive. However, it would be difficult to justify forcing people to save for a minimum pension if the government was prepared for many pensioners to live on less than the minimum.

On balance, the best solution is a selective use of contributions to supplement some people's funds during their working lives. The government would be unwise to make a commitment to top-up everyone's pension at the end of their lives despite the temptation to do so. In the past, such commitments have inevitably been broken by subsequent administrations, damaging people's trust in pension provision. But it would be wrong ask the lifetime low paid – primarily women – to contribute 11 per cent of their small income without the prospect of some additional government support. Introducing cash contributions to the funds of mothers[30] of young children would create a sense of partnership in aiming for the target, without making unsustainable promises.

4 Making it work

Some people think that a theoretically neat compulsory scheme will solve the pensions problems. It won't. For any compulsory scheme to be really effective the public must generally accept and have confidence in it.

Political acceptance

Compulsion must gain political acceptance if it is not to become another poll tax. The public are currently split about 50:50 for and against compulsion.[31] This may change, for there has been little serious debate so far. Many people will see it as a tax. As we noted in Part 1, when New Zealanders held a referendum about compulsory pensions last September, 92 per cent voted against their introduction.

Few people will be convinced by the paternalistic argument that the government should ensure that all people have a pension proportional to their earnings no matter how high these are. Most people just do not think that the government knows better than they do about their retirement needs and desires. Only 14 per cent claim to have general confidence in civil servants. Less than one in ten report confidence in Parliament.[32] Having established SERPS, then run it down and promoted personal pensions which were then mis-sold, people trust the government even less about pensions. In one survey about old age provision 87 per cent of respondents agreed with the statement that 'you can't trust the government – you have to look after yourself'.[33]

People do recognise that the population is ageing. Many also believe that this will make it difficult for the state to look after them when they are old.[34] But a lot of people seem torn about how the government should respond. If you ask people whether they think the government will be able to afford greater pension provision in the future, nearly everyone says no.[35] And the majority say that the individual is ultimately responsible for their retirement provision.[36] Yet when a survey asked people what, if any, social security benefits would be their highest priority for any extra government spending, 68 per cent choose retirement incomes as their first or second priority.[37] To put this into perspective, only 11.5 per cent chose benefits to single mothers. We already know how much antipathy reducing single mother benefits causes.

Taken together, the results of attitudinal surveys indicate that the government should be able to talk to people seriously about the problems of funding adequate retirement in the future. However, voters will want to see that it is helping poor pensioners as well as asking those who can fund their own adequate pension to do so. That is why keeping a basic pension and contributing to the funds of mothers with young children will be essential if compulsion is to be accepted. A Citizenship Pension for people doing unpaid caring work would similarly be welcomed. The cost to the poorest could also be reduced by other changes in tax, such as raising the tax thresholds on earned income or giving people tax credits.

The second serious political problem arising from compulsion is that the government is forcing people to take a risk. Time and again in discussions with the public, people question whether a new system will assure them of any pension at the end.

Unfortunately, the government could not honestly provide absolute guarantees. In the event of a global stock market failure pensioners would be just one group crying for help. Endowment and PEP mortgage policies would decline in value, currency markets would be chaotic, financial institutions would go bankrupt and the economy could enter a very deep recession. To suggest that the government could find billions of pounds to guarantee pensions in such a scenario is unreasonably optimistic.

In normal economic circumstances the political pressure to look after contributors of a failed pension provider would rightly be enormous given the compulsory nature of the savings. Careful regulation must be the main safeguard against such failure. Greater industry insurance might also be needed.

Eleven per cent compulsion, our recommended level, would squeeze the consumption of most people not already in good occupational pension schemes. It is not actually a high rate by international standards. The compulsory contributory rate is 18.5 per cent in Sweden and 21 per cent in Germany. It is also lower than the 16 per cent proposed by Frank Field, the Minister for Welfare Reform (although Field proposes a high lower earnings limit to reduce the burden on the lowest earners). However, even our 11 per cent rate would need to be phased in slowly, preferably during periods of economic growth.

The scheme would run most easily if SERPS was wound up and people's National Insurance contributions reduced by 4.6 per cent (the current level of rebate). The first year's compulsory contribution rate would be 4.6 per cent, rising annually thereafter. If SERPS was kept as one component of the pension system, either for some or all of the population, the compulsory scheme would be slightly different. SERPS contributors would eventually be compelled to save 6.4 per cent in addition to their SERPS contributions (11 per cent above the upper earnings limit and below the lower earnings limit).

Practical compliance

Even if compulsion is accepted politically, for a compulsory scheme to achieve high compliance the government will need to win people's hearts and minds about the need to save more. In Chile, the self-employed are excluded from the compulsory system. Nearly half of the working population manage to classify themselves as self-employed and therefore avoid contributions.

In Britain, the self-employed could be compelled to contribute by imposing new mandatory Class Four National Insurance contributions on profits above a minimum threshold.[38] However, in the future everybody could evade payment more easily than today if they really want to. A few people are already paid in vouchers to avoid National Insurance. With a proliferation of quasi-currencies – air miles, supermarket loyalty points, local currencies – it could become even harder for the government to trace payments in kind. Already government finds it difficult to control the cash economy. Luckily for it, formal transactions with cheques, credit cards, bank transfers and so on have increased over the past decades. These are much easier to identify. But that might be reversed with the introduction of electronic cash. Electronic cash has all the convenience of today's formal transactions. It is kept on a single card. But it will probably not leave any mark on a bank statement. People will just download it to someone else's card. As the use of electronic cash goes up, so does the potential for not declaring income.

Tax and compulsory insurance evasion is already rising in many economies. What keeps evasion down today is that most people do not want to break the law. Compulsory saving could be a more popular system than taxation, because people keep the money themselves. But if people have little acceptance of the need to save for an adequate minimum income or lack confidence in the system they will justify their evasion.

Another problem with unpopular insurance is that even if people do not evade payment they compensate for it by taking other risks. In some countries the introduction of compulsory motor cycle helmets appears not to have significantly reduced the rate of injury.[39] The reason is that people felt more secure, took more risks and consequently had more accidents. The analogous scenario with compulsory pensions is that people might feel financially more secure for their retirement and so take more risks during their working lives: borrowing more, reducing other forms of saving and insurance, and making commitments which they can not fulfil. The problem of poor financial planning would only be shifted by compulsory pensions. As we noted in Part 2, in Australia the rate of national saving has declined despite the introduction of a compulsory pension system. Some people have offset their higher saving for pensions by increasing their debt. In essence, the government must deal with the underlying problem of poor financial decision making and many people's excessive attachment to immediate consumption of their resources. Pension reform must also include an effort to boost financial understanding and the *cultural* underpinnings of higher saving; people's awareness of their financial needs; their ability to plan for the long term; confidently handle and talk about their finances; form habits of saving; and develop their ability to defer immediate benefits for long-term rewards.[40]

The government's commitment to greater financial education is a welcome attempt to boost people's financial skills. Childhood is a crucial period for learning financial competence. People who develop good habits during their early years tend to retain them for much of their life.

Financial education should comprise much more than learning facts and theory. It must develop children's practical skills and their broader ability to prioritise their use of resources and act on these priorities. Learning by *experience* is crucial to the development of both. If children are given real experience of saving and deciding how to use money they can develop not just day-to-day confidence and competence with money, but also the capacity to plan for the long term.

A second way to develop a more financially aware and able population would be to help people *engage* with their finances. It is people who talk through their finances with others who tend to plan better and become more willing to save. Simply being aware of the need to save tends not to be sufficient to change most people's behaviour – the vast majority of people vaguely want to save more, in the same way as they would like to take more exercise or lose weight. Simple financial products can help people to engage with their finances. So can face-to-face financial advice. Supporting good financial advice would be an efficient way to help engender a culture of saving.

People also engage with their finances more when money management is a team activity. That is why small credit unions and mutual saving clubs can be useful. People feel a sense of owning the system and take a greater interest in their saving and borrowing. Supporting credit unions and mutual saving groups with advice and possibly small start-up grants would be another way of stimulating the culture of saving necessary to prevent widespread evasion of mandatory saving of stimulating an increase in borrowing.

In summary, ensuring adequate pension provision is not a choice between compulsion and encouragement. For compulsion to work effectively the government must help form a culture of saving in which mandatory minimum pensions are just one part.

Conclusion

Compulsory pensions are not new. But as the pensions system is changed there is a danger that many mistakes could be made. As John Denham says, there is a lot of sloppy thinking about compulsion. An earnings-related compulsory scheme could be introduced, which would be unjustifiably paternalistic. Upper earnings limits could be established for pension contributions, allowing people with volatile lifetime incomes to contribute little despite their high total lifetime earnings. Compulsion could be placed on employers which risked distorting the labour market. Or the system could undermine good existing occupational schemes. The compulsory rate could be set so low that it fails to give most people an adequate income or so high that it unfairly penalises the lifetime poor, simply replacing poverty in their retirement with poverty during their working lives.

This *Commentary* proposes a simple scheme which avoids all these pitfalls. It suggests:

- compelling people to put 11 per cent of all their earnings into a pension scheme until they ensured a pension of at 30 per cent of average male earnings at the start of their retirement (thereafter linked to prices), combined with a basic state pension of 10 per cent throughout retirement;

- letting people opt out of contributions if they could prove that they had enough provision to ensure the minimum adequate pension; in the process of this auditing they would necessarily be induced to consider whether this minimum would meet their retirement wishes;
- funding additional contributions to mothers and possibly other groups who tend to have low lifetime earnings;
- a parallel campaign to win people's hearts and minds over the need to save more; this is essential if compulsion is to be politically sustainable and practically complied with.

Most importantly, the scheme should ensure that for the first time in history the vast majority of pensioners have adequate incomes, without placing an unaffordable burden on some people or forcing other people to save more than they need.

Appendix 1

Note on estimated costs to government of topping up those who did not earn enough at the end of their working lives

Table 4 The trade-off between level of contribution, proportion of population reaching the 30% target and the costs of topping up those who did not reach the target[41]

Level of contribution	Proportion of population reaching the 30% target*	Estimated cost to bring everyone's annuity fund up to the 30% target. Proportion GDP.**
2.5%	3%	*3.5*–7.1
5.0%	22%	*2.0*–4.0
7.0%	38%	*1.4*–2.9
8.0%	48%	*1.2*–2.5
11.0%	66%	0.8–1.7
14.0%	74%	*0.6*–1.2
17.5%	82%	*0.5*–1.1
25.0%	87%	*0.4*–0.8

* Approximate figures.
** Indicates two possible costs. The 'normal font' figure indicates the estimated cost if people's funds were topped up at retirement. Expenditure on means-tested benefits for people in retirement is currently a little over 1 per cent of GDP. If the level of meanstested benefits rose in line with earnings, then this figure is likely to grow a little over the coming years. Such expenditure would no longer be necessary with top-ups.

The italicised figure indicates the estimated cost if contributions were given in cash during people's working lives. The cost of cash contributions is lower than a top-up at retirement because pension assets are assumed to grow faster than GDP. Because the government could not assess who would fail to meet the target during people's working, it would have to give cash contributions to every one on a low income and re-claim such contributions from those who subsequently reached the target (as proposed by Falkingham and Johnson, 1995).

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Ben Jupp
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