

# Plaid Cymru Draft Pension Policy

## Introduction

1. There are two key elements of pension policy:
  - a. The alleviation of poverty in old age when people are no longer able to work; and
  - b. The spreading of earnings over a life-time, so that even when in retirement, pensioners' living standards are not hugely different from when they were working.
2. It is of importance to society to ensure that no-one falls into poverty at any age, whether it is during their working life or in retirement.
3. It is also in the interests of society to encourage the prudent saving of resources by citizens during their working life to try to ensure that they have adequate resources in retirement, and do not fall into poverty.
4. These two vitally important, but different policy objectives have become confused, and in the past policy has been made on a reactive basis, rather than ensuring that these two goals are met. Plaid Cymru therefore welcomes the thorough review provided by the first Turner Report<sup>1</sup> as an opportunity to fundamentally reform the pension system in the United Kingdom, and to take advantage of pension reforms that have taken place, or are being discussed in countries such as Sweden, the United States and Chile among others.

## The current system

5. The current system of state pensions recognises the distinction made above through the provision of both the basic state pension and the Second State Pension, (S2P) previously known as the State Earnings Related Pensions Scheme or SERPS, together with a provision for opting out. However this compulsory saving through national insurance and S2P (the old SERPS), fails to make any adequate link between saving and entitlement. By changing the basis of terms of indexation from average earnings to inflation the Thatcher government knowingly and deliberately devalued the state pension, but it did this at the cost of undermining public

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<sup>1</sup> **Pensions: Challenges and Choices** The First Report of the Pensions Commission, 2004, referred to as 'the Turner Report'

confidence both in the state pension and in a system where the terms could be changed to the public's disadvantage at a moment's notice<sup>2</sup>.

The Labour government's continuation of the policy has no basis in either principle or justice, striking as it does at some of the most vulnerable in society. Even with the inclusion of the maximum second state pension the UK has one of the least generous pension systems in the developed world, ranking not only well below continental Europe, but also Australia and the United States.<sup>3</sup> Part of the problem has been that the government has looked to the private sector to provide pensions, and indeed would like the private sector to provide more pension provision than the state in the future.

6. The result is that the current system provides the well off with very significant tax benefits to save for their retirement while the state pension is increasingly inadequate for the less well off. The State Second Pension is often little understood, and complicated with its contracting in and contracting out provisions. When it has been contracted out to occupational pension schemes which have subsequently had to be wound up employees' pension entitlements have in some cases very drastically reduced, or virtually disappeared. This has not only been a tragedy for the individuals involved, but it has also had an impact in further reducing public confidence in the system as a whole.
7. The growing inadequacy of the state pension has increasingly underlined the role of the state system as one for alleviating poverty in old age; its role as a method of deferring income into retirement, to ensure a reasonable standard of living in old age is rapidly reducing. Its value is now so low that it is failing even to alleviate poverty and the number of pensioners receiving benefits is rising<sup>4</sup>.
8. However, a number of the problems and a significant part of the expense of the current system derive from absurdly over-generous provision of pension and pension entitlement to the better off, many of whom require little or no tax incentive to save from the state. Indeed it is precisely these people who are likely to be most aware of the need to save for their retirement, and to be in a position to do so. It is unacceptable that more than half of the some £13 billion<sup>5</sup> of tax relief for pensions goes to 2.5 million higher rate tax payers<sup>6</sup>. The remainder goes to 13 million lower

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<sup>2</sup> See Turner Report Table 6.8 which indicates public mistrust of government to deliver on pension promises is even greater than that of pension providers and employers.

<sup>3</sup> Turner Report pp. 58 and seq.

<sup>4</sup> Turner Report, Table 3.21

<sup>5</sup> This is a matter of some dispute – the Turner Report indicates its own figures as being possibly £3 billion less than this.

<sup>6</sup> Ruth Kelly, Answer to PQ from Steve Webb, Hansard, 11 Feb 2004.

- rate tax payers. An additional nine million people do not benefit, since they do not make any private pension contributions.
9. It further makes no sense that the earnings cap, up to which pension payments can be tax deductible will be £215,000 p.a. in April 2006<sup>7</sup>. It is not at all clear what benefit society obtains by encouraging high earners to save for a pension which will be substantially higher than the amount that many people earn when they are working.
  10. It also not acceptable that the total pension fund pot that can be accrued will be £1.5 million as from April 2006<sup>8</sup>. This would allow for an annuity on retirement of a 65 year old man of over £100,000 p.a. at an interest rate of 3%<sup>9</sup>. Many hard working people are subsidising through their tax payments hugely generous pension provisions that they themselves can only dream about, and which are diverting badly needed and increasingly stretched resources from other calls on the public purse.

### **Current problems**

11. Although National Insurance contributions are separated out from general tax, they merely become part of the government's total funding and the income is not segregated from tax income. This means that the savings element is not transparent, and national insurance contributions are regarded as tax. When the State Second Pension is contracted out, it is usually to occupational pension schemes, and is often not really perceived as a separate savings fund in its own right; it is notable that contracting out to stakeholder schemes has not been very successful. The basic state pension is funded through a 'pay as you go system' which suffers from the demographic changes in the UK, with a continuing trend of growing numbers of people in retirement and fewer in work. The payment of pensions will therefore become an increasingly important part of the UK government budget in the future unless the system is reformed. The more the government has to pay in pensions the less money will be available for health, education, housing and so on.
12. Plaid Cymru recognises that the pension problem is further compounded by the change in demographics in the UK and that under the pay as you go system there will be fewer and fewer people of working age to support a rising number of pensioners in the decades ahead unless the age of retirement is deferred; this would have the effect of both expanding the number of people of working age and reducing the numbers in retirement,

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<sup>7</sup> Finance Act 2004

<sup>8</sup> Finance Act 2004

<sup>9</sup> Aon Consulting Annual Statistics 2004. Single life annuity for 65 year old male at 3% interest rates, is calculated at £14.167 for £1 per annum annuity.

as well as reducing the period over which the pension would be payable. However it gives rise to the additional consideration of whether a funded system would be a more appropriate way of dealing with these demographic factors – such a system would enable people to make provision for their own retirement rather than depending on the earning power and efforts of future generations.

13. In addition, as a result of a number of factors including the capping of company pension fund contributions under the Thatcher government<sup>10</sup>, and the removal of the tax exemption for dividends on UK company shares held by pension funds by Gordon Brown<sup>11</sup>, as well as falls in the stock market, confidence in company pension funds is also much lower than previously. Companies have started to realise the potential cost of their defined benefit schemes, and many have closed them to new employees, or closed them completely, and replaced them with defined contribution schemes. Not only has this resulted in the investment risk being transferred to the employees, but in many cases companies have significantly reduced the pension contributions which they pay into such schemes.
14. Under such defined contribution schemes, the employees are in no better a position than if they were able to contribute to a stand alone pension scheme. The costs of the scheme may be lower, as a result of aggregating the pension contributions of all the employees and the company, and the fund may have greater investment flexibility due to its size, but the employees have little practical control over the fund.
15. The change from defined benefit to defined contribution pension schemes has fundamentally altered the nature of involvement by the private sector in pensions, although this has not yet been generally recognised. Under defined benefit plans, the company's involvement in the fund was very important because in principle it agreed to make up any shortfall in the performance in the fund's assets to provide the employees with their specified pension, based on salary i.e. the company was at risk for the

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<sup>10</sup> See Turner Report p 124, and figure 3A.6. “Indeed not only did they [company pension contribution rates] fall but they were required to fall by deliberate government policy. HM Treasury had by the early 1980s become concerned that companies were using large pension fund contributions as a means of managing down corporate tax liability in years of high profit. The Finance Act of 1986 therefore required pension funds to identify whether (on certain actuarial assumptions), they had a surplus of 5% or more, and to take action to remove the surplus within five years, or else lose some part of their tax exempt status. The deep dip in contributions seen in the period 1988-91 in Figure 3A.6 [which shows company contributions to occupational pension schemes falling from a high of about 2.5% of GDP to below 1% of GDP between 1981 and 1991] almost certainly reflects the impact of this policy.”

<sup>11</sup> See Turner Report p 124. “Finally pension funds surpluses appeared to be so resilient that HM Treasury believed that it could increase tax on pension fund investment return (through the dividend tax changes of 1997) without endangering the continuity of the system. Tax relief on pension fund investment income fell from £7.1 billion in 1996-97 to £3.3 billion in 2002 (on Inland Revenue figures).”

shortfall. However, under defined contribution schemes this is no longer the case. There is therefore no longer any reason for a company to require an employee to pay pension contributions into a company defined contribution pension scheme – indeed it inhibits the choice of the employee; if the company insists on only paying its contributions into the company pension scheme, then the employee will feel obliged to join it to receive those extra contributions, but it may well not be the best performing fund, and the employee will have little control over the outcome. Indeed even though employees trust their employers more than the government to deliver on pension promises, the level of mistrust of occupational pensions is still sufficiently high that many workers have even opted out of defined benefit schemes that are still open to them, despite substantial contributions from the employer.<sup>12</sup>

16. Plaid Cymru recognises that the role of the company pension fund is fundamentally changing, and is likely to change more in the future. It believes the role of companies in providing pensions also needs to be reviewed.

### **Major changes to the Basic State Pension**

17. Plaid Cymru believes that government should recognise the fundamental distinction between the role of pensions as a means of alleviating poverty on the one hand and as long term savings on the other. To quote the Turner Report:

“Among the rich developed countries the UK is therefore in a specific group with Ireland, New Zealand and Canada, where the state pension is primarily designed to prevent poverty rather than to provide income replacement.”<sup>13</sup>

In the United States there is an earnings related pension scheme, which is virtually universal, but is looking to a shortfall in the next thirty five years or so.<sup>14</sup> Its assets are segregated, but it has no right to look to general

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<sup>12</sup> For example more than 20,000 employees (some 11% of the workforce) have opted out of the Royal Mail’s final salary scheme. See Professional Pensions, 11<sup>th</sup> August 2005.

<sup>13</sup> Turner Report, p.60

<sup>14</sup> There is a payroll tax of 12.4 percent, half on employers and half on employees, with the self-employed treated as both employer and employee. The tax is levied on earnings up to a cap that is automatically indexed to average earnings and is currently \$90,000. From 1983 to today roughly six percent of earners

taxation to make up a shortfall. The US system makes only limited provision for those with incomplete working records, and therefore only goes some of the way to alleviating poverty in old age. This is also true of the pay-as-you-go-systems in continental Europe, whose generosity in respect of the earnings related element has raised serious doubts about their future affordability. Sweden, which has also instituted a funded pension scheme, substantially overhauled its pension scheme in the 1990s as a result of anticipated unaffordability.<sup>15</sup> However the new system is still a combination of both poverty alleviation and income replacement. We believe that there is a great deal of merit in distinguishing clearly between these two different policy goals. The pension systems in a variety of different countries were reviewed in the Turner Report<sup>16</sup>. We believe that the poverty alleviation part of pension policy has been addressed most cogently and clearly in New Zealand.

The New Zealand state pension, called New Zealand Superannuation (NZS) is a flat-rate, universal state pension payable to people aged over 65 who are resident, and have lived in the country for ten years since age 20, five of which must be since age 50. This is payable irrespective of work history, thus ensuring that women and disabled people are not disadvantaged.

The Pension Policy Institute has done a great deal of work on both the nature of the New Zealand pension<sup>17</sup>. They have also suggested a way in which the transition could take place between the current system<sup>18</sup> and the New Zealand system, and have calculated that it is just as affordable as the current system.

Plaid Cymru believes that the United Kingdom should recognize the reality of funding the basic state pension out of tax revenue and move to a citizen's pension at the level of a minimum of £110 per week, which would be about 22% of National Average Earnings<sup>19</sup>, and be indexed to remain at least this level. Even including the UK's State Second Pension, the

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have had earnings above the cap. As income distribution has become steadily more unequal, the fraction of earnings not subject to this payroll tax has grown from 10 percent to 15 percent. Coverage is almost universal... See Professor Diamond, MIT, Reforming Public Pensions in the US and the UK, 18<sup>th</sup> May 2005. UBS Pensions Public Research lecture LSE.

<sup>15</sup> It now has a multi tier earnings related pensions scheme, where there is a comparatively low cap of Swedish Kroner 290,000 (approximately £21,500) for the lowest tier, since most Swedes also belong to a quasi mandatory additional scheme. . See for example 'The New Swedish Pension System' by Edward Palmer, Swedish National Social Board and Uppsala University

<sup>16</sup> See particularly Appendix D in respect of a number of international comparisons, and Table D1 for a brief overview.

<sup>17</sup> "Citizen's Pension: Lessons from New Zealand, March 2004", A Discussion Paper by Alison O'Connell published by the Pensions Policy Institute

<sup>18</sup> How the offset could work in transitioning to a citizen's pension.

<sup>19</sup> This is in fact slightly below the ratio of the basic state pension to average earnings in 1974, which was 24%, but significantly higher than the current rate of 16% of average earnings.

average pensioner in the UK is little better off than under the flat citizen's pension in New Zealand.<sup>20</sup>

The Basic State Pension of £82.05 per week alone is only about 16% of UK National Average Earnings.<sup>21</sup> The level of the New Zealand citizen's pension is reviewed each year, but has to be kept between 32.5% and 36.25% of the net average wage. This is usually described as '65 at 65', that is, at age 65 a married couple will receive at least a net 65% (two times 32.5%) of the net average wage.<sup>22</sup>

18. Plaid Cymru further notes that the current level of Guarantee Credit (previously the Minimum Income Guarantee) is £109.45 per week and its current and future application together with Savings Credit is immensely complex and difficult to understand<sup>23</sup>. The level of pension proposed by Plaid Cymru is therefore the minimum that is consistent with logic, and the government's calculations as to a necessary minimum income. It should be emphasised that although it would be a considerable improvement on current UK levels, it would still be very low by comparison not only with New Zealand, but with the pensions paid under the systems in many European and other countries<sup>24</sup> the additional cost of introducing such a pension would, of course, be reduced by the fact that many people already receive the equivalent amount under Guarantee Credit, albeit on a means tested basis.

19. It is utterly absurd that the government has a pension system in place, which is notionally contributory, but which results in a pension which the government itself calculates is below the minimum income. It then adds insult to injury by penalising those who have saved and rewards not only those who have been too poor to save, but also those who have been profligate. Such a system not only has bred justified cynicism, but is a direct discouragement to savings, particularly by those on lower earnings who will be most affected by withdrawal of tax and other benefits at the margin.

20. The current system of tax treatment for pension savings is not only hugely unfair it is totally illogical and inconsistent.

On the one hand it is currently possible to benefit from tax deductions for pension savings up to £1.5 million, and for annual income up to £215,000 p.a.<sup>25</sup>. At the same time if a person has Minimal savings they can lose £1

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<sup>20</sup> See Turner Report, Table 3.3, p.60

<sup>21</sup> Pensions Policy Institute, the Pensions Primer, June 2005.

<sup>22</sup> "Citizen's Pension: Lessons from New Zealand, March 2004", A Discussion Paper by Alison O'Connell published by the Pensions Policy Institute, p. 4

<sup>23</sup> See for example the Turner Report, pp226 et seq.

<sup>24</sup> See Turner Report, p.59

<sup>25</sup> Finance Act 2004

of benefit for every £1 of savings, a 'withdrawal rate' of 100%. Even with other factors and Savings Credit taken into account entitlement to Pension Credit reduces very rapidly indeed, with over 25% of those affected suffering from 75% reduction of their Guarantee and Savings Credit as a result of savings<sup>26</sup> of over £6,000 this substantially reduces entitlement to Guarantee Credit. The Savings Credit has a 40% 'taper', but this may be much higher in practice since the government appears to make the absurd assumption that for every £500 or part of £500 over the £6,000 ceiling the individual receives an annual income of £52, or more than 10% p.a.<sup>27</sup> With interest rates well below 5% this is an additional and totally unjustifiable disincentive to save for the less well off.

The effect of this system is therefore a huge government subsidy to the savings of the very well-off and massive disincentives to save for those with the least money. It would be difficult to devise a system more effective at helping the few at the expense of the many, while costing huge amounts of public money.

21. Plaid Cymru does not accept that the institution of a citizen's pension would result by Britain being 'swamped by elderly Europeans'<sup>28</sup> We believe that this is scaremongering of the worst sort. It seems extraordinary that millions of people in the UK, and particularly women, should be deprived of a decent minimum pension because of a supposed inability of government to draw up adequate residency requirements. We agree with the much more measured approach of the National Association of Pension Funds, which also supports a citizen's pension, who stated "We believe there are sufficient safeguards already in place in the system to avoid so-called 'welfare tourists.'"<sup>29</sup>

22. Plaid Cymru believes that a citizen's pension would have the following advantages:

- a. It would be easy to understand – the New Zealand legislation runs to some 55 pages, as compared with 3,500 in the United Kingdom.
- b. It would be simple and cheap to administer (National Insurance contributions for both BSP and S2P could be treated as part of the general tax rate, and notional contribution records would not be needed. In addition this would abolish the need for expensive needs testing of benefit.
- c. It would encourage additional savings, both because citizens would know very clearly what they could expect in retirement and plan

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<sup>26</sup> Turner Report, p. 226 and Appendix F, figure F6

<sup>27</sup> "Am I entitled to Pension Credit?" On the Pension Service Website.

<sup>28</sup> Reportedly the remarks of David Blunkett to delegates at an Age Concern meeting in Sheffield, Professional Pensions, 18<sup>th</sup> August 2005, p.3..

<sup>29</sup> Professional Pensions p.3, 18<sup>th</sup> August 2005, p.3.

accordingly, and because since it would be a universal benefit it would not discourage savings in the way the current means tested Pension Credit does.

- d. It would ensure that women, the disabled and those who had suffered periods of unemployment were not disadvantaged
- e. It would be regarded as a more honest system, by acknowledging that the state pension is concerned with poverty alleviation, and paid out of general taxes, rather than pretending to be some kind of contributory system.
- f. It would at least ensure that many people who are currently entitled to Guarantee Credit, but so do not take it up will also be able to live in dignity in the future.

Plaid Cymru believes that a citizen's pension along the lines of the New Zealand system would meet the first requirement of a pension policy – that of alleviating poverty. We believe that the Deputy Prime Minister of New Zealand put it well when he said:

*“...the ability to retire in a degree of personal comfort, without worry and with dignity, is the least that citizens can expect in a modern, developed economy.....it is also most they can expect. They cannot expect the state to maintain in retirement the incomes people became accustomed to during their working lives”.*<sup>30</sup>

23. Plaid Cymru recognises that as a result of increases in longevity, with men having a life expectancy of some 19 years at age 65 and women over 22 years<sup>31</sup> at the same age, a long term solution is required to the proportion of the government budget going to pay pensions rather than other expenditure, such as education, health and so on. It proposes that the retirement age should be recalibrated periodically to take account of life expectancy after retirement.

24. The retirement age would be calculated on the basis of the current longevity of retirement, once retirement ages for men and women had been equalised at 65. The retirement age would be changed for those with 20 years or more to go before retiring. For example, if the current life expectancy for a man aged 65 is 19 years and this were to increase to 20 years, then those men under the age of 45 would have to retire at 66 instead of 65. This would mean that irrespective of age, all people would be saving for the same length of retirement, whenever that started.

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<sup>30</sup> Taken from a speech by Hon Dr. Michael Cullen, New Zealand's Deputy Prime Minister and Minister of Finance to a Retirement Commission Symposium 13 June 2003, and quoted in "Citizen's Pension: Lessons from New Zealand, March 2004", A Discussion Paper by Alison O'Connell published by the Pensions Policy Institute, p. 4.

<sup>31</sup> Aon Consulting, Annual statistics, 2004.

25. Such a policy should go hand in hand with positive measures to reduce age discrimination, and a government policy which enables those who wish to, to work up to and indeed beyond the normal age of retirement.

### **A Policy for Saving**

26. In addition Plaid Cymru believes that the government should also provide incentives for saving.
27. As mentioned above companies are coming to realise the true cost of their defined benefit pension commitments, under which they promise to make up the difference if pension fund investment performance falls short of what is required to meet specified pension obligations. They are increasingly closing their defined benefit pension schemes to new entrants or closing them completely. Defined contribution schemes taking their place have tended to be far less generous, with company contributions being considerably lower, and with the investment risk staying with the employee.
28. The savings element of pensions is nothing more or less than deferred pay. Plaid Cymru does not believe it is logical for companies to drive the savings habits of employees, particularly given the fact that employees are increasingly taking the risk of the underperformance of the assets. It also believes that that the current alternatives available to lower paid employees are not attractive. Although stakeholder funds have been designed with the lower paid in mind they have not enjoyed great popularity, despite their capped charges of 1% p.a.
29. The fund management industry feels that stakeholder charges are too low, and this has resulted in the Treasury agreeing that the cap can now be increased to 1.5% for the first 10 years; this is because they have to support considerable marketing costs as well as providing their investors a return. Even at this level, such charges can result in a reduction of approximately 20% of final balances over a working life because the deposits stay in the account for an average of 20 years. This was pointed out by Professor Peter Diamond of MIT in his recent lecture at the LSE, when he referred to the Chilean and Swedish systems of personal savings accounts, which cost about 0.75% p.a., rather than the 1% p.a. of the stakeholder products, and he calculated accordingly that they reduced final balances in those systems by about 15%.<sup>32</sup> The Turner Report estimated that taking into account such costs would result in a 30% reduction in pension assets over the savings period and reduce the return

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<sup>32</sup> Reforming Public Pensions in the US and the UK, 18<sup>th</sup> May 2005. UBS Pensions Public Research lecture LSE.

on investment by almost half. It questioned whether the market could sell profitably to lower earners<sup>33</sup> “

30. The US is currently reviewing a system which would combine features of both the Chilean system – where individuals can choose between a small number of highly regulated funds, and the Swedish system, where individuals can choose between a wide variety of funds, but these choices are then aggregated by the government agencies to reduce running costs. It is anticipated by the US Government actuary that the US system will run at a cost of 0.30% p.a.<sup>34</sup> A state sponsored savings system clearly has the potential to administer systems at low cost, improving returns for all, and widening access for low earners.
31. Plaid Cymru believes that it is not a good use of public funds to provide tax relief to enable high earning individuals to receive very large pensions in retirement, and this would be even more the case where a universal citizen's pension had been instituted. However it does believe that the state should encourage individuals to save for their retirement. It recognises that a citizen's pension would provide only the basis for a dignified retirement and, as mentioned above by international standards it would be a very modest amount.
32. In addition with changing patterns of employment, where individuals often work for more than one company during their working lives, and are also possibly self-employed, or working on a part time basis for periods it is important to ensure that there is adequate encouragement and security for people to save for their retirement. It is therefore preferable that pensions be as portable as possible. This implies a coherent pension savings system rather than company based systems.

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<sup>33</sup> “The issue which therefore needs to be debated, and on which the Pensions Commission invites views during our consultation process, is whether this implies that there is a segment of the pension market, comprised of lower income savers and people working for small firms, to which a free market will never be able to sell pension products profitably except at RIYs [Reduction in Yields] which make saving unattractive.” Turner Report p.224.

<sup>34</sup> Per Professor Diamond “That is, workers would have a choice from a very limited set of alternative mutual funds —roughly half a dozen, with no choice among fund managers. The government would aggregate the deposits and hold competitive bidding from private investment companies for the right to invest the money, based on index tracker funds —that is, funds that attempt to approximate the return from holding all the assets in a particular class. For example, there can be funds that approximate holding the entire stock market, or the set of large firms or of small firms, or all of corporate bonds. Thus, this is a combination of the limited choice in Chile with the central government role in Sweden, but without individual choice of provider, which is present in both Chile and Sweden. This focus on limited costs with limited choice seems very wise to me. The Office of the Actuary has estimated that such an approach, once up and running, would cost about 30 basis points per year, less than half the cost in Chile or Sweden.”

33. Plaid Cymru also recognises that a pension system overseen by the state is capable of reducing costs of operations, while at the same time removing the sponsor bankruptcy credit risks inherent in the private sector. Plaid Cymru therefore proposes that since the citizen's pension would not be based on saving there should in addition be an earnings related system in place.
34. The earnings related system proposed by Plaid Cymru would have a lower and an upper threshold. For people on very low earnings it makes no sense for them to save for the future, since they need all of their available income to meet their current expenditure. These would be the people who would be most likely to benefit from a citizen's pension. However for those with the capacity to save for their retirement Plaid Cymru believes that there should be a state sponsored system which would bring with it the advantages of state subsidy. The state system and the state subsidy would only be available up to an upper threshold. It would not be possible to contribute to the state system over this cap, and no state subsidies would be available over this cap. Those below the lower threshold could save on a voluntary basis. The upper threshold would be set initially based on the current cost of tax relief on pension contributions.

The issues as to compulsion are often confused. There is already compulsory saving through national insurance contributions, what really is in question is how much saving should be made compulsory, and whether it should be on a funded, or as a pay as you go basis. The Turner Report<sup>35</sup> listed those countries which had instituted a compulsory funded secondary pension. Although there are arguments as to whether such a system affects the aggregate savings rate of an economy<sup>36</sup>, the Australian Reserve Bank came to the conclusion that it did in Australia, and, importantly, particularly among lower earners.

In addition, by having a funded pension plan the system becomes much more transparent. It is likely to encourage long term saving habits because it both encourages awareness of the necessity to save, and the results of savings already made. A simple compulsory funded system is likely to be particularly important for lower earners since it will be more easily understandable than the current system, as well as providing the confidence of a state backed fund where the rights of the savers are clear and safeguarded by the government.

35. As stated above the current system tries to achieve two objectives; to ensure that there is no absolute poverty in old age and to ensure that earnings over a lifetime are spread adequately. To the extent that the state wishes to ensure that no-one falls into poverty in old age, it has a

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<sup>35</sup> in Table 7.2 (p.253)

<sup>36</sup>Turner Report, p. 254

responsibility to ensure that people save enough so that this does not happen. The current compulsion in respect of national insurance contributions and of the second state pension reflect this fact. The fact that in retirement, after a certain age, there is a requirement to purchase annuities with pension assets (or with effect from April 2006 an alternatively secured pension (ASP) from age 75) also reflects this approach.<sup>37</sup>

Plaid Cymru is therefore of the view that there is a substantial argument in favour of making secondary pension contributions compulsory. What is vital is that pension contributions start at an affordable level, and are only compulsory up to a level which is sufficient to ensure that the assets saved are enough to provide pensioners with a reasonable income in retirement.

36. Plaid Cymru therefore believes that contributions should therefore be compulsory to a state sponsored pension scheme above a certain threshold. Instead of providing tax relief, the government would match payments into the fund on a like for like basis; initially on a pound for pound basis, and thereafter on a diminishing basis up to a maximum amount. For those on lower and standard rates of income tax this would represent a very significant increase in state help towards savings, and even for those on higher rates of tax this would represent a substantial increase over current levels up to the capped amount. In terms of being mandatory, this would not in practice be very different from automatic enrolment in a private company scheme. Employees of a company benefit from payments by the company into a pension scheme, but only if it is the company pension scheme; employees cannot choose a different scheme. In the same way the government would make payments into the state sponsored pension savings system.

37. This state system would be invested in widely diversified portfolios of shares and bonds and other assets. As is being contemplated for the US the government would aggregate the deposits and hold competitive bidding from private investment companies for the right to invest the money, based on index tracker funds—that is, funds that attempt to approximate the return from holding all the assets in a particular class. For example, there can be funds that approximate holding the entire stock market, or the set of large firms or of small firms, or all of corporate bonds.

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<sup>37</sup> See Turner Report, p.250, "...the UK does have and will have for many years at least an element of compulsory earnings-related pension, which can, at the employer or individual's option, take the form of a state determined minimum savings level. Thus, while the Pensions Commission's terms of reference asked us to consider whether the UK should ever develop a tier of compulsory private saving, the question is rather whether that tier should be increased in scope.

38. This increased support of pension provision up to a cap will redistribute the government pension subsidy to the less well paid, and would be paid for by the transfer of tax relief on private pension payments. This system would be designed initially to be revenue neutral. The United Kingdom allocates a far lower proportion of its GDP to pensions than other advanced countries (5.5% as compared with a 10.4% average for the European Union before enlargement)<sup>38</sup>. Plaid Cymru certainly believes that there is scope to increase this percentage. However, we should not lose sight of the fact that any state subsidy to encourage retirement savings will always be at the expense of alternative expenditure on hospitals, schools etc.
39. In addition this system will be considerably more transparent, since it will be far clearer both to the individual and the state how much money is being saved, and how much money will be spent by the state in respect of pensions, and who benefits from government subsidies.
40. In order to ensure that the importance of savings, everyone who was entitled to a state pension would receive at least once a year a statement showing the amount of money that they had contributed or had been contributed on their behalf to a state pension, with a calculation to show what pension this could provide at retirement age. This would reinforce the contractual nature of the pension arrangements and constantly remind people of what they could expect to receive on retirement. In practice the state is the entity which is best placed over the long term to provide a defined benefit pension.
41. Plaid Cymru believes that by providing a citizens pension there would already be an element of defined benefit within the system. However, we believe that public confidence in a public pensions system could be restored by a minimum guaranteed return on investments paid into the state pension scheme. The work done by a number of economists<sup>39</sup> has shown that over the long term the returns on equities for example are reasonably predictable. It should therefore be possible for the state to provide a safety net given the relative predictability of returns over long periods.
42. There is, quite rightly, great concern about levels of state pension paid to women as a result of their often broken earnings record, and due to the

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<sup>38</sup> See Turner Report, Table 3.1, p. 61, but these other figures in the report and appendices produce very different numbers – e.g. figure D.8 in appendix D, highlighting both the complexity and lack of transparency of the UK system.

<sup>39</sup> See e.g. ‘Valuing Wall Street’, Andrew Smithies and Stephen Wright. See also figures 3.52 and 3.53 in the Turner Report, p. 210, based on the Barclays Equity Gilt Study 2004, which showed that over 100 years the real return on equities was 5.5% p.a. over 20 year periods and page 224, “Looking forward, reasonable expectations of real rates of return are more likely to be about 6% for equities, 2% for gilts and 2.7% for corporate bonds, implying overall pre-cost returns of about 4.1% for a balanced portfolio.”

fact that they often have to take part time jobs to suit school hours and school holidays. Plaid Cymru would institute a shadow pension arrangement, so that any parent who is not in full time employment and is responsible for bringing up children would be credited with contributions relating to a percentage of their full time employment for a period of time after childbirth<sup>40</sup>.

43. This system will combine in a much more efficient way a second state pension and the tax deductibility currently given to corporate and other pension schemes. After a transition period pension contributions by companies to their employees would not be paid into the company pension scheme, but into the state sponsored scheme above the lower thresholds of salary up to the contribution cap. These payments would benefit from the state matching payments referred to above. Pension contributions above the contribution cap would be paid into the company pension scheme as currently, but would not benefit from any preferential tax treatment.<sup>41</sup>
44. Plaid Cymru believes that a state administered pension savings scheme would have the following advantages:
  - a. It would target government assistance for savings where it is most needed, at the lower paid
  - b. It would not be affected by individuals moving from one company to another and would be open to the self employed
  - c. It would be cheap to operate, thus ensuring that a greater proportion of contributions went to pension payments rather than fees
  - d. It would form a coherent, transparent and easy to comprehend system, where anticipated pension entitlement would be known on a year by year basis
  - e. It would reinforce good saving habits
  - f. It would remove the credit risk of the private sector from pension provision; employees would not depend on the creditworthiness of their company for pensions under this system, and pension obligations would not destabilise otherwise creditworthy companies
  - g. As a result of the above it would restore public confidence in pension saving

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<sup>40</sup> For example, in the rather different funded Swedish system parental shadow contributions are paid for four years after childbirth and are typically 75% of previous earnings. See for example The New Swedish Pension System by Edward Palmer, Swedish National Social Board and Uppsala University.

<sup>41</sup> Companies already make significant contributions to the pensions of executives over and above the current tax deductible threshold. The chief executive of BP, for example, has a 'pension pot' of over £15 million, and is currently due to receive a pension of around £1 million per year on retirement. The chief executives of other large companies have similar arrangements see Professional Pensions, p. 4, 28<sup>th</sup> July 2005.

## **Transition**

45. Because pensions involve very long time scales, any changes that are made will have to have a reasonable transition period, so that people who have saved over their lifetimes in the expectation of receiving certain benefits should not be deprived of these. Although implementation of transition is always difficult, it should be pointed out that current pension entitlements would remain in place – that is to say that savings and benefits accrued from the current system would not be altered. These would merely become deferred benefits in the same way that when an employee leaves one company and starts at another his or her pension entitlement is typically frozen until retirement age.
46. Plaid Cymru would envisage that the new system would be additional to pension rights already accrued, so that, for example, those entitled to receive the state second pension would be entitled to receive the higher of the current basic state pension and their serps/S2P entitlement and the citizen's pension. However after the introduction of the state sponsored savings system, any pension contributions that are currently made under S2P would be consolidated as contributions to general revenues to be used for the payment of the citizens pension. In this way the pension entitlement to the current state second pension would decline over the years.
47. All pension rights accrued until the introduction of the state sponsored savings scheme would remain in place, but after its introduction tax deductibility would only be available to payments into the state scheme and pension payments above the lower threshold of income up to the permitted cap would have to be paid into the state scheme.

## **Summary**

48. The pensions' dilemma in the United Kingdom is therefore in some respects an artificial one. As noted above by international standards we spend an exceptionally low proportion of our GDP on pensions, and although we also face real demographic challenges, these are not as severe as in other countries. The problem lies essentially in accepting that some individuals will have to save more for their retirement, some may receive less in retirement, that there should be an increase in state retirement age in line with increasing longevity and there needs to be better targeting of pension savings support to those who really need it. There is no reason why a company should not make generous provision for the pensions of its employees, but there is also no reason why the government should subsidise such provision for the better off, nor that the subsidy should attach to occupational pension schemes rather than be

paid to a country wide scheme with lower costs. Too much money is being spent on supporting high living standards of high earners in retirement, and not enough on those who need it.

49. Plaid Cymru's pension policy will meet the two critical requirements of poverty alleviation in old age and assistance with long term savings which is both fair to all, targeted to those most in need and affordable.