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CABINET

SOCIAL SECURITY REVIEW: PENSIONS

Memorandum by the Secretary of State for Social Services

My paper (C(85) 9) on the outcome of the Review of Social Security set out a strategy for pensions which would replace the State Earnings Related Pension Scheme (SERPS) and give all those in work the right to an occupational or personal pension to which their employers would also contribute. I have been discussing further with colleagues concerned the best way of achieving that strategy and we are agreed on a phased implementation process which is explained below. It may be helpful, however, to remind colleagues first of the reasons why change is essential.

COST OF SERPS

2. Projections forward are obviously difficult. But there are some estimates on which we can be virtually certain - notably that the number of pensioners is set to rise substantially. This rise is:

1985	9.98 million pensioners
2005	10.1 million pensioners
2015	11.1 million pensioners
2025	12.3 million pensioners
2035	12.5 million pensioners.

There is no doubt, therefore, that expenditure on pensions is set to rise significantly. The only question is by how much. Current pensions spending is about £15½ billion. Without any allowance for inflation, the cost of SERPS alone will reach £25 billion a year by 2033-34 - making total pensions spending £45 billion a year (if basic pensions are uprated by prices) and £66 billion a year (on earnings). At the same time projections by the Government Actuary's Department shows that the number of contributors remain about the same. The ratio of contributors to pensioners therefore worsens:

1985	2:3
2005	2:2
2015	2:0
2025	1:8
2035	1:8

Thus a broadly static workforce has to pay for bigger pensions for more pensioners.

3. The build up of spending on SERPS is about to begin. If we do not act now it is inevitable that:

a. Costs will increase and the contributions of the working population will increase with them.

b. Public spending will be pre-empted - at a time when demands from the elderly will mean more pressure for spending on the health service and personal social services. There will be consequences for all other programmes.

c. There will be no improvement in personal occupational pension cover. The trend to more pension benefits provided by the State will continue.

Our conclusion in the Ministerial Group on Social Security (MISC 111) was that the cost of SERPS was unacceptable. But we also saw a wider objective: to give everybody the right to their own pension through their job; and to give people a personal stake in the economy and their future through their own pension investments.

REPLACING SERPS

4. The proposal agreed in MISC 111 was that SERPS should be replaced by a requirement for at least a minimum level of contribution by both employers and employees to an occupational or personal pension scheme. The focus in subsequent discussions has been on how to carry through the change to private pensions for all.

5. There are two main issues:

a. There is the short-term impact of a major extension of funded occupational and personal pension provision while the liabilities of the existing pay-as-you-go National Insurance system continue as before. This must have an impact on employers and employees both in the public and private sectors. But we have concluded that the effect - which is shared between employment costs, the Public Sector Borrowing Requirement (PSBR) and take-home pay - can be reduced to acceptable levels by phasing in the new arrangements over three years. This will allow sufficient time both for contributors and the financial institutions to adapt to the changed financial flows.

b. We need to take account of the impact of the change in the pension expectations of those retiring in the coming years. This could be considerable for those now in their fifties who would not have time to build up their own pension sufficiently to replace the SERPS entitlement they might be expecting. For the younger age groups, this is not a problem: even at the minimum contribution level (4 per cent), they should be able to achieve a reasonable level of pension entitlement from their own investment. We have concluded that the best way to proceed will be to allow older workers to remain in SERPS until retirement. This will require a system of age-related National Insurance contributions to be introduced but it will ensure that nobody retiring this century would be affected by the ending of SERPS.

6. In summary, my proposal could be put into effect as follows:

a. for men aged 50 or over and women aged 45 or over, SERPS would continue until their retirement;

b. for all other employees SERPS would be replaced over three years by a minimum private pension requirement. This would involve:

i. preservation of all SERPS rights earned up to 1987;

ii. reduced rates of accrual of additional SERPS rights in 1987-88 and 1988-89; and no new SERPS rights thereafter;

iii. a minimum private pension contribution by employers and employees of 1 per cent each in 1987-88; 1.5 per cent in 1988-89; and 2 per cent in 1989-90;

c. National Insurance contribution rates would be changed to match:

i. all those under 50 who would no longer be in SERPS would pay a standard contribution rate of 16.45 per cent (shared between employers and employees) in 1989-90 with no contracted-out rebate following a phased change from the current combined rate of 19.45 per cent;

ii. those remaining in the SERPS (ie the contracted-in over 50s) would pay a combined rate of 20.45 per cent from 1987-88 instead of 19.45 per cent at present;

iii. those over 50 currently contracted-out would pay a combined rate of 16.45 per cent in 1989-90 following a phased change from the current 19.45 per cent combined rate less the contracted-out rebate of 6.25 per cent on relevant earnings;

The figures assume that the self-employed would not be affected by the change.

7. Cost implications. The phasing out of SERPS in this way will:

a. Lessen the initial impact of the change. In the first year the net effect would be to increase the PSBR by £100 million. An extra £600 million of pensions investment would be generated but this would mean on average a net increase of only 0.3 per cent in private sector employment costs and a net reduction in take-home pay (after paying pension contributions) of only 0.2 per cent. Even at the end of the transitional period in 1989-90 the net effects are manageable: the total additional pensions investment would be £1.3 billion and the PSBR would be increased by £0.6 billion in 1989-90. The net effect over the three year period would be an increase of only 0.2 per cent in private sector employment costs and an average reduction in take-home pay of 0.5 per cent.

b. Still secure almost all the possible long-term public expenditure savings. Compared with an unphased abolition of SERPS, the proposal means foregoing savings which would have risen to about £1 billion by the turn of the century. But thereafter the savings rise to over £22 billion in 2033-34.

8. The implications for individuals are as follows. Those within fifteen years of retirment - the age group most concerned about their pension expectations - will be unaffected. For the younger age groups the move to private provision should not pose any serious problems. Even at the minimum level of contribution and on cautious forecasts of investment performance, the expected pension offers a reasonable comparison with SERPS. We must also expect that a substantial proportion of people will choose to invest more than the minimum. Nonetheless, there could be a problem for those just below the age limit for remaining in SERPS who will have insufficient time to build up extra pension provision. I shall be considering further how the cliff-edge effect of the age limit can be ameliorated.

THE NEW SYSTEM

9. The approach to pensions put forward in C(85) 9 is based on the principle of twin pillars; basic flat-rate provision to be made through the State; additional provision to be made by the individual through his job and his own savings. It is an approach which not only seeks to give everybody the right to their own pension but also offers the individual

much greater involvement and much greater choice in his pension arrangements. We are currently legislating to give members of occupational pension schemes fairer treatment:

a. the right to a transfer value when leaving a job;

b. preserved rights for early leavers;

c. better information for scheme members.

We have shown our commitment to the concept of personal pensions, and they would be much easier to operate without the complexities of the current pensions structure. To carry the process further is difficult if not impossible with the present SERPS structure. The proposals I have outlined will enable us to achieve our strategy while safeguarding those nearing retirement age. They will meet our obligations to those now in SERPS. They will allow employers and employees to adjust to the change over a reasonable period, and they will enable us to stimulate the creation of industry-wide schemes for those industries in which employers may be reluctant to set up their own schemes. The new framework of minimum requirements will show that we have put in place an entirely credible and effective replacement for SERPS which offers virtually everyone the assurance of their own occupational pension.

10. I invite colleagues to endorse my proposals.

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Department of Health and Social Security

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