Stop Press: Summary of Two Government Green Papers Published in December 2002

In December 2002, just as this book was going to press, two consultation documents (green papers) were published by two government departments, the Department of Work and Pensions, and the Inland Revenue. The first proposed measures to make it easier for people to work and save for their retirement, while the second proposed a radical simplification of the pensions taxation system in the United Kingdom. The two green papers are briefly summarized here.

Simplicity, Security, and Choice: Working and Saving for Retirement
Department of Work and Pensions, December 2002

The green paper sets out the UK government's proposals to renew the partnership between the government, individuals, employers, and the financial services industry that has long been a strength of the UK pensions system. The new proposals will:

- simplify the tax regime for pensions;
- help people make better-informed choices about their retirement;
- reaffirm the role and responsibilities of employers in the pensions partnership, improving saving through the workplace, and providing greater protection for members of occupational schemes;
- encourage simple and flexible savings products, broadening access to the financial services industry; and
- introduce measures to extend working lives.

The green paper builds on three reviews of pensions and saving:

- *A Simpler Way to Better Pensions—An Independent Report*, by Alan Pickering, July 2002, put forward suggestions for simplifying the the regulation of the occupational pensions system.
- *Medium and Long-term Retail Savings in the UK—A Revie*w, by Ron Sandler, July 2002, addressed the market for personal pensions and other personal investments.
- *Simplifying the Taxation of Pensions—Increasing Choice and Flexibility for All*, Inland Revenue, December 2002, proposed a new, simple system for taxing pensions.

The main concerns underlying these reviews are:

- longer life-spans mean that people will have longer retirements: if people choose not to work longer, and do not wish to see a drop in living standards, they will need to save more;
- at the same time, there are signs of a decline in pension provision by some employers; while a shift from defined benefit to defined contribution pensions may not in itself be a cause for concern, the level of employer contributions does matter; also some companies have become insolvent, leaving under-funded pension schemes;
- the complexity of products, the cost of financial advice, and the legacy of pensions mis-selling mean that too many people are excluded from the financial services industry; and
- many people are leaving employment too early.

The government wishes to see greater informed choice for individuals. While the state provides the foundation stone of pension income, via the basic state pension, the additional pension savings people make in a voluntary system will depend on their own circumstances and preferences. Current estimates show that up to 3 million people are seriously undersaving for their retirement or planning to retire too soon. In addition, a further group of between 5 and 10 million people may want to consider saving more, working longer, or a combination of both, depending on their expectations for retirement. The government puts this down to a combination of the complexity of existing pension arrangements, confusing flows of information that do not relate clearly to an individual's circumstances, hard-to-compare products, and expensive advice. The government wants to help people make better-informed choices about their retirement and believes that those who seem to be saving too little will save more if there is a simpler framework to help people understand their choices, and if individuals are equipped to understand financial choices and receive clear information tailored to their own circumstances.

The first component of the government's strategy will be to simplify the pensions system by having a simpler tax regime. There are currently eight different tax regimes for pensions, and within these regimes there are different rules concerning the levels of contributions and the levels of benefits. This proliferation of regimes and rules creates complexity, which makes pensions difficult to understand and explain, constrains people's choices about when and how to save, and imposes unnecessary administrative burdens on employers, individuals, and pension providers.

To reduce this complexity, the government will introduce a single regime with a lifetime limit on the amount of tax-privileged pension saving. This is explained in more detail in the green paper *Simplifying the Taxation of Pensions: Increasing*

Choice and Flexibility for All issued by the Inland Revenue in December 2002 (and discussed below).

The second component of the government's strategy will be helping individuals to understand the financial choices they have to make. This will include:

- improving basic financial literacy;
- providing tailored information based on an individual's circumstances by:
  - — increasing the number of people receiving forecasts of their pension income, by working with employers and scheme providers so that more people with private savings can receive combined pension forecasts, and beginning to issue state pension forecasts to the self-employed and to people who are not members of personal or occupational pension schemes; and
  - — improving the range of services providing tailored information, by offering an integrated telephone service and website, and by issuing information at key points in people's lives to encourage greater awareness and understanding of savings options.

As an example of this, the green paper presents savings amounts and rates required to retire on half and two-thirds of final salary in 2050, taking account of both state and private income:

Gross replacement rate		Gross weekly earnings over working life			
		£300	£400	£500	£600
Half	Savings amount	£5	£30	£55	£70
	Savings rate	1%	7%	11%	12%
Two-thirds	Savings amount	£30	£60	£85	£110
	Savings rate	10%	15%	17%	18%

Assumptions: Real returns of 4% per annum during the accumulation phase, level annuities during the decumulation phase with mortality based on 2002 data with no mortality improvements.

The third component of the government's strategy will be to make pension provision easier for employers. Employers have expressed concerns about the burdens of administering pension schemes. There are also growing anxieties among employees and trade unions over scheme closures and reductions in pension contributions. Confidence has been undermined by a number of well-publicized cases where schemes have wound up, sometimes failing to meet the reasonable expectations of their employees.

The government's proposals will reaffirm the role and responsibilities of employers in the pensions partnership and encourage saving in the workplace. However, the government will make it easier for employers to set up and run good pension schemes. The complexity in pensions legislation and tax rules will be reduced by:

- radically simplifying the tax treatment of pensions to reduce the costs of providing and administering a pension scheme, by removing unnecessary burdens and introducing new, more flexible rules;
- replacing the Minimum Funding Requirement with scheme-specific regulation to allow schemes greater flexibility, as recommended in the Myners Report. It will also make the funding position more transparent for scheme members;
- simplifying the structure of contracted-out benefits and reducing complexity for both past and future service, by changing the reference scheme test to one based on career average earnings, cumulatively revalued by price inflation up to 5 per cent per annum, with a pension accrual rate of 1/100th (the current reference scheme test is based on average earnings during the final three tax years and has an accrual rate of 1/80th); and
- consolidating existing pensions legislation and simplifying legislation that relates directly to scheme administration and governance, giving schemes greater flexibility to design and manage themselves in a more efficient and effective way that supports the business of the sponsoring employer.

At the same time, there will be better protection for members in order to give them the confidence they need to join schemes. Therefore, there will be a new pensions regulator that will focus on protecting the benefits of scheme members. The new regulator will operate proactively to anticipate problems, concentrating its effort on schemes where it assesses that there is a high risk of fraud, bad governance, or maladministration.

In addition, the government wants more employers and employees to see a good pension as a key part of a total remuneration package. It wants to encourage greater employee awareness of pension benefits by:

- encouraging employers to adopt best practice in informing employees and prospective employees of the pensions offered through total benefit statements, information on payslips, and in recruitment material;
- helping employers to provide information and guidance for employees, through such initiatives as a Financial Services Authority-approved pension pack for employers to use to communicate with their employees;
- possibly allowing employers to make joining their pension scheme a condition of employment for new recruits; and
- encouraging immediate vesting to ensure that all members enjoy the benefits of their employer's contribution as soon as they join the scheme, but with transfers of *de minimis* amounts to a stakeholder pension scheme when an employee leaves.

The fourth component of the government's strategy will be to rebuild trust in the financial services industry following the personal pensions mis-selling scandal. This will be achieved through the introduction of simple, flexible savings products to help more people save more for their retirement:

- implementing Ron Sandler's recommendations to make it easier to save through simple products and sales processes;
- developing generic advice products;
- making offering financial advice through the workplace easier;
- introducing value-protected (capital-guaranteed) and limited-period annuities; and
- ensuring that the regulation of equity release and home-reversion plans protects consumers and allows the market to work effectively.

The fifth component of the government's strategy will be to extend opportunities for older workers. In planning for retirement, saving is only half of the equation. Enabling people to work a few years longer can make a huge difference to the income they can expect, and the government intends to give individuals the choice to extend their working lives by doing more to help the over-50s into work and by tackling age discrimination:

- providing extra back-to-work help for those aged 50 and over and piloting measures to help recipients of incapacity benefits return to work;
- treating men and women between 60 and 64 as active labour market participants, as women's state pension age rises towards 65 from 2010; and
- implementing by December 2006 age legislation covering employment and vocational training in which compulsory retirement ages are likely to be unlawful unless employers can show that they are objectively justified.

The government will also do more for those in employment who are prevented by tax rules from carrying on working by, for example, allowing individuals to continue working for the sponsoring employer while drawing their occupational pension, and ensuring that occupational pension rules do not discourage flexible retirement. In public sector schemes, the retirement age will be raised from 60 to 65.

However, the government does not intend to raise the state pension age above 65 at the present time. Nevertheless, it is keen to encourage people to work past 65 where they want to by developing further the concept of flexible retirement. At present, people who defer taking their state pension until after they reach 65 (60 for women until 2010) get an increase in their pension. This will be raised to 10 per cent for each year they delay drawing their pension, compared with 7.5 per cent now. As an alternative, the government will allow this increase to be taken as a taxable lump-sum payment.

The government also intends to improve the pension position of women by supporting their position in the labour market through:

- additional investment in childcare,
- the introduction of the national minimum wage, and
- extra support for families from April 2003 with the introduction of new tax credits and changes to maternity and paternity provision.

The green paper concludes: 'Pensions policy has to be for the long-term. If we want people to plan for the future, stability in the framework of pensions policy is a key component. There are currently obstacles in the way of an effective voluntary system. The measures outlined in this paper are designed to address this issue and to make the voluntary system work effectively. It is vital that progress is closely and independently monitored. We need good information so that we can judge whether sufficient progress is being made and that employers, the financial services industry and individuals are responding to the challenge. But this will require all partners fully to play their part. We will be establishing an independent pensions commission to report regularly to the Secretary of State for Work and Pensions on how effectively the current voluntarist approach is developing.'

Simplifying the Taxation of Pensions: Increasing Choice and Flexibility for All **Inland Revenue, December 2002**

The green paper proposes a radical simplification of pensions taxation. The complexity of the tax rules for pensions has come about because each successive set of changes has overlaid the previous rules, which have been allowed to continue for people who stay in the same pension scheme. There are now eight different tax regimes governing pensions, each with overly complex rules limiting the amount an individual can contribute to a pension scheme and the benefits a scheme can pay out:

- Approved occupational pension schemes:
  - Pre-1970
  - Post-1970
  - Post-1987
  - Post-1989
- Approved personal pension schemes:
  - Retirement annuity contracts
  - Personal pensions
- Unapproved schemes:
  - Funded schemes
  - Unfunded schemes.

These rules restrict choice and flexibility for individuals, employers, and pension providers alike. As a result, pensions tax relief has become so complicated that people are put off saving for retirement and employers have become reluctant to sponsor workplace pensions. The complex rules add to the costs faced by individuals, employers, and pension providers, and distort the advice people get. So they restrict what people actually save for their retirement. And that can mean that people are disappointed with the income they achieve in retirement.

The main elements of the government's proposals are:

- the abolition of the existing tax regimes governing pensions;
- the introduction of a single, unified set of rules; unlike previous changes to the taxation of pensions, the government is proposing a clean break: pension rights built up before the reform is implemented will be respected, but pension saving after implementation will follow a single set of rules, which will apply to saving in all kinds of pension schemes;
- a single lifetime limit in the new system: the current limits on annual pension contributions will be replaced by a single lifetime limit of £1.4 million on the amount of pension saving that can benefit from tax relief when the new scheme is introduced in 2004 (the limit will be indexed thereafter);
- a light-touch compliance regime: the lifetime limit will be complemented by a light-touch compliance regime with an annual limit on inflows of value to an individual's pension fund of £200,000 for introduction in 2004 and indexed thereafter;
- flexible retirement: the proposals drop outmoded rules that prevent people in occupational schemes from mixing work and retirement; people will be able to draw benefits from their pension while continuing to work, although the minimum age at which benefits can be drawn from a pension scheme will be raised from 50 to 55 years of age by 2010;
- a single set of rules on pensions in payment: the proposals match simplification of the rules governing contributions to pensions with similar reform to those governing payments of benefits; the tax-free lump sum for retirees will be set at 25 per cent of the value of an individual's pension fund (for both defined contribution and defined benefit pensions, where in the latter case, the lump sum equivalent of the prospective pensions will be capitalized using annuity factors determined by the government); and
- more flexible annuities: building on the themes of choice and flexibility, the government also intends to allow scope for more innovation in the annuity market, including:
  - — limited-period annuities, which would allow someone to use part of their pension fund to provide an annuity for a predetermined period; and
  - — value-protected (capital-guaranteed) annuities, which would allow the annuity provider to make a residual capital payment on the death of the annuitant

before age 75, equal to the difference between the amount paid for the annuity and the stream of payments already made under the annuity.

The green paper provides examples of how the new tax regime would operate in practice:

- Pension savers:
  - Individuals contributing to a pension under the current tax regimes need to consider many factors: tax limits, salary, type of scheme, and previous employment. Under the new regime almost all savers need only consider when and how much to pay into a pension. The new tax rules will allow 99 per cent of people to save more in a pension than the current tax rules allow.
  - An occupational pension scheme member earning £32,000 consistently cannot currently join a stakeholder pension, but will be able to in the new regime.
  - Three people employed by the same company on the same salary joining the same pension scheme in 1986, 1988, and 1990 would all be entitled to different pension benefits under the existing regimes. The new regime will apply equally and consistently across the board.
  - A person wishing to top up a pension currently has three different options: an additional voluntary contribution, a freestanding additional voluntary contribution, or a stakeholder pension scheme. All of these have different rules on how benefits may eventually be drawn. These rules are likely to distort the decision on how best to contribute more. The proposals remove such arbitrary distortions.
- Pensions in payment:
  - Currently, a 57-year-old working for one company cannot continue to work for that company and draw her pension. But she could move to the company next door and draw her pension at the same time. The new rules will remove this anomaly.
  - The proposals will mean that many occupational pensions can pay out more generous tax-free lump sums than the current tax rules allow.
  - Pension schemes in surplus will not be restricted by tax limits on how much of the surplus they can pay out. Some schemes are currently in surplus—and want and can afford to pass surplus funds on to their members—but the tax rules restrict them. The new regime will remove restrictions of this nature, meaning that members will, in some cases, receive more generous benefits.
- Pension providers:
  - Pension providers currently have to design their schemes to meet Inland Revenue limits on: annual contributions, the speed at which benefits accrue, and final benefits. The proposals will remove these restrictions, meaning that the tax rules no longer influence scheme design. The proposals will reduce scheme administration costs by at least £80 million each year.

— Pension providers will no longer be expected to carry out many tests, all of which are required under the existing tax rules. For example, they will no longer need to test additional voluntary contributions against Inland Revenue limits; check triennial valuations to see whether the scheme is in surplus; check benefits deferred from previous schemes against Inland Revenue limits; compare the initial lump sum and residual pension against complicated Inland Revenue limits; restrict increases to pensions in payment to the maximum allowed; store data on pay, pensionable service, and regime status for deferred members; ensure the member is eligible to join and that the contributions are permissible; establish the regime status for all new members of occupational schemes; or obtain Inland Revenue approval for any material changes to the documentation of a scheme.