Pensions Policy Institute

PPI

A Commentary on the Pension Reform Debate

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The PPI is independent and does not lobby for a particular solution or campaign on any particular issues. Our concern is that a sustainable pension system is designed with the right facts and analysis.

In this short document the PPI provides some commentary on the key points that have arisen in the pension reform debate so far. This commentary is underpinned by the PPI's work on pension reform over the last three years and in particular by recent detailed economic analysis. More on this analysis will be available in forthcoming reports. All of the PPI's published work is available on www.pensionspolicyinstitute.org.uk.

Some key facts to inform the reform debate[1]

(1) Only half of women over state pension age receive the full Basic State Pension compared to 9 out of 10 men. Over time, more women will get more entitlement, but women will on average always fare worse than men.

(2) Over 3.5 million households are now eligible for Pension Credit. The number is expected to keep growing, by around one-third over the next 10 years. In estimating future costs, the Government currently assumes that no more than 75% of those eligible will claim Pension Credit.

(3) The UK is planning to spend a constant share of GDP on state pension and benefits to older people over the next 50 years, while the number of people over state pension age increases by 50% (Chart 1).

(4) Around 15 million working age people have a contribution going into an occupational or personal pension. Around 20 million do not. So state provision will continue to be a large part of retirement income for most people and many people will depend on it (Chart 2).

(5) Tax relief on pension contributions costs around £16bn a year. 55% of it goes to 2.5 million high rate taxpayers; 45% goes to 13 million lower rate taxpayers. In total the net cost of all tax advantages for pensions is around £19bn a year. This cost is not counted in Government estimates of future expenditure.

(6) Today's 40 year olds are as likely to live beyond age 70 as their parents are to live beyond age 65. One quarter of 40-year old women are expected to live beyond age 95.

(7) After the proposed reforms, the average occupational pension for a public service worker will be worth an additional 3% to 18% of salary compared to the average private sector worker's pension.

[1] For sources see page 12

Chart 1

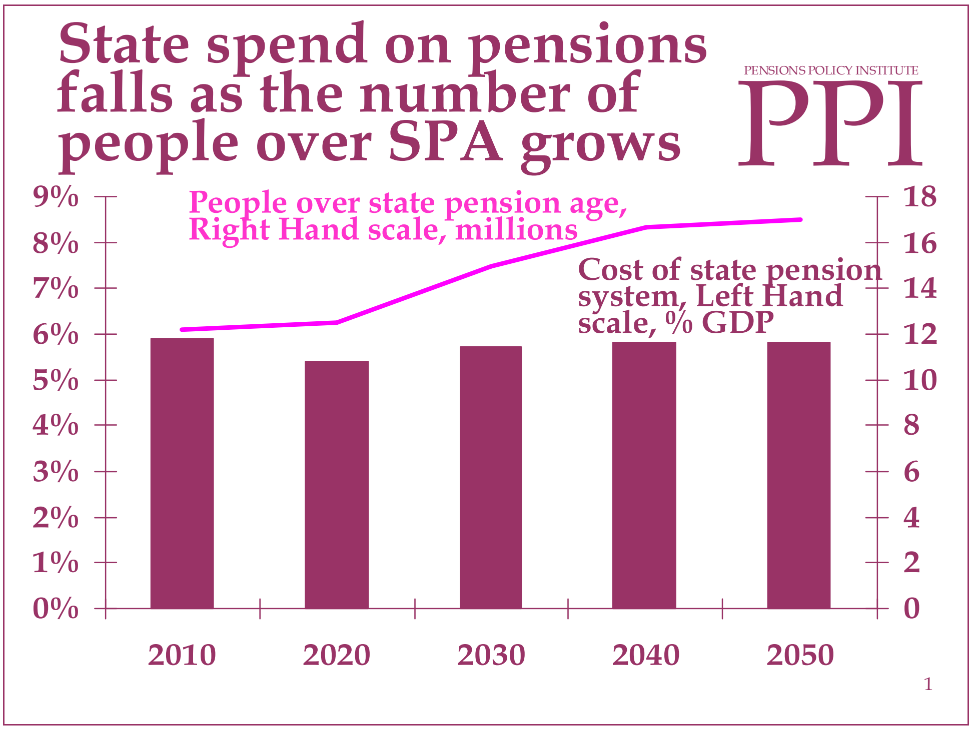
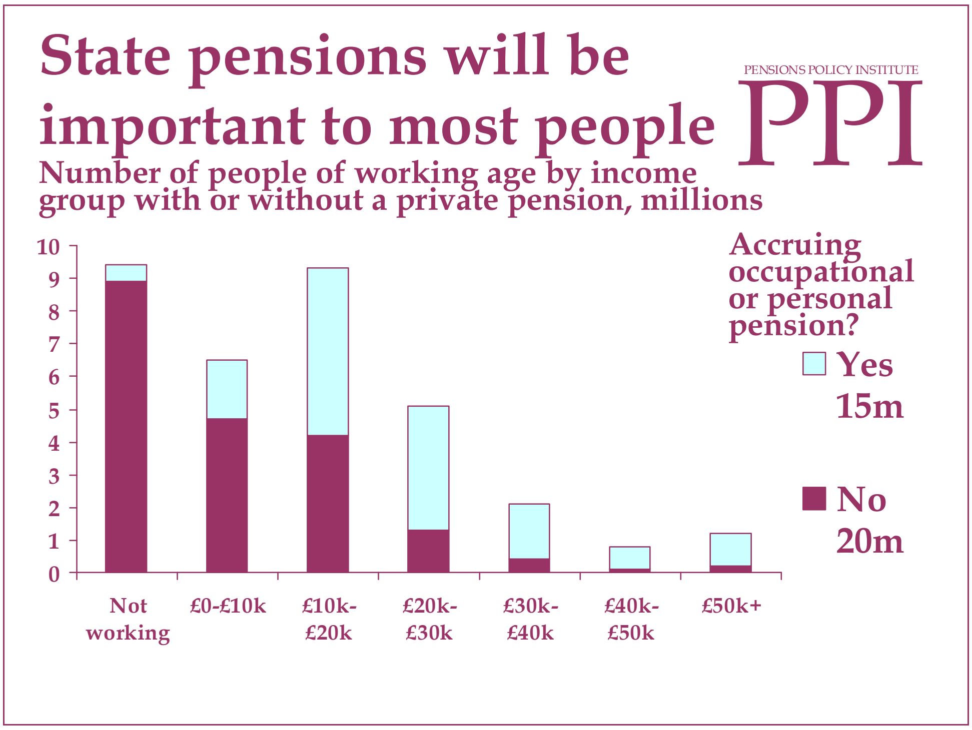


Chart 2



Why is reform being considered?

1. Against the backdrop of longer lives, concerns have been raised that structural problems in the pension system are causing inequality and uncertainty:
   - **Unequal outcomes** arise because higher earners accumulate advantages. Compared to lower income people they are more likely to have full National Insurance (NI) contribution records, benefit more from earnings-related state pensions and get more out of tax relief. In particular women, the majority of people, are disadvantaged.
   - **Individuals cannot understand or be sure what they will get from the state in future** because of the complexity of over 100 parameters defining state pension income, and uncertainty in what those parameters will be in future. Confidence in future state provision is low.
   - **Too high expectations are placed on the private pensions sector**, which seems unlikely to grow significantly on current trends. Private pensions contributions have been, at best, flat and employer provision is changing. Therefore the switch from the state providing 60% of pension income to private income doing so is very unlikely to happen. The state is likely to remain the majority provider of retirement income.
   - **State provision suffers from a 'reverse credibility' problem.** State expenditure on pensions in the UK is comparatively low and planned to stay constant as a share of GDP while the number of people over state pension age increases significantly. In the absence of increasing private pension provision, this seems a politically difficult strategy for the long-term. Higher state spending on pensions in future seems unavoidable.

Importance of improving the state first tier

2. Government has recognised that the state has to prevent poverty in later life, however people got there. Pension Credit has done well, but there is now widespread concern that continuing with it will worsen all of the above problems over time.

3. Most pension experts agree that reducing the reliance on Pension Credit in future by strengthening the state first-tier pension would make poverty prevention more secure. It would provide a more easily understandable first rung of the ladder on which occupational pensions and personal saving can be built.

4. Change on three dimensions would strengthen the Basic State Pension (BSP): improve its <u>coverage</u>, increase its <u>level</u>, and improve the rate of <u>indexation</u>. Reform proposals make different choices on these three dimensions.

Improving the coverage of the state first tier

5. Each year, fewer than 6 out of 10 people contribute enough to qualify for the BSP. Around 3 out of 10 rely on credits, and 1 in 10 people do not qualify at all. This pattern is not expected to change significantly in future. Suggested changes to improve coverage include reducing the number of qualifying years needed for a full contributory pension from 44 to, say, 20, or widening the criteria for being credited for a qualifying year, or changing to a residency-based universal criterion.

6. Modifying the contributory rules has the advantage of working from the existing system. Changing the qualifying rules will not be straightforward, and it will be difficult to make them retrospective so that can they apply to today's older women. Even after such changes, gaps in coverage will continue to disadvantage low earners and carers, who are predominantly women.

7. A residency-based criterion would give the same first-tier pension to men and women, and to different income groups.

8. There are administrative complexities with both contributory and residency-based criteria. What individuals will get from a residency-based pension seems easier to understand and more certain.

9. More research would be useful on the eligibility criterion which the public would support as 'fair'. The limited research available suggests support both for the contributory principle as people "don't have a right to what they have not paid for" and for the universal principle (in particular that women should get the same as men) as the state has a responsibility to look after everyone's basic needs, similar to the National Health Service.

10. All non-state sources of retirement income follow the contributory principle (e.g., occupational pensions or private saving). This creates differences in retirement income across income groups which are exacerbated if the state first tier is contributory too.

11. There are concerns that some people who do not 'deserve' additional pension could benefit from a residency pension, for example, recent immigrants. This can be mitigated by the length of residency needed to qualify.

12. There are also concerns that some people who do not 'need' additional pension could benefit from a residency pension, for example, rich non-working spouses. The actual number gaining in this way would be small, compared to the much larger number of 'deserving' gaining. The concern could be mitigated by, for example, different rates of pension for single and married people, or affluence-testing or through taxation.

Increasing the level of the state first tier

13. Practically all organisations interested in pensions agree that, whatever the eligibility criterion, the new Basic State Pension (BSP) needs to be at least at the level of the Guarantee Credit (GC, £109 a week) and indexed to earnings to avoid poverty without extensive means-testing.

14. Increasing the level of the BSP without improving coverage significantly will be regressive, as people with a full BSP will get most out of the increase.

15. If the level of the new BSP were higher than GC, then it could also cover Savings Credit. If not, transitional protection would be needed for Savings Credit awards so that no household suffers an immediate drop in income. But in any event Savings Credit is widely thought to need reform as its cost is expected to grow rapidly, while not providing an effective reward for saving. Guarantee Credit would remain but with a higher BSP there could be millions fewer older people being means-tested.

16. Earnings indexation in payment is important to prevent poverty at all ages – not just at age 65 where policy analysis tends to concentrate. Price indexation means people can become eligible for means-testing at older ages without realising.

Paying for reform of the state first tier

17. The current pension system is likely to cost more in future than official estimates suggest. Instead of the Government estimate of 5.8% of GDP in 2050, the PPI estimates the cost could reasonably be 6.6% of GDP and potentially as high as 7.5% of GDP.

18. PPI estimates are based on realistic scenarios for the cost of Pension Credit. There is a large 'funnel of doubt' in the future cost of the current pension system because of uncertainty in the amount of Pension Credit people could be eligible for, and how many take up the benefit. Such wide uncertainty in future cost adds to the pressure for pension reform.

19. The long-term cost of the system is driven much more by the level and indexation of the state pension than it is by coverage. For example, making the current price-linked BSP residency-based would still mean the system would cost around 6.6% of GDP by 2050.

20. Alternatively, replacing the current system with a <u>single</u> residency-based earnings-linked BSP of £75 a week would also cost about the same as the current system in 2050. Another option is a single residency-based BSP at the level of Guarantee Credit (£109 a week), indexed to earnings, which would cost around 8.3% of GDP in 2050.

21. This higher cost of the single BSP at £109 would put the UK in the middle of an international comparison of projected state spending on pensions by 2050. The UK is currently ranked among the lowest spending countries, and is set to fall further over time.

22. To illustrate one option for covering the additional long-term cost of the single residency-based BSP at £109: a small increase in NI contributions (lower than the recent 1% rise for the NHS) and a rise in state pension age to 68 by 2030 would be sufficient.

23. An <u>immediate</u> transition to this model could be paid for by stopping accruals to State Second Pension (S2P), maintaining the value of all past accruals but not increasing state pension to those already receiving £109 or more. This method of transition would target immediate improvements to the current poorest pensioners.

24. Slower transition is possible, for example, improving BSP first then rolling S2P in later, or improving BSP at older ages first. If both old and new systems are maintained for a period, so S2P continues to accrue, then slower transition would cost more. A longer transition period would need a well-defined roadmap so that people can trust it will happen.

Second tier pensions

25. While most organisations involved with pensions agree the first-tier pension should be strengthened, there are different views on whether the state should provide a second-tier pension as well.

26. If a second tier is earnings-related, it gives more to higher earners. The aim of this would be for the state to compel some degree of smoothing of spending over individual lifetimes. For the second tier to be redistributive, it would need to be flatter, more like S2P.

27. Maintaining S2P on top of the £109 first tier would take state spending on pensions over 10% of GDP. This means it will be difficult for the state to provide both a strengthened first tier and a good second tier. Doing so may increase the risk that, for cost reasons, the poverty prevention tier is cut back in future (as happened following the introduction of SERPS).

28. A <u>single</u> BSP at the level of GC (£109 a week) and linked to earnings would give more than the current system does to the majority of the working age population, and would be a progressive redistribution. This is because of people reaching state pension age in 25 years time only the minority earning consistently above male median earnings are on track for BSP plus S2P to be higher than GC.

29. Further, a second state tier (especially with contracting-out) continues complexity. With a simple single state pension, the message on savings expectations can be made more clearly and reliably.

30. There are doubts that compulsory employer or personal pension saving will result in good pensions for all, especially on top of the current state pension system with its complexity, regulatory environment and reliance on mean-testing.

31. Instead, many organisations believe that, provided the state has fulfilled its role in poverty prevention for older people, then its role in second-tier pensions should be to foster an efficient and easy environment for employers and individuals to save how they choose.

32. Demographic and social trends, such as starting work later and having more debt early in life, mean that people are starting to save later, and save in vehicles other than pensions. We should therefore be realistic about likely savings patterns. Help for people aspiring to save seems more likely to succeed than exhorting people to save.

33. One element of this could be an extension of Informed Choice: for the Government to sponsor a website giving impartial, straightforward, generic advice on all aspects of personal finance through the life course - from Child Trust Funds to debt management to saving for later life. www.sorted.org.nz could be used as a role model.

34. Auto-enrolment should improve participation for those with access to employer-based schemes, as it helps would-be savers overcome natural inertia.

35. For those without access to an employer-based scheme, a simple national auto-enrolment 'BritSaver' scheme seems an attractive option. By using HMRC to channel contributions to pre-selected investment providers, the costs across the chain from contribution collection, through administration, investment management, communication and benefit payout, should be kept low. There will be a trade-off between making choice and advice available on investment types and investment providers on the one hand and low cost and simplicity on the other.

36. Major reform to get better value for money from tax incentives for occupational and personal pension saving, and to make them more progressive, would be difficult in practice. Although also not without difficulty, ways to make tax relief for employer-based provision depend on a high enough level of participation from all income groups in the workforce could be explored. If the current highly regressive tax incentives remain, the argument for removing inequalities in the state pension is strengthened.

What about contracting-out?

37. If S2P ends, then contracting-out ends. This would make employer-based pensions easier to provide and individual saving easier to do. The selling process for personal pensions would be shortened and so cost less.

38. The ending of contracting-out does not reduce total pension provision. It switches the contracted-out portion of pension income (which is less than 20-30% of total retirement income for most people) from being provided by the private sector to being provided by the state.

39. Ending contracting-out would mean higher NI contributions for some people in currently contracted-out occupational schemes. Pension scheme contributions could be reduced accordingly, with no change in overall net level of contribution.

40. Ending contracting-out would increase revenue to the NI fund by around £10.5bn a year and increase future state pension liabilities by the actuarial equivalent. It would reduce current contributions to private pensions and the future liabilities by the same amount.

41. The cashflow to the NI fund is improved short-term, with higher liabilities long-term. The short-term gain could be used, for example, to improve the surplus in the NI fund, or to pay for immediate improvements to the state pension, or for other purposes.

42. Around £2.5bn of the £10.5bn is due to the contracting-out of unfunded public service occupational pensions. There may be inter-departmental administration issues, but there should be no macro-economic implications.

43. Around £4bn goes to funded occupational Defined Benefit (DB) schemes. This type of provision is declining and switching to Defined Contribution schemes which are practically all contracted-in. Some remaining DB schemes are reported to be contracting-in, to simplify and reduce risk to the employer.

44. A further £4bn goes to personal pensions sold by insurance companies. This is also declining as some major insurance companies are either advising customers it is in their best interest to contract-in, or are automatically contracting customers in. Very little new contracted-out business is being sold.

45. Ending contracting-out would therefore reduce the amount going into <u>funded</u> pensions (but not into pensions overall) by around £8bn in the first year, or likely less than that by the time such a proposal were implemented. £8bn is 15% of total contributions to funded pensions.

46. If the impact on funded provision is a macro-economic concern, then the state could invest part of the NI fund into a 'reserve fund'. In other countries such a fund has been controversial but it may help to support long-term stability of the state pension system.

47. There is no evidence that ending contracting-out would reduce funded provision still further. Instead many practitioners suggest funded pensions would increase after ending contracting-out, especially with state pension reform, because the regulation and selling environment would improve.

48. Currently the contracted-out rebate is roughly the actuarial equivalent of the state pension given up. Contracting-out can only be a successful way to increase funded pension provision if the rebate is so much more generous than the state pension equivalent that 'best advice' is clearly to buy a contracted-out pension (as in the late 1980s). This would mean Government funding an opaque financial incentive to contract-out, which would not necessarily improve overall retirement income.

Later working and state pension age

49. Evidence suggests that later working is and will continue to be a natural choice of many individuals in response to demographic and social trends.

50. 'Savings gap' or 'undersaving' analyses tend to assume no increase in working at older ages, even over a 50 year period. But it seems inevitable that, on average, people will work later than they do today. This means that the inadequacy of savings can be over-stated, and the significant potential for later working to make a difference to incomes can be overlooked.

51. Government initiatives to encourage employers to offer the kind of jobs older workers want, and to keep growing the economy, are therefore fundamental to improving future retirement incomes.

52. A measured increase in State Pension Age (SPA) <u>in future</u> (starting with, say, current under-40s) is a logical way to help pay for better state pensions, given the evidence on longer, healthier lives.

53. Misunderstandings about raising SPA should be countered, especially the myth that it means "work till you drop". However, raising SPA is a powerful signal that later working is expected in future.

54. An independent permanent body set up to research likely future health and longevity trends and advise on SPA within specific Terms of Reference may help gain public acceptance for policy decisions.

55. The most practical way of giving a safety-net for those unable to work before SPA seems to be to continue to make Guarantee Credit available a few years before SPA. Therefore, as a response to socio-economic inequality concerns about raising SPA, the planned increase of the age of eligibility to GC from 60 to 65 could be reconsidered.

56. Deferring all or part of state pension seems an attractive way of giving choice to people with other income available, but people can get to a similar result without deferral by taking the pension and saving it. To be a true incentive for later working, there needs to be value from deferring that is more than the actuarial cost. This extra cost has to be funded from Government, and is most likely to be more valuable to higher rate taxpayers.

Reform process

57. Reform of public sector occupational pensions should be resolved soon so that there are no overhanging issues for state pension reform.

58. The PPI welcomes Government's commitment to develop reform ideas by Spring 2006. This will help those organisations involved in pensions to order priorities and make trade-off decisions informed by concrete proposals and cost constraints.

Acknowledgements and Contact Details

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Further reading

The following are the most recent reports published by or commissioned from the PPI which cover points made in this document. All are available on www.pensionspolicyinstitute.org.uk.

PPI Briefing Note Number 23 *Can work close the 'savings gap'?*

PPI Briefing Note Number 21 *KiwiSaver: Another lesson from New Zealand?*

PPI Briefing Note Number 20 *Should the state provide an earnings-related pension?*

PPI Briefing Note Number 18 *Pension reform: An update*

PPI Briefing Note Number 17 *How big is the life expectancy gap by social class?*

PPI (2005) *Should state pensions be contributory or universal?* Published for a PPI/Nuffield seminar in July 2005.

PPI (2005) *What should be the balance between state and private pensions?* Published for a PPI/Nuffield seminar in July 2005.

PPI (2005) *Occupational pensions in the public sector*

PPI (2005) *Response to the Pensions Commission First Report* and *A Note to the Pensions Commission March 2005*

PPI (2003) *State Pension Age: An update*

Age Concern England (2004) *Tax Relief and Incentives for Pension Saving*

NAPF (2005) *Towards a Citizen's Pension Final Report*

EEF (2005) *Rethinking Pensions – Preparing For An Ageing Society*

Sources for key facts on page 1

(1) *Hansard* 17 March 2005 Column 425W and PPI analysis of Department for Work and Pensions (DWP) and Government Actuary's Department (GAD) figures
(2) and (3) PPI analysis of DWP figures
(4) PPI analysis from 2003/4 *Family Resources Survey*
(5) HMRC figures and *Hansard* 11 February 2004 Column 1491W
(6) PPI analysis of GAD principal cohort-based projections
(7) PPI (2005) *Occupational pensions in the public sector*

The Family Resources Survey 2003/4 was supplied by the UK Data Archive, University of Essex, and is funded by the DWP. The UK Data Archive and the DWP bear no responsibility for further analysis and interpretation.

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