

PENSIONS POLICY INSTITUTE

PPPI

A GUIDE TO  
STATE PENSION REFORM



## A Guide to State Pension Reform

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## A Guide to State Pension Reform: Introduction

The Pensions Policy Institute has championed the need for debate on reforming the UK's state pension system<sup>1</sup>. The PPI has proposed an agenda for an independent review taskforce<sup>2</sup>:

1. Understand the current pressure points in UK pensions
2. Develop the key tests against which a proposed new state pension system can be measured
3. Focus on a few possible models for a new state pension system
4. Test each model, analysing the tradeoffs in each
5. Develop transition plans for each model
6. Present a comparison between the different models so that a choice can be made with consistent and objective information

This Discussion Paper is a guide to the debate, and follows the first half of the agenda proposed above. This paper reviews the current critical issues in UK pensions, suggests objectives for reform and proposes five reform models worth focusing on as possible future models for UK state pensions.

This paper does not recommend the right solution. The aim is to invite input to inform the next stage of work.

The structure for this document is as follows:

Chapter 1 explains more about the reform agenda and proposes a general framework for state pension reform.

Chapter 2 describes the pressure points in the UK state pension system compared to a minimum standard.

Chapter 3 sets the UK state pension system in the context of a comparison with the state pension systems in other countries.

Chapter 4 reviews the interface between state and private pensions, bringing out the critical points for the current UK situation.

Chapter 5 brings together the strands in earlier chapters to a summary of the current pressure points in UK pensions and tests to apply to proposed reform models.

Chapter 6 describes the five reform models worth focusing on.

<sup>1</sup> See, for example, *The Pensions Landscape* (Curry and O'Connell 2003)

<sup>2</sup> See, for example, the PPI's submissions to the House of Lords Select Committee on Economic Affairs February 2003 and to the Department of Work and Pensions Green Paper March 2003, available [www.pensionspolicyinstitute.org.uk](http://www.pensionspolicyinstitute.org.uk).

In an area as complex as pensions, which is so closely connected to other complex areas such as labour market changes, social trends and macroeconomic policy, both the big picture and the detail are important. This document sets out to clarify the big picture, and reference is made to detailed analysis elsewhere where relevant.

A companion Reference Manual *State Pension Models* describes state pension systems in other countries and reform models for the UK proposed by other organisations.

## A Guide to State Pension Reform: Summary

This paper starts the PPI's review of the UK's state pension system.

The analysis in this paper confirms the case for reform by comparing the UK system to a minimum objective standard and to state pension systems in other countries, and by considering how state pensions are interacting with private pensions. A review of UK state pensions is needed because there are serious pressure points in the current system.

### Summary of current pressure points in the UK state pension system

1. The UK has an uncomfortably high number of pensioners in poverty.
2. With no change, UK state pensions will become less adequate.
3. The UK currently spends less than most other countries on state pensions.
4. The forecast of future UK spend on state pensions is likely to prove unrealistically low and socially unacceptable.
5. The UK state pension system has become separated from the significantly improved capacity for longer working lives.
6. The UK state pension system works particularly badly for some groups, especially women.
7. The complexity of the UK state pension system makes it harder than it need be for people to understand what they are likely to receive from the state during later life.
8. The combination of low price-indexed state pensions and extensive means-tested benefits means that the UK state pension system disadvantages people as they grow old.
9. Private pensions are not filling the gap left by low state pensions, and many of the causes of this can only be resolved once state pensions have been reformed.

A major programme of work is required to move state pensions policy forward in the most positive way. A clear sense of where the reform is heading (the long-term objective) needs to be balanced with ideas for how to get there (the transition practicalities). There are no 'off the shelf' solutions available from other countries.

The PPI proposes these questions by which possible models for state pension reform should be tested. It is unlikely that any solution will score a clear 'yes' on all tests. Choosing future pension policy is about making tradeoffs to find the best balanced solution.

#### **Tests for a reformed state pension system**

1. Is the reformed policy capable of being sustained for at least 30 years, and preferably 40 years?
2. How would the number of pensioners at risk of poverty in the UK change? How would pensioner poverty compare with that in other countries and with that in other age groups in the UK?
3. How much would the total 'economic cost' to the state – including state pension benefits, contracting-out rebates and tax relief – be in the short term?
4. By how much would the total 'economic cost' to the state increase in the long term?
5. Does the reformed UK state pension system recognise past and likely future improvements in health and longevity and is it flexible for different working arrangements and retirement choices?
6. Is the reformed UK state pension system fair to all groups?
7. Is the reformed UK state pension system simple? Does it help people to understand what income they will receive from the state during later life?
8. Does access to the reformed UK state pension system become easier (or at least not harder) for people as they grow old?
9. Does the reformed UK state pension system enable individuals to meet their personal objectives for additional retirement income through occupational and personal private pensions?

By making international comparisons and building on proposals made by other UK organisations, the PPI proposes five models of state pension reform to be evaluated against the proposed tests.

#### State pension reform models to be tested in the PPI review

1. **Status quo:** A multi-component system with extensive means-testing. The current system with minor changes should be compared with other possible reform models.
2. **Reform S2P:** Make the State Second Pension flat-rate and/or increase accruals to it for lower earners. This would keep the overall system structure, but increase redistribution to the poorest during their period of working age.
3. **Much higher BSP, scrap S2P:** Keep the contributory link and the structure of the Basic State Pension, but at a much higher rate, so that there is less means-testing. Stop accruals to the State Second Pension, so that the system is simplified to one main component.
4. **Citizen's Pension:** As the previous option, but instead of eligibility being built up by contributions during working life, eligibility is based on citizenship or residency criteria. This would be particularly beneficial to women, and others who spend time out of the labour market, or working at low levels of earnings.
5. **Age additions:** Increase Basic State Pension to the means-tested level (Model 3 or 4 above) but only for the oldest pensioners, say, age 80 and over. This reflects that people get poorer as they get older.

This document invites input on three areas:

- Is the analysis of the current **pressure points** in the UK state pension system correct?
- Are the proposed **tests** appropriate to guide the debate and analysis?
- Has a useful set of reform **models** to be tested been identified?

Input will be gathered over the coming months to inform the next stage of work. Comments are welcome.

## Chapter 1: A framework for state pension reform

This chapter explains more about the reform agenda and proposes a general framework for state pension reform. It concludes that in reforming state pensions for the long-term, a clear sense of where the reform is heading (the objective) needs to be balanced with ideas for how to get there (the transition practicalities).

### Objectives for state pensions are hard to define, but necessary

There are many possible ways to describe objectives for pensions policy. Many of these appear broadly obvious but become more contentious on detailed examination. For example, *people must be rewarded and adequately incentivised for saving* is subject to different points of view on what an adequate incentive might be; *equal opportunity to build up pension entitlements* begs the question of whether the higher cost of pensions for longer-living women is or is not costed<sup>3</sup>.

Perhaps because of the difficulties in agreeing objectives, it is not easy to find a country where there is a clear definition of the objective or role of the state pension system. Even though many governments have written extensively about their own country's state pension scheme<sup>4</sup>, the given objective for it tends to be imprecise. For example:

*The foundation of the retirement income system...[providing] a safety net that underpins the other pillars* – Australia

*The goal of public pension is a decent minimum standard of living for all citizens* – Denmark

*Assure old people a reasonable standard of living related to their former income* – Germany

*Those who can save for their retirement have the responsibility to do so, and the state must provide effective security for those who cannot* – UK

The quotes show the different views on the appropriate level of state pension: a safety net, a minimum standard of living or a reasonable standard of living. Perhaps not surprisingly the level of pension tends to be a focus.

When a country has started a process of reforming state pensions, particular pressure points at the time of reform are naturally at the front of the mind. For example, Sweden has specific objectives for its new pension system, agreed as a result of a review process similar to that now being suggested by this paper for the UK<sup>5</sup>:

<sup>3</sup> Examples from IPPR (2001) and (2002)

<sup>4</sup> For example, government websites or reports written for cross-country comparisons such as those published by the EU. These quotes from a variety of sources, available on request.

<sup>5</sup> National Strategy Report on the Future of Pension Systems - Sweden (2002) p. 2

*The principal purposes of the reformed pension system are to promote greater justice both between and within generations and to comply with economic and demographic developments. Its design is intended to ensure socially efficient insurance, while satisfying the conditions that the system must be financially stable and must encourage an augmented supply of labour and raise the total level of savings in the economy.*

The Beveridge report of 1942, considering major long-term reform of state pensions, contained this statement of the problem to be resolved, which illustrates the contemporary reform objectives<sup>6</sup>:

*The problem for the future is how persons who are past work can be given a guarantee against want, in a form which gives the maximum of encouragement to voluntary saving for maintenance of standards above the subsistence minimum, and at the same time avoids spending money which is urgently needed elsewhere or money on a scale throwing an intolerable financial burden on the community.*

As the following sections will show, the UK now has a number of pressure points in its state pension system (and these are remarkably similar to those present in 1942). It is therefore appropriate to consider the objectives we might seek to achieve in a possible new state pension system.

### **Deciding on the right solution has to balance objective and transition**

The objective of state pensions, as described by the World Bank<sup>7</sup>, is:

- To redistribute in order to alleviate old age poverty, and,
- To co-insure against other risks better taken on by the state than by individuals, namely: *against long spells of low investment returns, recession, inflation and private market failures.*

This is in a context of mixed provision, with widespread private pensions. It can also be the case that the state has some role in smoothing consumption over a lifetime, that is, encouraging savings. So the objective as stated represents one suggestion for the minimum role of state pensions, recognising that neither the state nor the private pension market alone can provide an appropriate pension system<sup>8</sup>. Without necessarily agreeing with all the World Bank recommendations, this framework provides a useful starting point for this document's discussion of the objectives of state pensions.

The specific roles suggested for state pensions by the World Bank are to:

1. Redistribute to the poor
2. Augment the income of the old who can no longer work productively
3. Protect the old from risk by defining the benefits in advance
4. Protect the old against inflation
5. Be a remedy for myopia among workers

<sup>6</sup> Beveridge (1942) Paragraph 238

<sup>7</sup> World Bank (1994), pp. 15-16, pp.101-102

<sup>8</sup> See also Littlewood (1998) Chapter 2, and Chapter 4 of this document

The World Bank list of roles raises some eternal questions of pensions policy. Who are 'the old'? How much redistribution and augmentation of income should there be? How precisely can future benefits be defined, and what inflation should be protected against? How far should myopia (short-sightedness in saving) be remedied by a high state pension?

These questions cannot only be answered in isolation. There are numerous **tradeoffs** between different parameters. For example:

- If state pension age were increased to age 70 by 2030, this could increase the amount of UK Basic State Pension by up to 50% compared to a state pension age of 65, with no overall change in the total cost of pension benefits<sup>9</sup>.

Further, the impact of a change cannot only be considered in aggregate for the whole population. There are **distributional effects**, that is, the impact of a policy change varies according to individual income. An estimate of the overall impact can only be made by modelling the distribution of individual impacts across the population. For example:

- Increases in either the Basic State Pension or means-tested benefits could be used to increase average pensioner income overnight (at the same total annual cost), but current poorer pensioners would see larger proportionate increases in their income if means-tested benefits were increased<sup>10</sup>.

Analysing these tradeoff issues and distributional impacts is not easy. This is why in the PPI agenda for state pensions policy reform, it is suggested that first some broad objectives are agreed, then a few possible reform models chosen. Then the analysis is focused and manageable.

**Transition** issues – that is, how to bring in a new state pension scheme without disrupting pensions for current and soon-to-be pensioners – can mean that the pure objective of a reform has to be adapted to be practical.

This is illustrated by the experience of the Beveridge report proposals. Beveridge recommended that the new pensions should be phased in, so that the full rate was not paid to all pensioners until 20 years later. In fact, the new pensions were paid in full to each pensioner from the appointed day. This was a political decision, it being thought that pensioners would not tolerate having lower pensions than later generations. The Beveridge rationale was that transition was consistent with the logic of contributory pensions (that is, what one was paid as a pensioner depended on what one had put in as a worker) and that means-tested assistance was available to those in difficulties before transition was completed.

<sup>9</sup> PricewaterhouseCoopers calculations in O'Connell (2002)

<sup>10</sup> IFS analysis in House of Commons Work and Pensions Select Committee (2003), p. 48

Beveridge also envisaged pensions paid at a subsistence level, but the eventual level was lower (just above means-tested National Assistance payments, which left many pensioners eligible for means-tested housing benefits), and not indexed to increase with inflation. The Treasury had argued that the Beveridge proposal would cost too much<sup>11</sup>.

Although the suggested PPI agenda shows transition being considered after the analysis of possible reform models, in practice transition would be considered at the same time. But a review of state pension policy should do its best to strike the right balance between long-term objective and immediate transition.

<sup>11</sup> Beveridge (1942) Paragraphs 241-243, Timmins (2001)

## Chapter 2: Current pressure points in the UK

This chapter assesses how well the UK state pension system does – and most importantly for this purpose, how well it will do in future – against the World Bank minimum standard of objectives for a state pension system. It concludes that there are many pressure points which, taken together, make an overwhelming case for reform.

### The UK state pension system compared to a minimum standard: Summary

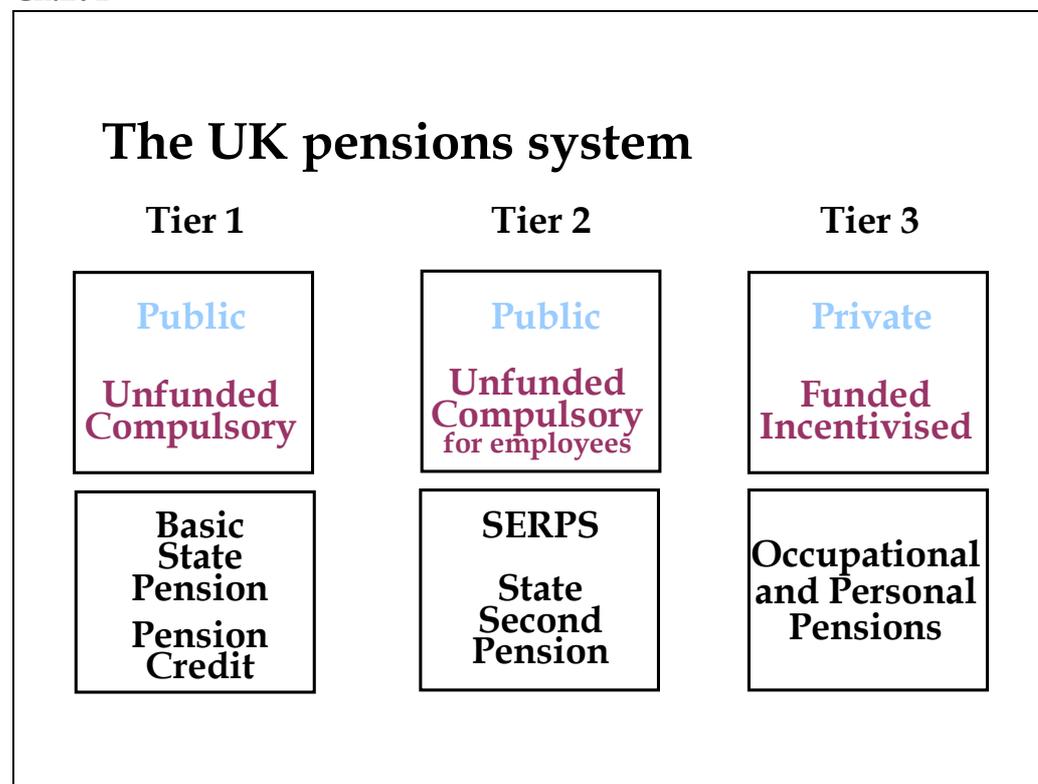
1. **Does the UK state pension system redistribute to the poor?**  
Redistribution from workers to poorer pensioners has increased. But the adequacy of state pension provision is questionable, and this concern is likely to increase. Further, some groups are more likely to be pension-poor.
2. **Does the UK state pension system augment the income of the old who can no longer work productively?**  
The numbers of the ‘old’ are increasing. This does not imply a ‘crisis’, but the pension system does have to be robust to cope with future demographics. However, the current UK pension system disadvantages people as they grow older. Further, the UK state pension system has not changed to reflect the improved opportunity for longer working lives.
3. **Does the UK pension system protect the old from risk by defining the benefits in advance?**  
State benefits are only partially defined in advance, and are becoming less well defined. Complexity of the system is a real barrier to people knowing what state benefits they are likely to receive. Further, the UK system is now being challenged so widely that it is not expected to last without change.
4. **Does the UK state pension system protect the old against inflation?**  
A most persistent complaint from pensioners in particular is that the UK state pension system does not protect the old against the effects of general earnings inflation. But the system does offer some link to earnings, and guarantees price inflation for most of the state pension.
5. **Does the UK state pension system provide a remedy for savings myopia among workers?**  
Because of the adequacy issues, the UK state pension system does not provide a fail-safe mechanism against not saving. The UK state pension system does not set out to be (nor ever could be) a remedy for people who could have saved, but did not. There will always need to be private saving. But, the UK state pension system is thought to set up a barrier to saving, partly because of widespread means-tested benefits.

For context, current pension policy objectives for the UK can be summarised as to:

- Maintain state spend on pension-related benefits at 5% of GDP
- Target state resources on the poorest pensioners by increasing the use of means-testing, and,
- Encourage people to save more and/or work longer.

The UK state pension system is complicated and multi-component (Chart 1).

Chart 1<sup>12</sup>



The state (or public) pension system referred to in this document is mostly Tiers 1 and 2. But some of Tier 3 is dependent on state funding, and all of it dependent on state legislation and working rules. A wider discussion of Tier 3 issues is in Chapter 4.

<sup>12</sup> For a fuller description of the UK pension system, see *The Pensions Primer* published by the PPI, 2003

## 1. Does the UK state pension system redistribute to the poor?

Redistribution from workers to poorer pensioners has increased. But the adequacy of state pension provision is questionable, and this concern is likely to increase. It is also questionable whether redistribution is effective for certain groups.

**1.1 Redistribution from workers to poorer pensioners has increased.** The proportion of pensioners in the bottom fifth of the UK's overall income distribution was 26% in 2001/2, down from 47% in 1979<sup>13</sup>. More state money is being targeted to the poorest pensioners by the current policy of increasing means-tested benefits. The number of pensioners receiving means-tested benefits rose to nearly 1.8m in 2002, from a low of 1.6m in 1999<sup>14</sup>.

Redistribution to the poor takes place before and after pension is paid. When rights to state pensions are being accrued, redistribution from richer to poorer workers takes place as contributions are made as a percentage of earnings, within limits, and (some) benefits are flat-rate. Redistribution to non-workers or low earners takes place by earning credits to state pension. Then, when pensions are in payment, means-tested benefits achieve further redistribution from tax-payers to poorer pensioners.

**1.2 The adequacy of current pension provision is questionable.** By definition the Basic State Pension is not adequate by itself, as it is set below the level of the means-tested Minimum Income Guarantee (MIG). Around 90% of recently retired men have a full BSP, and only around 25% of recently retired women have a full BSP in their own right<sup>15</sup>. An individual with an incomplete entitlement to Basic State Pension and/or little additional pension above the Basic State Pension can claim a means-tested top-up income<sup>16</sup>. It is estimated that 43% of pensioner households will be eligible for this additional income<sup>17</sup>.

However, it is estimated that at least 25% (and perhaps more than 30%) of eligible pensioners do not claim what they are entitled to, so that their incomes are below the official target for minimum income<sup>18</sup>.

<sup>13</sup> DWP (2003 HBAI)

<sup>14</sup> See Chart 2 *The Pensions Landscape*, p. 10

<sup>15</sup> GAD (1999)

<sup>16</sup> Pension Credit (from October 2003) comprises a minimum income of £102.10 per week for a single person (the Guarantee Credit) plus a further amount of up to £14.80 per week (the Savings Credit) granted to people who have made some savings which would otherwise reduce the amount of GC given

<sup>17</sup> DWP data. 29% are eligible for GC, 14% for SC only.

<sup>18</sup> DWP (2003 TU). The non- take-up figures are those estimated for the Minimum Income Guarantee (to be renamed Guarantee Credit) in 2000/1.

Around 22% of current UK pensioners are in relative poverty, compared to 19% of working age people<sup>19</sup>. Around half of single pensioners have incomes below a *Low Cost but Acceptable Standard* and half of all pensioners have incomes below a *Modest but Adequate Standard*<sup>20</sup>.

### 1.3 The future adequacy of state pension provision is more questionable.

The state currently spends 5% of GDP on state pensions and means-tested income supplements paid to pensioners. Over the next 40 years, the number of pensioners will rise by 40%, while the level of state spend remains at 5% of GDP<sup>21</sup>. Therefore, on average each future pensioner will receive relatively less from the state than each current pensioner does. The state spend is planned to be more targeted, through more extensive means-testing, but this will have to be extremely efficient to improve adequacy. As the number of pensioners increases so significantly, the question of the adequacy of state pensions will become even more relevant.

It was intended that private pensions would fill the gap<sup>22</sup>. This now seems unlikely, as total contributions to private pensions (from employers and employees) are, at best, flat relative to average earnings<sup>23</sup>. This means that they are not keeping pace with the increasing cost of longevity or the expected lower investment returns in future, let alone filling the gap made by the declining value of state pensions.

### 1.4 Some groups are more likely to be pension-poor.

UK state pension benefits (Basic State Pension and State Second Pension) are linked to labour market activity. Contributions made while earning give rights to future state pension income. People who spend time not working, or working below the required income level, therefore are at risk of not receiving the full Basic State Pension. The rules are detailed, and the compensatory system of credits not perfect. This partly explains why women pensioners are more likely to have to claim means-tested benefits – women make up three-quarters of single pensioners, but over four-fifths of single MIG claimants<sup>24</sup>.

<sup>19</sup> DWP (2003 HBAI). The measure used here is the proportion of households with income below 60% of median contemporary income after housing costs, 2001/2. If the same measure is used before housing costs, the proportions are 22% for pensioners and 14% for working age people.

<sup>20</sup> See *The Pensions Landscape*, p. 17 and Parker (2000, 2002)

<sup>21</sup> DWP (2002 GP) and see Chapter 4

<sup>22</sup> DSS (1998)

<sup>23</sup> See Chart 24 *The Pensions Landscape*, p. 37

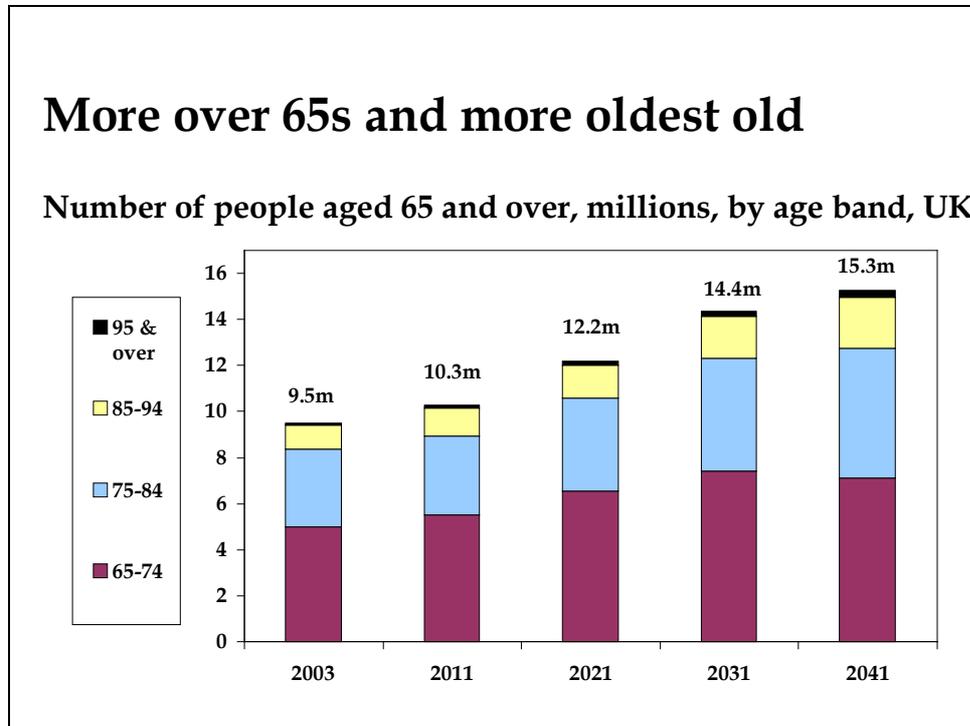
<sup>24</sup> PPI analysis

**2. Does the UK state pension system augment the income of the old who can no longer work productively?**

The numbers of the ‘old’ are increasing. This does not imply a ‘crisis’, but the pension system does have to be robust to cope with future demographics. However, the current UK pension system makes it more difficult for the oldest pensioners to receive their benefits. Further, the UK state pension system has not changed to reflect the improved opportunity for longer working lives.

**2.1 The UK state pension system has to be robust to cope with future demographics.** The number of people over 65 will continue to increase dramatically, especially the numbers of the oldest old (Chart 2).

Chart 2<sup>25</sup>



By 2041 there are expected to be around 5.8 million more people aged 65 and over than there are in 2003 - an increase of over 60%. Over the same period, the total number of people in the UK is expected to increase by 8%. The rates of increases are higher for each older age band - so that over the same period the number of people aged 65 to 74 is expected to increase by 40%, and aged 95 and over by 240%.

Nearly 60% of people over age 65 today are women, and this falls slightly to 55% by 2041. But the proportion of women rises with each age-band, so that there are expected to be twice as many women aged 95 and over as men by 2041.

<sup>25</sup> PPI analysis from Government Actuary’s Department principal population projections [www.gad.gov.uk](http://www.gad.gov.uk)

These projections provide the demographic assumptions for calculations of what state pension can be afforded in future. But the social consequences of these changing demographics also have to be taken into account when designing possible future state pension models. The future UK state pension will have to be robust for an increasingly 'old-old' profile.

For example, as we all live longer, there is a case for state pensions to become *more* necessary - as insurance against longevity. After reaching age 65, people are living longer than could have been envisaged when the current pension system was set up. Today's 40-somethings, reaching pension age around 2025 are expected to live to collect their pension for around 8 years longer than the Beveridge generation of pensioners who reached age 65 in 1950<sup>26</sup>.

Life expectancy is an increasing risk, which may be open-ended<sup>27</sup>. Pooling the risk as widely as possible is to be preferred. The state can pool the risk of living longer than expected wider than any other organisation could achieve. The role of the state pension in protecting the old against unexpectedly living so long that other sources of income have run down (e.g., savings, or the value of pensions income relative to earnings<sup>28</sup>) or are unavailable (e.g., earnings) is therefore becoming increasingly important. It is particularly important for women, who are expected to live on average 18.9 years after age 65, whereas men are expected to live 15.7 years<sup>29</sup>.

## 2.2 The UK state pension system disadvantages people as they grow old.

Some people retire with income below the means-tested level, and so need to claim means-tested benefits for the duration of their retirement. Others start retirement with income above the means-tested level and then, because pensions are indexed to prices and means-tested benefits indexed to earnings<sup>30</sup>, that gap narrows. Therefore, the older one gets, the more likely one is to have to claim means-tested benefits.

43% of all pensioner households are estimated to be eligible to claim Pension Credit (PC) when it is introduced in October 2003. The rate of eligibility increases sharply with age, from one-third of 65-69s eligible to two-thirds of the over 80s (Chart 3).

<sup>26</sup> O'Connell (2002)

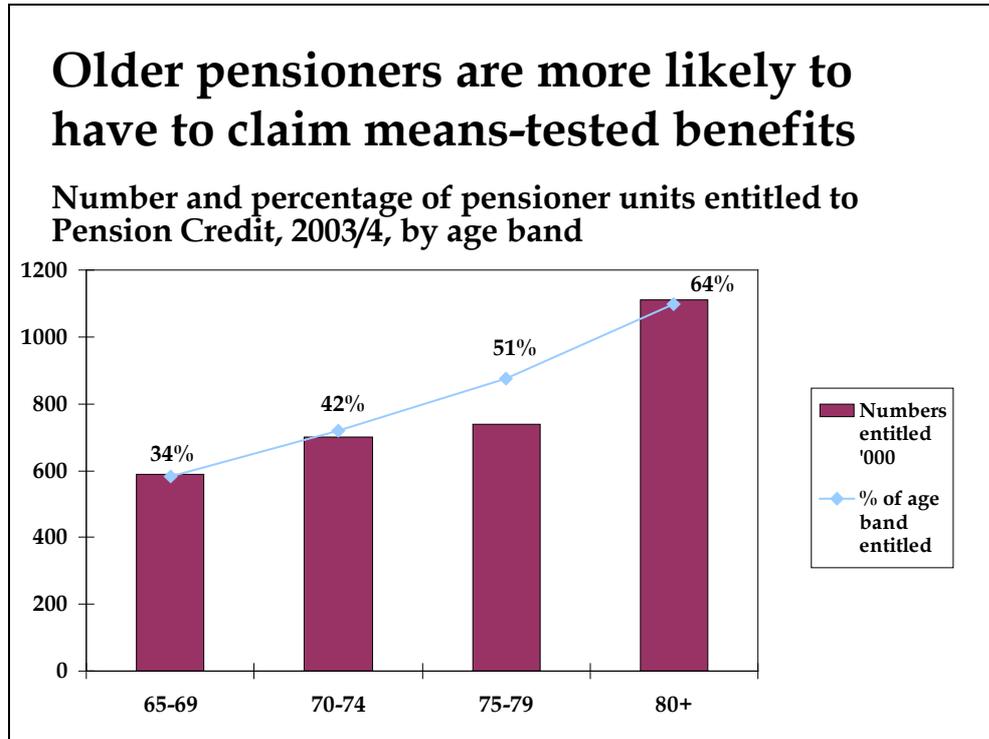
<sup>27</sup> Oeppen and Vaupel (2002)

<sup>28</sup> After 20 years in retirement, income is around 50% lower than that of a new retiree in earnings terms because pension income (whether state or private) is indexed to prices. Price inflation is typically 1.5% -2% lower than earnings inflation each year.

<sup>29</sup> Government Actuary's Department Interim Life Tables 1999-2001

<sup>30</sup> Means-tested benefits are expected to be indexed to earnings, as the poverty level is relative to all income, of which earnings is the major part

Chart 3<sup>31</sup>



Over time, as the gap between pension and means-tested benefits widens (in aggregate and for the increasing numbers of older pensioners) higher percentages of pensioners eligible for means-tested benefits are expected.

However easy the means-testing process can be made, it is still a process that has to be self-managed. Take-up rates of under 75% suggest a significant number of pensioners do not want, or are unable, to go through the process. The oldest pensioners, who are more likely to have to go through the process, are more likely to be frail, more likely to be single, and least likely to be able do so. This seems to be confirmed as, currently, those not claiming their benefits tend to be older than those that do claim<sup>32</sup>.

<sup>31</sup> DWP data

<sup>32</sup> For the Minimum Income Guarantee (the old name for GC) in 2000/1 DWP (2003 TU)

**2.3 The UK state pension system has not changed to reflect the improved opportunity for longer working lives.** Employment rates decline rapidly after age 50. While around 80% of people aged 50 in the UK are in work, 40% of women and 60% of men are still employed by age 60<sup>33</sup>.

Only 10% of women and 17% of men actually stop work at state pension age (SPA)<sup>34</sup>. After age 65, around 10% of people work. The median age of withdrawal from the labour force is 62.6 years for men and 60.4 years for women.

SPA does not mark the age at which a majority become incapable of work. The current UK state pension age is after the age when most people have chosen to stop work, or have stopped work for other reasons<sup>35</sup>. But many could still be capable of 'working productively'.

After age 65, a woman can expect on average 9.5 years free of limiting long-standing illness, and in good or fairly good health; a man can expect 8.3 years. Fifteen years ago, these figures would be 8.5 years and 7.6 years respectively<sup>36</sup>.

There is much debate about whether the increased years after 'retirement' are getting more or less healthy. It is usually said that 'healthy life expectancy has increased but not by as much as total life expectancy'. But there are fewer years in poor health than in good health after age 65. So, as the number of years of life after age 65 has been increasing, a slightly higher percentage of those years are in good health (Table 1).

<sup>33</sup> Labour Force Survey 2002, quoted in DWP (2002 GP)

<sup>34</sup> Smeaton and McKay (2003). Other data in this paragraph from DWP (2002 GP).

<sup>35</sup> The current SPA is 65 for men, and increasing to 65 from 60 for women between 2020 and 2020. For the issues around raising SPA see, for example, O'Connell (2002).

<sup>36</sup> See Chart 13, O'Connell (2002) p. 25 and Kelly et al (2000). Data is for years 1995 and 1981.

**Table 1: Life expectancy (total years lived) and healthy life expectancy (the number of those years in good or fairly good health, some of which may be with a limiting long-standing illness): years lived after age 65, 1981-1995<sup>37</sup>**

	1981	1995	Increase, years	Increase, %
<b>Men</b>				
Total life expectancy	13.0	14.7	1.7	13%
Healthy life expectancy	9.9	11.3	1.4	14%
HLE as % LE	76%	77%		
<b>Women</b>				
Total life expectancy	16.9	18.3	1.4	8%
Healthy life expectancy	11.9	13.0	1.1	9%
HLE as % LE	70%	71%		

Apart from gender, there will of course be variations between groups. For example, there are complex inter-related effects by socio-economic group and smoking history. But on average, as the number of years after age 65 has increased, so has the number of potentially 'productive' years.

Not surprisingly, people who continue to work after age 65 are healthier. 13% of non-working men aged between 65-75 report poor health, compared with 7% of working men of the same age. For women, the figures are 14% and 6% respectively. Whether health is a more important cause or effect of working is not clear<sup>38</sup>.

State pensions were from 1909 to 1946 only dependent on age. The Beveridge reforms introduced a requirement to stop receiving earnings in order to receive state pension, so that state pension would be given only to pensioners who do no work. In 1989, that rule was abolished, and state pensions can be received regardless of whether working or not. There is therefore already considerable retirement flexibility in the state pension system<sup>39</sup>.

<sup>37</sup> Kelly et al (2000)

<sup>38</sup> Smeaton and McKay (2003)

<sup>39</sup> See Disney R. Submission to House of Commons Work and Pensions Select Committee (2003)

It seems unlikely that state pensions could again be tied to employment. This would deny the fact that for most people retirement is totally separate from SPA. It would also restrict choice at a time when flexible working (both in terms of reducing hours worked and the age at which work stops altogether) for people of older ages is an important part of government policy. However, not having a link means that state pensions are a relatively ineffective lever for retirement policy.

Keeping eligibility for state pensions separate from employment is consistent with the role of state pensions being insurance against longevity. But then it is even more important that state pensions reflect improvements in total and healthy life expectancy. Otherwise, the risk is that a tradeoff decision on how to spend the money available for state pensions overly favours healthy younger pensioners at the expense of older pensioners in poor health. SPA will remain a focus of debate as long as healthy life expectancy continues to improve.

### 3. Does the UK pension system protect the old from risk by defining the benefits in advance?

State benefits are only partially defined in advance, and are becoming less well defined. Complexity of the system is a real barrier to people knowing what state benefits they are likely to receive. Further, the UK system is now being challenged so widely that it is not expected that the structure of the system will last.

#### 3.1 State pensions and benefits are partially defined in advance and are becoming less well defined. Changes in the formulae for accruing rights to state pensions are usually made well in advance. For example, changes to SERPS accruals announced in 1986 did not affect actual entitlements until 1998. Similarly, the increase in state pension age for women legislated for in 1995 takes effect between 2010 and 2020.

However, legislative changes to the structure of means-tested benefits tend to have a shorter cycle. People cannot be as certain about the future of these benefits as they can be about contributory state benefits. For example, the Minimum Income Guarantee, announced at the end of 1998, was in place by April 1999. The qualifying level of income is changed every year.

A further complication with means-tested benefits is that the amount granted depends on other income available at the time. This is not predictable, as it depends on pension entitlements and other savings built up over the lifetime.

Therefore, as state provision shifts towards greater means-testing, there is a risk that benefits will be less well defined in advance.

**3.2 Complexity means that few people understand what they are likely to get in advance.** The state pension system has been criticised for its complexity, particularly as there are many components of the system, and many rules have changed over time, but still apply for past accruals. In all there are 23 potential entitlements for pensioners with 36 different linkages between 16 of them<sup>40</sup>. A state pension statement for someone currently aged 65 consists of 14 components. Cash items such as Winter Fuel Payment are paid separately and means-tested benefits have to be claimed for by following different processes.

Many organisations point out that not understanding what the state system is likely to give does not help to encourage private saving<sup>41</sup>.

The multi-component nature of the system means that forecasts of future state pension benefit are incomplete. People of working age can apply for a forecast of state pension, and there are plans for this information to be sent automatically without request<sup>42</sup>. This will undoubtedly be useful information, but it excludes means-tested and other benefits.

The forecasts do not signal changes in circumstances during retirement. As has been noted, the indexation of state pensions to prices means that people who have been retired some years are worse off in real earnings terms than recent retirees.

After retiring, the gap between state pension income and means-tested benefits widens. A single pensioner, who retired with average income, would need to claim means-tested benefits 10 years after retirement. A typical pension experience for someone retiring in 2003 could be: at age 65, receive a total pension of 37% National Average Earnings (NAE), which declines to 32% NAE at age 75. By this time, he or she would be eligible for PC. If PC is claimed, then after age 75 income will remain around 30% NAE, but if not, income will decline further relative to NAE<sup>43</sup>.

To define state pension benefits properly in advance, forecasts will need to give more information on the real future value of all the possible components at more than one time point.

<sup>40</sup> House of Commons Public Accounts Select Committee (2003)

<sup>41</sup> For example, the responses to the 2002 DWP Green Paper from Norwich Union, Standard Life and Watson Wyatt

<sup>42</sup> For self-employed people from May 2003 and within 5 years to the rest of the working population. DWP (2002 GP) p. 43.

<sup>43</sup> See Chart 20 *The Pensions Landscape*, p. 31

**3.3 The UK state pension system is now being challenged so widely that it is not expected to last without change.** Many pension commentators have argued the case that the state pension system needs reform for the long-term. For example<sup>44</sup>:

*The ABI...recommends a radical reform to the state pension system - Association of British Insurers*

*Reforming the basic state pension is a vital step - Help the Aged*

*Suggestions for how the state pension regime could be reformed ...[have]... remarkable consensus within the industry - Mercer*

*A root and branch review of pensions coverage in the UK is required - National Association of Pension Funds*

*The government needs to create a better framework for state provision - Work Foundation*

*We encourage the government to develop a consensus on pension reform for the long term and to create a pensions system with improved incentives to save for the today's younger workers, which has less complexity - House of Commons Work & Pensions Select Committee April 2003*

There is also plenty of media coverage suggesting that something is wrong in pensions, so the preference for reform over the status quo may not be limited to the pensions expert community.

The state pensions spend being constrained at 5% of GDP over the next 40 years while the number of recipients is growing at 40% was referred to earlier. It has been suggested that while this may be a correct *ex ante* analysis, it will not actually turn out as an *ex post* outcome. The trend will be socially unacceptable and adjustments will probably have to be made to change it<sup>45</sup>.

**4. Does the UK state pension system protect the old against inflation?**

A most persistent complaint from pensioners in particular is that the UK state pension system does not fully protect the old against the effects of general earnings inflation. But the system does offer some link to earnings, and guarantees price inflation for most of the state pension.

<sup>44</sup> Apart from the last, these are all from responses to the 2002 DWP Green Paper

<sup>45</sup> A point made by David Willetts MP at a PPI seminar March 2003

The main elements of state pensions in payment are statutorily indexed to prices. Any additional uplifts are usually announced some months before they take effect as part of the annual Budget process. The current government has guaranteed that state pensions will be increased by the greater of the Retail Price Index or 2.5% a year until the end of the current parliament<sup>46</sup>.

The indexation of means-tested benefits is not set in legislation, but it is commonly expected to be linked to the average level of earnings and is assumed to do so in government projections<sup>47</sup>. Changes in benefit level are usually announced through the Budget. Therefore, as more pensioners become eligible for means-tested benefits, more are likely to have at least part of their income inflating in line with earnings.

Other elements of state pensions are not statutorily linked to any index. For example, the additional sum paid at age 80 has been the same monetary amount since 1971. Cash universal benefits such as the Winter Fuel Payment are dealt with in the Budget and there is no general expectation that they will be raised each year.

Overall therefore, provided means-tested benefits are claimed, the poorest pensioners have a safety net that is expected, but not guaranteed, to protect against the effects of earnings inflation. Most, but not all, other state pension benefits protect only against price inflation.

## **5. Does the UK state pension system provide a remedy for savings myopia among workers?**

Because of the adequacy issues, the UK state pension system does not provide a fail-safe mechanism against not saving. The UK state pension system does not set out to be (nor ever could be) a remedy for people who could have saved, but did not. There will always need to be private saving. But, the UK state pension system is thought to set up a barrier to saving, partly because of widespread means-tested benefits.

**5.1 The state pension system is not a remedy for savings myopia.** The UK state pension system does not set out to be a remedy for people who could have saved, but, for whatever reason, did not. The level of total income in retirement is often illustrated by the replacement rate – retirement income as a proportion of pre-retirement final earnings. Usually a range between one-half and two-thirds is considered appropriate<sup>48</sup>, although an even higher rate may be appropriate for lower-income people.

<sup>46</sup> At the latest May 2006

<sup>47</sup> For example, DWP (2002 GP)

<sup>48</sup> For example, as used in the 2002 DWP Green Paper

The majority of people currently of working age will not receive sufficient state pension or means-tested benefits to reach either of these benchmark replacement rates without private saving (Table 2).

**Table 2: Number of people of working age with estimated gross replacement rates at benchmark levels or higher from state pension benefits alone<sup>49</sup>**

<b>Millions of people of working age:</b>	Target gross replacement rate of half of final earnings or more	Target gross replacement rate of two-thirds of final earnings or more
For whom state pension income reaches target replacement rate	11m	7m
For whom state pension income does not reach target replacement rate	14m	18m
Who are not in work - replacement rate uncertain	9m	9m

On the higher replacement rate, state pension and means-tested supplements, at current levels, can only be an appropriate replacement income (a total remedy for myopia) for 28% of those in work (7m out of 25m - those earning below £10,000 per annum). On the lower replacement rate, the state pension system would be sufficient for 44% of those in work (those earning below £14,000 per annum)<sup>50</sup>.

The state pension could never be a satisfactory remedy for myopia for the majority. The average earner can receive a maximum state benefit of 35% of National Average Earnings (NAE). Clearly, a replacement rate of 50% of NAE would require a significantly more costly state benefit.

<sup>49</sup> PPI estimates using the 2001/2 Family Resources Survey (GB). Based on current earnings, and assuming these remain constant (relative to average earnings levels) throughout a working life of 40 years. Replacement rates for those not currently working are not calculated, as there is no 'final earnings' comparison. State pensions include BSP, SERPS / S2P and PC. The self-employed are assumed to have no SERPS / S2P benefit. The amount provided by the state changes over time - figures here are based on the amounts provided for those retiring in 2020, which would overstate benefits for those retiring today (and so overestimate the numbers reaching target replacement rates), but understate them for those retiring after 2020 (so underestimating the numbers reaching target income levels).

<sup>50</sup> PPI analysis; outcomes broadly similar to that in DWP (2002 GP)

Therefore, pensions policy has to be a joint effort between state provision and private savings. The controversial issues are

- Where in the income distribution should there be an expectation of private saving
- How to ensure the state system does not act as a barrier to saving, and
- How to put in the right incentives (or compulsion) for private saving.

Clearly if the state pension were to be reformed to approach a remedy for myopia (that is, it provided a higher level of benefit that would be an acceptable replacement ratio for more people) then there would be a different answer to how much private saving there 'should' be, and the income groups for which saving is expected. The question of appropriate incentives (or compulsion) for private savings therefore has to be linked to the level and distribution of state pensions.

**5.2 The UK state pension system is thought to set up a barrier to saving (or a 'disincentive to save').** Most people do not make knowledgeable and economically rational decisions about pension saving. Instead, research shows that people put off saving, as it is complicated and they are unsure of what to do. But it is possible, and by anecdote likely, that adults of working age with doubts about the wisdom of saving, are encouraged in that view by the prospect of receiving means-tested benefits in future, and by seeing older relatives receiving them (or not).

Further, given the uncertainty of how the means-testing rules will operate in the future, advisers – including advisers to employer-based schemes – find it difficult to recommend pension saving, especially for lower-income clients. Therefore, while it cannot be proved that means-testing acts as a barrier to save, practitioners believe it to be the case<sup>51</sup>. It is also worth noting that the reverse cannot be proved.

In summary, the UK state pension system does not measure up to many of the criteria in the World Bank minimum standard – and the future prospects are no better. There are of course other standards for state pensions to be measured against; the one used can be viewed as a minimum. The next chapter measures the UK state pension system against that in other countries.

<sup>51</sup> See for example, responses to the 2002 DWP Green Paper by the Association of British Insurers, Friends Provident, Norwich Union, Standard Life, Scottish Widows and Watson Wyatt

## Chapter 3: State pensions in other countries

This chapter compares state pensions across different countries. It concludes that the diversity of different systems means that there is no one model available off the shelf for the UK. It demonstrates that compared to its peers in other countries, the UK state pension system is more complex and less generous. Further, the adequacy of the state pension will continue to be a concern as the UK constrains spending despite an ageing population.

### No off the shelf solution from other countries

In this report, the following terms are used to describe the design of state pensions<sup>52</sup>.

**Universal:** The benefit is available to everyone meeting certain criteria, usually based on age and citizenship or residency, but not based on income.

**Contributory:** The amount of benefit paid depends in some way on how many contributions were made while of working age (but not that the benefit paid is the accumulation of contributions).

**Flat-rate benefit:** Everyone receiving the benefit gets the same amount for the same number of contributions paid (if contributory) or for the same criteria fulfilled (if universal).

**Earnings-related benefit** (has to be contributory): The amount of benefit received is dependent not only on how many contributions were made but on how much those contributions were – as these are usually a percentage of salary, people who earned more while in work receive more pension.

**Means-tested:** An income test (and usually an asset test) is used to determine who should get all or part of a benefit; those people with most income will not receive the benefit. The means-test is a test of eligibility which people on low income need to go through to apply for the benefit; **affluence-testing** looks to identify the most affluent people from whom to withhold benefits.

**Pay-As-You-Go (PAYG):** Current taxes (or contributions) pay for current pensioners' benefits. The alternative is **funded**, where designated funds are accumulated from contributions, and benefits paid from these funds.

<sup>52</sup> There are a number of good summaries of design parameters, for example Disney and Johnson (2001), Evason (1999), Littlewood (1998) pp. 28-30

Different countries use different combinations of these methods to deliver their state pensions (Table 3). All are fully PAYG, except for Sweden, which in its recent reforms has an element of funding.

**Table 3: State pension models in selected countries<sup>53</sup>**

	Affluence-tested			Multi conditional		Work-related					Universal	
	AUS	DK	S	IRL	UK	US	I	F	E	D	NL	NZ
Universal flat-rate PAYG pension											*	*
Universal flat-rate funded pension												
Affluence-tested flat-rate PAYG pension	*	*	*									
Means-tested flat-rate PAYG pension		*		*	*	*	*	*	*		*	
Contributory flat-rate PAYG pension				*	*							
Contributory flat-rate funded pension												
Contributory earnings-related PAYG pension			*		*	*	*	*	*	*		
Contributory earnings-related funded pension			*									

Four basic models explain the nature of the state pension coverage, as follows (reading from right to left on Table 3):

- Universal:** New Zealand and the Netherlands base eligibility to the state pension on residency. The flat-rate benefit is not means-tested, although there is a means-tested pension benefit available in the Netherlands for the few who do not fulfil the residency requirement. In both countries, the single pensioner would receive around 35-40% of National Average Earnings (NAE) from the state<sup>54</sup>.

<sup>53</sup> PPI analysis. See detail and sources for each country in the PPI Reference Manual *State Pensions Models*. AUS (Australia), DK (Denmark), F (France), D (Germany), IRL (Ireland), I (Italy), NL (Netherlands) NZ (New Zealand), E (Spain), S (Sweden), UK (United Kingdom), US (United States)

<sup>54</sup> For comparison, in the UK, the Minimum Income Guarantee is 22% of NAE; the full Basic State Pension is 16% NAE, and someone retiring with a full employment record on average earnings would receive 35% of NAE in total state pension. All figures for 2003/4.

- **Work-related:** The Continental European state pension models all relate heavily to the labour market, not just because the benefits and contributions are earnings-related, but also by some of the schemes being organised through occupational groupings. Most state pension comes from the earnings-related contributory schemes, and there is also a means-tested flat benefit aimed at lower income groups. The US also has the same structure of pension components as the Continental European countries, organised on a state rather than occupational basis. The end result is a less generous pension, in the order of 35-40% NAE, compared with the Continental European state pension of 65-75% NAE.
- **Multi-conditional:** The UK and Ireland have multi-component schemes, each component of which has different eligibility criteria. Both are connected with the labour market via a contributory flat-rate pension; the UK also has a contributory earnings-related pension. Both countries have an adequacy issue with these arrangements as there is also a means-tested flat pension that is claimed by around 40%-50% of the pensioner population. In both countries the end result is an average state pension of around 25-30% NAE.
- **Affluence-tested:** Australia has just a single component – an affluence-tested flat state pension. It is also the least generous; the full benefit is around 25% NAE. Sweden and Denmark have multiple component systems based on targeted affluence-testing, but achieving fairly wide coverage of more generous state pension. In Denmark affluence-testing means that only the 1% with highest other income do not receive any state pension. In the recently reformed Swedish system, there is a guaranteed pension based on residency and affluence-tested as well as two other state-run pensions components, which are intended to build up earnings-related benefits. The end-result for both is an average state pension of around 50% NAE.

There are of course many detailed variations in how these different systems operate. Two of the most important areas of difference are the method of means-testing (or affluence-testing as referred to above) and the way in which the contributory link works.

The nature of the contributory link (and therefore the links to the labour market and the taxation system) varies significantly. In Denmark state pensions are paid for from general taxation revenues; in most other countries there is at least some notional hypothecation of employer and employee contributions. The contributions are usually a percentage of salary within limits (e.g., UK, US). The rules for calculation of the benefit can depend on number of contributions (Germany) and/or have a formula relating to actual earnings over a period (Spain).

As referred to briefly above, the level at which state pension is pitched varies by country (Chart 4).

Chart 4<sup>55</sup>

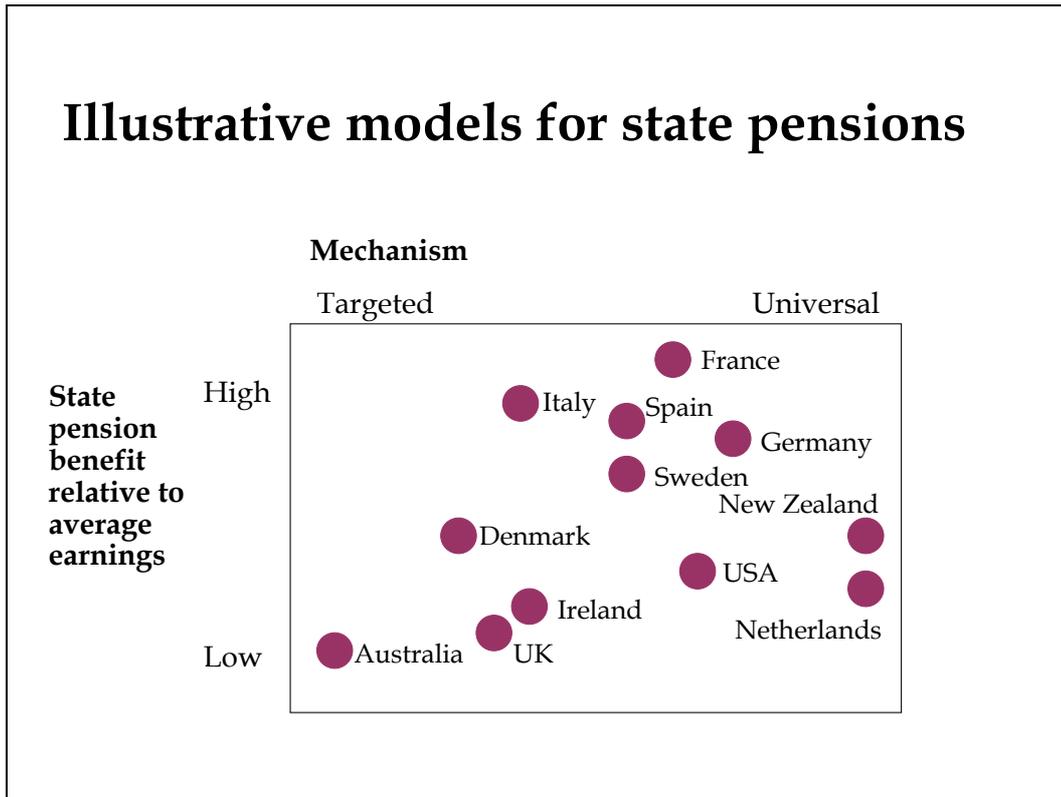


Chart 4 illustrates the spread between the most targeted, conditional system (Australia) and the widest coverage, universal state pension systems (New Zealand and the Netherlands). This is necessarily somewhat subjective, but statistics on the proportion of pensioners receiving means-tested benefits gives some guide<sup>56</sup>. High coverage implies that few pensioners need to claim means-tested benefits.

Chart 4 also shows that the most generous state pensions are in the continental European countries, and the least generous in the UK and Australia. This is an extremely difficult comparison to make exactly. There are at least two approaches:

- The state pension expected in the future by the hypothetical person who has earned at average earnings throughout life, expressed as a percentage of national average earnings at the time of first receiving pension, or,
- The actual average pensioner income, expressed as a percentage of the actual national average earnings at a point in time.

<sup>55</sup> PPI analysis

<sup>56</sup> PPI analysis of country-specific sources available on request

There are clearly issues with both of these definitions, and the practical problem is finding comparative data on the same definition for each country for the same time period. The illustrative comparison of the level of benefit from the different state pension systems in Chart 4 shows the general picture<sup>57</sup>.

Chart 4 represents the current situation, for pensioners now. The expected impact of future trends gives a mixed picture. The recent reforms in Sweden will move that country's position down (less generous) and slightly to the right (less targeting). The plans in Italy will also move that country down (less generous) but to the left (more targeted). In the UK, the effect of past changes in the state system rolled out into the future will also be to move the UK down (less generous) and to the left (more targeted).

Another issue making comparison between countries difficult is that each country has different state-sponsored cash benefits and concessions available, such as assistance with healthcare costs, housing and travel. So far as is known, a cross-country comparison of the value of these has not been attempted.

For whatever reasons, different countries have evolved very different methods of delivering state pensions, different extents to which state pension covers the pensioner population, and different levels of state pension benefit. These reasons could include different views on social justice, acceptable tax rates, labour market dynamics, political expediency and unintended consequences.

The different systems show that **there is not one obvious best solution for how to deliver state pensions**. A number of different models exist, and there is unlikely to be one country model that can be slotted in to reform the UK's state pension system. The UK reform should learn from other countries, but the lessons should be clearly directed towards the current objectives of UK pension reform.

<sup>57</sup> Relevant data points and PPI analysis available on request

**UK state pensions: more complex, less generous, over-compensating for ageing**

Chapter 2 compared the UK's state pension system to a minimum standard and identified current pressure points. Comparing the UK's state pension system with its peers confirms the significance of some of these pressure points, particularly the complexity of the system and the adequacy issues – now and in the future when there will be more pensioners.

*The UK has one of the most complex state pension system.* It is multi-conditional and targets pension benefits very tightly.

It has both a flat-rate and earnings-related state pension, the levels of which are dependent on having made, or been credited with, contributions throughout working life. There is also a two-part means-tested benefit, Pension Credit. More complexity is added as individuals and occupational schemes can contract out of the contributory earnings-related State Second Pension<sup>58</sup>.

*The components in the UK state system add up to one of the lowest levels of state pension income.* The complexity of the UK system means that the actual outcome falls short of the expected outcome. In comparing the level of benefits between countries, the previous section used two methods of calculation. On the first definition, the average earner reaching 65 in 2000/1 would be expected to have a total state pension of 35% of NAE. But the average single pensioner actually received 27% of NAE. There is a difference because the average pensioner has not been the hypothetical male average earner throughout a stable period of accruing pension rights.

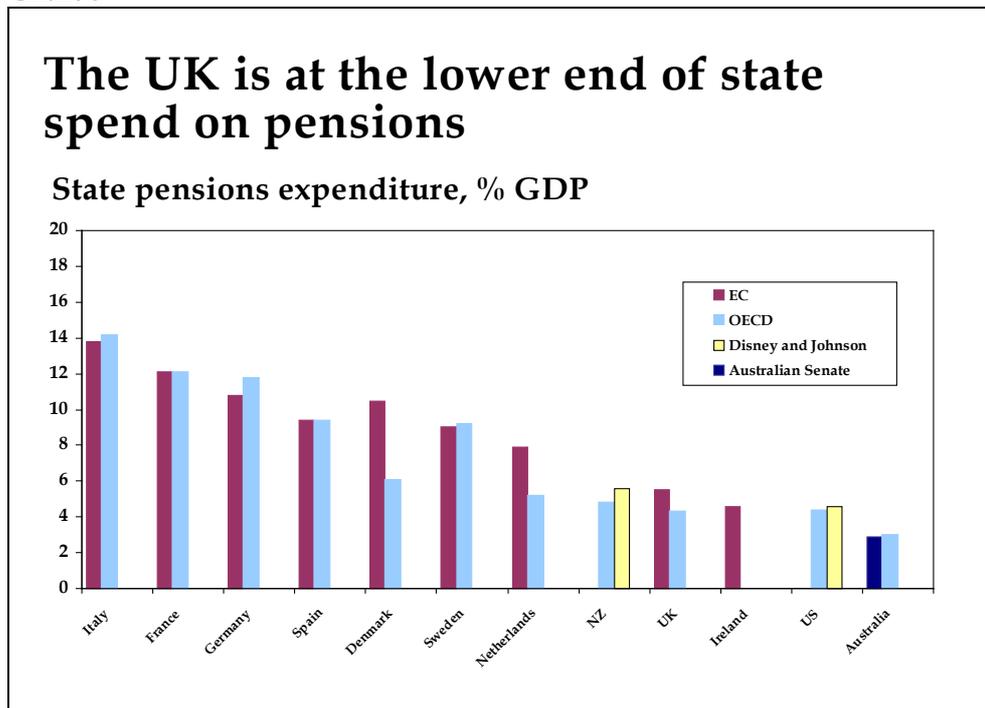
This shows the dangers of interpreting outcomes and developing policy on a theoretical basis. It also shows that the UK model of multiple eligibility criteria is particularly vulnerable to actual outcomes being lower than what could be achieved by the hypothetical person who fulfilled all the criteria. The outcome in countries with simple systems – for example, Australia and New Zealand – cannot be confused.

*The UK spends relatively less on state pensions than most other countries.* The cost of UK state pension benefits, including other means-tested supplements given to pensioners is around 5% of GDP, which puts it at the lower end of the range (Chart 5).

Note that this definition does not include other benefits paid to people of pension age for specific purposes. In the UK, these benefits, mostly Housing Benefit, Attendance Allowance, Disability Living Allowance and Council Tax Benefit add up to 1.2% GDP<sup>59</sup>. See also Chapter 4 for a discussion of the additional expenditure (or revenue foregone) related to private pensions.

<sup>58</sup> A more detailed description of the UK state pension system can be found in *The Pensions Primer* (PPI, 2003)

<sup>59</sup> PPI calculation from DWP benefit expenditure data for 2002/3

Chart 5<sup>60</sup>

As with many cross-country comparisons, there are a number of different sources for state pension spend as a percentage of GDP, not all using precisely the same definition. In broad terms, the comparison of spend and outcome can be summarised (Table 4):

**Table 4: Number of people over 65 as % of the total population, outcome in terms of average state pension as % of National Average Earnings (NAE) and approximated % of GDP currently spent on state pensions<sup>61</sup>**

Country	Number of people over 65 as % total	Average outcome as % NAE	Spend as % GDP
Australia	12%	25%	Up to 5% GDP
Ireland	11%	25-35%	
New Zealand	12%		
<b>UK</b>	<b>16%</b>		
US	13%	40%	5-10% GDP
Netherlands, Denmark	14%-15%	45%-50%	
Sweden	17%	50%	
Spain	17%	65%	
Germany, France, Italy	16-18%	70-75%	

<sup>60</sup> EC (2003), OECD (2002), Disney and Johnson (2001), FACS (2002): Figures are not directly comparable as different years and definitions apply. EC (2003) figures refer to the percentage of GDP spent on 'public pensions' in 2000. Public pensions may refer to all public revenues for older persons and not only to 'old age pensions'. OECD (2002) figures refer to the percentage of GDP spent on 'old-age pensions' in 2000. Australian Senate figures refer specifically to the Age and Service Pension in 2001/02. Figures for the US and NZ refer to 'public pension spending' as a percentage of GDP in 1996 and 1995 respectively.

<sup>61</sup> PPI analysis; demographic numbers from [www.ined.fr](http://www.ined.fr)

In broad terms therefore, the UK spends one of the lowest amounts on state pensions. But it also has a high proportion of people over 65, compared with its low-spending peers. The outcome is a low average level of state pension in the UK.

*The adequacy of UK state pensions is set to get worse not better*, as a result of the chosen response to longevity improvements. Over the next 50 years, all countries analysed are ageing, which means that, with no policy change, there will be more people receiving pensions for longer. These trends have provoked a variety of policy responses. These different responses will lead to different increases in the level of state pensions spend in future (Table 5).

**Table 5: Pension policy responses to the ageing trend<sup>62</sup>**

<b>The increasing number of pensioners is:</b>	<b>Effect on GDP</b>	<b>Countries</b>
<b>Mostly allowed to flow through</b> to an increased cost with minimal adjustments	Substantial increase in % GDP (>3 percentage points)	France Germany Netherlands New Zealand Spain
<b>Mitigated</b> by reducing the level of pension benefit per pensioner	Small increase in % GDP (0-3pp)	Denmark Sweden
<b>Mitigated</b> by reducing the level of pension benefit per pensioner and tightening eligibility criteria for pension	Small increase in % GDP (0-3pp)	US Australia
<b>Over-compensated for</b> by reducing the level of pension benefit per pensioner	Small reduction in % GDP (<1pp)	UK
<b>Over-compensated for</b> by reducing the level of pension benefit per pensioner and tightening eligibility criteria for pension	Small reduction in % GDP (<1pp)	Italy

The UK is planning a decrease in spend on state pensions over the next 50 years<sup>63</sup>. Italy is also doing so, but Italy starts from an average state pension income that is around double that of the UK's in earnings terms, and even in 2050, after cutbacks, plans to spend nearly 3 times as much as the UK as a percentage of GDP.

<sup>62</sup> PPI analysis based on OECD (2002)

<sup>63</sup> On this OECD basis, which was calculated before the introduction of Pension Credit, the decrease in the UK's spend is 0.7% GDP over 50 years. In the latest DWP projections, including Pension Credit, the decrease is 0.2% of GDP. See *The Pensions Landscape*, pp. 57-60.

This comparison shows that the adequacy issues with the UK state pension are set to worsen. Other countries allow the ageing effect to flow through at least partly so that state pension spend increases overall. The UK more than compensates for the ageing effect by reducing the value of state pension benefits per pensioner. Despite the better targeting that is intended, the reducing average spend is likely to be an increasing point of concern.

In summary, comparing the UK with its peers confirms some of the pressure points identified in Chapter 2 (which compared the UK against a generic state pensions framework). In particular, UK state pensions are more complex and less generous than those of other countries, and adequacy issues are set to worsen as the UK over-compensates for the demographic trends.

## Chapter 4: The interface of state and private pensions

In the World Bank framework, private pensions are the way to save for an income in retirement that maintains the individual's required standard of living. The emphasis for the role of the state pension is security; for private savings it is income replacement.

This chapter reviews the interface between state and private pensions, bringing out the critical points for the current UK situation. It concludes that private pensions and the state/private interface are particularly important in the UK. For most of those areas where reform is suggested, state pension reform is needed first.

### **Getting the state/private interface right is a critical issue for the UK**

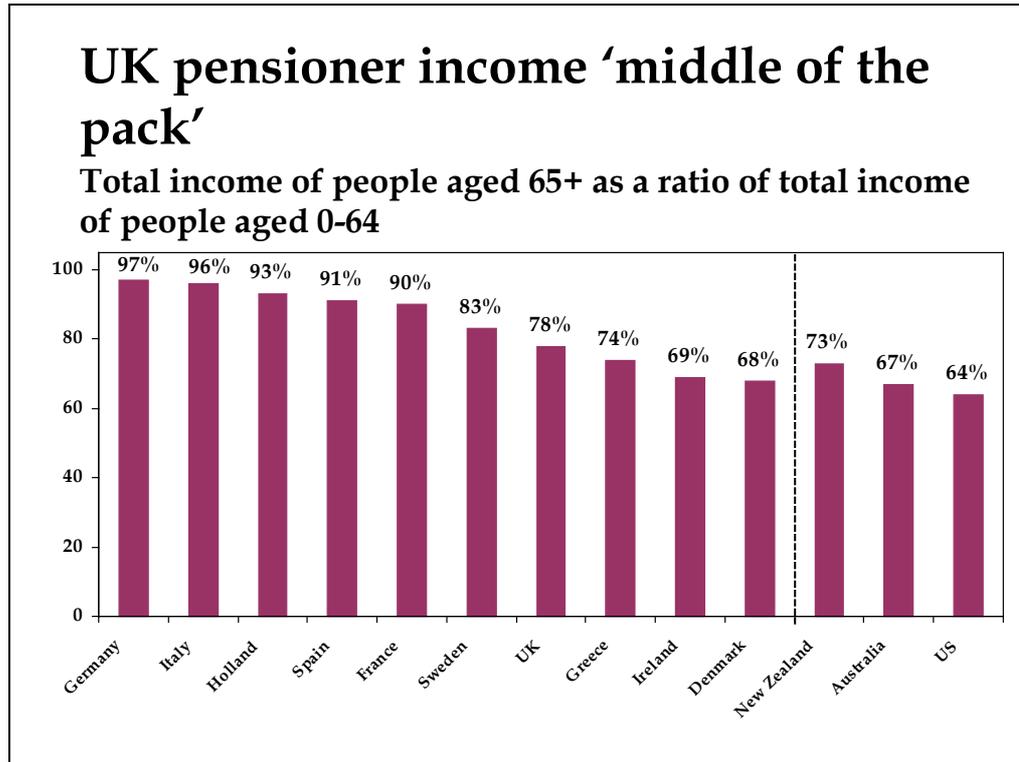
The UK's private pension market is an important source of income for many people, and is a major part of pensions policy. The future state spend on pensions may be too low unless the private pensions market grows faster. But there is no off the shelf solution.

### *The state/private interface is particularly important in the UK*

The UK has an extensive private pensions market, comprising occupational schemes and individual personal pensions. For current pensioners, 57% of pension income comes from state pension-related benefits and 43% from private pensions and other savings<sup>64</sup>.

Private pensions lift the average pensioner income so that the total average pensioner income in the UK looks more favourable compared with that in other countries than the comparison of average state pensioner income. But it is not enough to put the UK's pensioner income into the highest league. The total average pensioner income in the UK is at best middle of the pack (Chart 6).

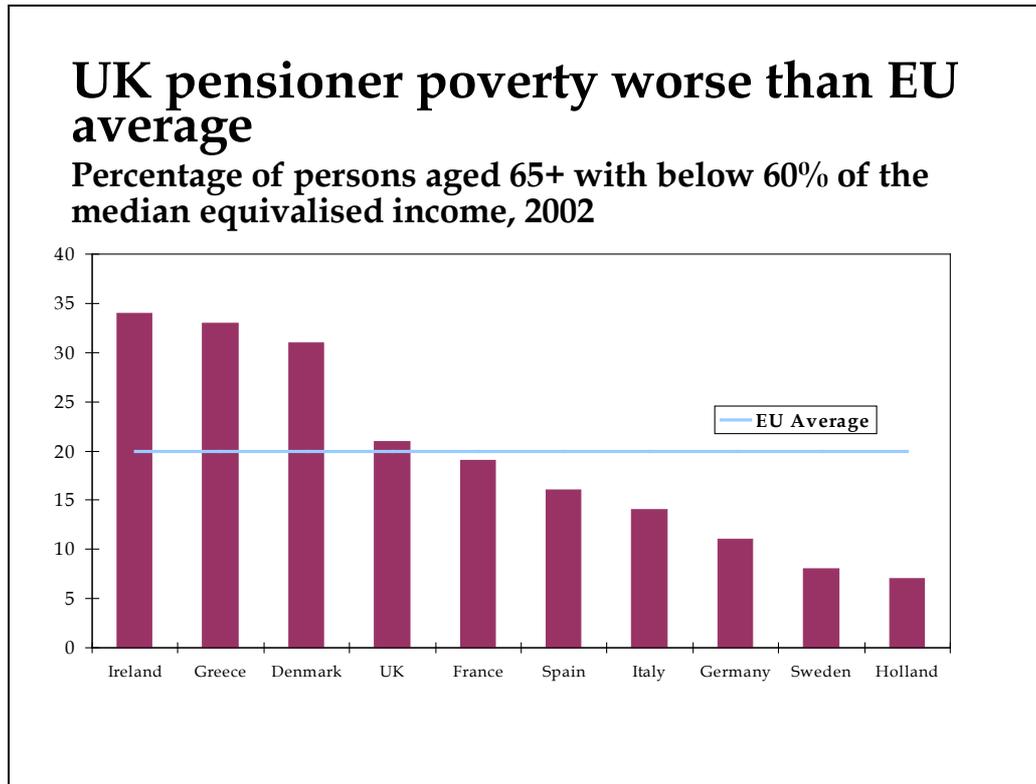
<sup>64</sup> Calculated from DWP (2003 PIS)

Chart 6<sup>65</sup>

Taking all income into account, there is a higher risk of being in poverty at ages 65 and over in the UK, compared to other EU countries (Chart 7).

<sup>65</sup> EC (2003), Disney and Johnson (2001) (NZ), FACS (2002) (AUS), US Census Bureau (2001). European figures refer to income (equivalised disposable income) of people aged 65+ as a ratio of income of people aged 0-64 (2002). New Zealand figure refers to a Superannuitant's income as a ratio of the average equivalent income for all households (1995-96). Australian figure refers to Superannuation Guarantee (SG) and Age Pension (AP) after 30 years of contributions for a single male as a ratio of the Adult Weekly Ordinary Time Earnings. The denominator for the US is age 15-64.

Chart 7<sup>66</sup>



*Private pensions are a major part of state pensions policy.* The state is an important source of funding for private pensions. Over a third of contributions into private pensions (personal and occupational) come from the state, through tax relief and NI contracted-out rebates<sup>67</sup>.

Each year the state incurs an ‘economic cost’ (or foregoes revenue) by paying contracted-out rebates and giving tax relief to private pensions (Table 6).

**Table 6: UK indirect state expenditure as % GDP<sup>68</sup>**

	2000/1	2001/2
Contracting-out rebates	1.0%	1.0%
Tax relief on contributions to private pensions	1.6%	1.6%
Tax relief on investment income in pension funds	0.4%	0.3%
Tax relief on lump sum pension benefits	<0.1%	<0.1%
Higher tax allowances for pensioners	0.2%	0.1%
Less tax liable on private pensions in payment	(0.7%)	(0.7%)

<sup>66</sup> EU (2003) This rate shows the percentage of persons with an equivalised income below the defined ‘at risk of poverty threshold’. In this case those whose income falls below 60% of the median equivalised income. (Eurostat methodological note p1-5).

<sup>67</sup> PPI estimate for 2001/2 from IR (2003) Tax expenditure and ready reckoners table 1.5, Pensions and tax-free savings and investments table 7.9 and ONS (2002 MQ5)

<sup>68</sup> PPI estimate based on IR (2003) Tax expenditure and ready reckoners table 1.5, Pensions and tax-free savings and investments table 7.9

Each year, the 'economic cost' to the state of contracted-out rebates is around 1% of GDP. This would be expected over time to be equivalent to the 'saving' from not paying state second pension to contracted-out individuals.

Tax relief on pension contributions, on investment returns in pension funds, on lump-sum benefits, and in granting higher tax allowances for pensioners adds around 2% GDP to the 'cost' to the state<sup>69</sup>, mostly in the first two items. The state is expected to benefit in future from spending on these items now by receiving tax paid on future pension income. The current tax take from private pensions in payment is 0.7% GDP.

Therefore, the total current net annual 'economic cost' to the state in relation to private pensions is around 2.5% GDP, half of the headline 5% GDP figure spent on state pensions. The future of this 'cost' is not known. There could be an increased tax take from private pensions in payment over time, as more pensioners have more private income. But the amount of relief on private pension contributions and funds may also increase if current policy is successful in encouraging people to save more in the private market.

Conversely, if the policy is not successful, there will be higher state costs for means-tested benefits in future. It is recognised that the cost of future state pensions provision is dependent to a large extent on the success of the private market:

*Financial sustainability [of the UK pension system] appears to be well under control, but depends to a larger extent than in other [European] countries on the performance of private pension providers. The [UK's] national strategy report does not allow to draw conclusions about the financial sustainability of these private schemes. If private provision produces significantly less than the anticipated coverage or level of pensions, future governments may face increased claims of means-tested benefits. Summary on the UK, Economic Policy and Social Protection Committees<sup>70</sup>*

The point being made here is that, if private pensions and other savings do not grow as assumed in the forecast of future state spend on pensions, then the amount needed to be spent on means-tested benefits in future will be higher than expected.

In the Treasury/DWP forecast of a roughly level 5% of GDP to be spent on state pensions and other benefits over the next 40 years, the base-case assumption is that income from private savings grows in line with earnings<sup>71</sup>. There are no obvious signs that future growth is likely at this rate<sup>72</sup>. If this continues to be the case, then the 5% GDP forecast is unrealistically low.

<sup>69</sup> Not accounted for as a cost but as revenue foregone

<sup>70</sup> EC (2003)

<sup>71</sup> DWP (2002 GP) p. 149

<sup>72</sup> See Chart 24, *The Pensions Landscape*, p. 37 and subsequent analysis

The cost in 2050 of Pension Credit could be 2 percentage points of GDP higher if the income brought into account for the PC calculation increased in line with prices compared with the base-case of that income growing in line with earnings<sup>73</sup>.

***Private pension systems in other countries do not offer a solution off the shelf.***

The UK is unusual in the scale and variety of private pension vehicles, and in the ability to contract-out of part of state provision into private provision. As with state pension systems, very different approaches are taken in other countries.

For example:

- **Australia** has an affluence-tested state pension at a level just below the average UK state pension. Unlike in the UK, private saving through employers is compulsory in Australia. However, as the accumulated savings do not have to be taken as an income (they can be spent as a lump sum), the end result is not always higher income in retirement.
- The **Netherlands** has a higher state pension than the UK, and a significant occupational sector. Most employees are in mandatory schemes, which aim to top up state income to provide a total of 70% of last earned salary.
- **New Zealand** provides a universal state pension at around the same level as the Netherlands, but provides no tax incentives for private pensions. There is therefore very little regulation on pension schemes - there is no need to ensure pension income is taxed, to cap pension contributions or to prevent any pension money being taken as cash (every pensioner is above the means-tested limit by virtue of the residency-based state pension). Fewer than 20% of employees are in occupational schemes.

Therefore, while getting the state/private interface right is a critical issue for the UK, there is no obvious off the shelf solution available from other countries.

**Reform of most issues in UK private pensions needs to follow state pension reform**

The focus of current policy is to encourage people to save more in the private market, as well as work (and save) for longer<sup>74</sup>. Despite the many reforms proposed for the private pensions market, many pressure points remain including: insufficient private saving, the complexity of private provision, and the extent of regulation. These issues are either integral to state pension reform or cannot be solved until the issues in state pensions are resolved.

***Sufficiency of private pensions is a current concern, which does depend on state pension policy.*** Private saving is, at best, flat relative to earnings – at a time when contributions should be increasing to allow for greater longevity and falling investment returns. Alternatives are not obviously filling the gap.

<sup>73</sup> PQs David Willetts MP, Lynne Jones MP 3 June 2003, House of Commons Hansard Col 390 W. Base case cost of PC in 2050 is 1.45% GDP.

<sup>74</sup> DWP (2002 GP)

Private pension income in the UK is heavily weighted to the top end of the income distribution – it makes the difference between rich and poor pensioners<sup>75</sup>. Although the number of pensioners with private income is still increasing, there is still likely to be a sizeable gap between rich and poor pensioners.

As noted in Chapter 2, the current state pension system provides a reasonable replacement rate after age 65 for at least 7m people (and possibly some of the 9m in an uncertain situation). 18m are expected to be saving - or to take a significant cut in living standards or work after age 65<sup>76</sup>. Of these 18m, between 8 and 13m are not thought to be saving enough. They are likely to be the lowest earners in this category - higher earners tend to save more and more regularly.

Controversial issues in private pensions are

- Where in the income distribution should there be an expectation of private saving
- How to ensure the state system does not act as a barrier to saving, and
- How to put in the right incentives (or compulsion) for private saving.

Reform of the state pension system would help to clarify whether the state pension should be made more generous so that the income level at which private saving is 'expected' increases. The role of private pensions could then be clarified.

Put simply, if the state pension provides, say, a flat-rate 25% of National Average Earnings (NAE), the role of private pensions is different to what it would be if the state system offered 15% or 35%. In the current UK state pension system, the Basic State Pension offers 16% of NAE, which should be topped up to 22% of NAE through a means-tested benefit. SERPS/S2P will provide additional state pension giving the highest, most consistent earners a total state pension of 45% NAE. The role of private pension saving therefore depends on individual circumstances and cannot be simply explained.

Earnings level is used as an indicator of ability to save, but it has limitations. First, employer contributions enable private provision to build up even if an individual does not save personally. Second, people with the same earnings may have different costs and spending priorities and so different abilities and opportunities to save at different points in their working life. They will also have different personal objectives for their standard of living in retirement.

<sup>75</sup> See Chart 5 *The Pensions Landscape*, p. 13

<sup>76</sup> PPI analysis, broadly consistent with that in DWP (2002 GP) Annex 3

However, there is a sense that the current state pension system assumes private pension saving starts at an unrealistically low earnings level. The fear is that the saving that could be realistically achieved by someone earning around £15,000 a year would build up a fund sufficient only for an income that would match the means-tested benefits available without saving<sup>77</sup>. This means that people earning between, roughly, £10,000 and £15,000 are in a 'grey area' where the state system does not provide an acceptable replacement rate, but an affordable level of private saving may not always be worthwhile.

Other barriers to pension saving might be lack of understanding, interest or trust in private markets and/or a perception that other assets or the state will provide. Reform of the state system could make a difference to the last of these issues. Once individuals understand what the state is providing, they should be better able to plan private saving.

It may also be the case that tax incentives to save do not appear generous enough. However, as tax incentives are thought to operate on the choice of savings vehicle rather than the amount of total savings<sup>78</sup>, this argument may apply only to those with some money and inclination to save.

Tax relief on private pensions is intended to be largely tax deferral, not tax avoidance or advantage. But it is the case that state funding of private pensions, through tax relief and NI contracted rebates, disproportionately favours higher earners. Over half of the total cost of tax relief on pension contributions is received by the 10% of taxpayers (2.9m people) who pay the highest rate of income tax<sup>79</sup>.

Tax incentives (or relief) for pension saving could be considered in isolation. But setting the level, shape and cost of tax incentives to reflect the role private pensions are expected to fulfil would be better done if there were clearer objectives for the state pension system.

*Complexity of the state/private interface remains, even if simpler private pension products are introduced.* Recognising the complexity of private pensions, the government proposes a simpler tax regime and simpler products. There is no proof that simpler products would increase the motivations of people to buy pensions<sup>80</sup>. But it seems intuitive that, as simplification of the state system would help people to understand it, so simpler pensions may help to encourage private saving (for those who could save but do not because of not understanding the system). This reform could proceed regardless of any state pension reform, except for the caveat that over-regulation can have unintended consequences (see later).

<sup>77</sup> Axa Sun Life submission to House of Commons Work and Pensions Select Committee (2003)

<sup>78</sup> Sandler (2002) pp. 147-151.

<sup>79</sup> 57% in 2001/02, from IR (2003) Income tax and personal income tables 2.1, 3.4 and 3.6

<sup>80</sup> For example, see the response to the DWP Green Paper by the ESRC/SAGE Research Group at LSE, Evandrou et al (2003)

The complexity of contracting-out has increased. Different financial institutions now take different points of view as to whether contracting-out of the State Second Pension is appropriate. There are reports of schemes contracting back in to the state system and new schemes are not contracting out. The situation is now very different from the initial intention which was that it should be a straightforward decision to contract-out, without having to reconsider frequently. This is not just a matter of the right level of rebate, but that the number of parameters in the rebate formula has increased since the introduction of State Second Pension<sup>81</sup>. Reform of contracting-out is clearly integral to reform of the state pension system.

*The appropriate extent of regulation in the private pension market depends on the nature of the state pension system.* The UK private pension market is highly regulated on a number of parameters, including product design and charging, the selling process, contribution limits, occupational scheme rules and benefits amounts. Legislation can have consequences that turn out to be much less positive than intended. For example:

- The cost of providing Defined Benefit (DB) occupational pension schemes has increased because legislation has mandated improvements to the benefit structure, such as revaluation of deferred benefits, indexation in retirement and spouses' pensions. The additional cost, more significant over the last decade than increasing costs from improving longevity and falling investment returns, has led many employers to close or cut back their DB schemes<sup>82</sup>.
- 90% of the stakeholder schemes required to be set up in 2001 by every employer of 5 or more employees remain empty of contributions<sup>83</sup>.
- Giving pensioners first call on the DB schemes that are winding-up (as in the Pensions Act 1995 Section 73) was not intended to cause the hardship it has done for those particularly near retirement who have lost a large proportion of expected pension on the insolvency of the sponsoring company.

More regulation can conflict with free market principles of a private saving industry. But, the more private pensions are expected to replace state pension income, the argument for tighter regulation becomes stronger. Therefore, the appropriate future role of state pensions should be secured and considered before major regulatory or legislative changes in the private market.

<sup>81</sup> See *The Pensions Primer* pp. 36-40

<sup>82</sup> See Mercer's response to the DWP 2002 Green Paper, Appendix A

<sup>83</sup> ABI (2002)

The December 2002 Green Paper ruled out any reform of the state pension system. But, many responses specifically inserted comments that **reform of the state system is necessary in order for reform of the private system to work**. For example:

*Changes to the private and occupational sectors cannot be considered in isolation of state provision – Age Concern and the Fawcett Society*

*A successful private pension system can only be built on the foundations of a robust and durable state pension framework – Association of British Insurers*

*Reform of the State scheme is vital in convincing employers to continue to support private provision – Association of Consulting Actuaries*

*The state needs to develop a robust system.... [which] would then form the firm foundation on which people could build additional pension options – Equal Opportunities Commission*

*There still appears to be a lack of recognition of the inextricable link between State provision and private provision – Friends Provident*

*It is not sufficient that private products are simplified if the interface between state and private provision remains confusing – Mercer*

*It is important the Government recognises the interdependence of state pensions and private pensions – Standard Life*

The point was echoed by the House of Commons Work and Pensions Select Committee (April 2003):

*In considering the future of UK pensions, we found that much of the evidence led us to conclude that a successful system of private pension provision needed the sound foundation of a sustainable system of state pensions.*

## Chapter 5: Summary of issues and reform tests

This chapter brings together the strands of earlier chapters to propose for further debate a summary of the critical issues at stake in UK pensions and tests to apply to proposed models for a new state pension system.

The analysis in this paper confirms the case for reform by comparing the UK system to a minimum objective standard and to state pension systems in other countries, and by considering how state pensions are interacting with private pensions. A review of UK state pensions is needed because there are serious pressure points in the current system.

### Summary of current pressure points in the UK state pension system

1. The UK has an uncomfortably high number of pensioners in poverty.
2. With no change, UK state pensions will become less adequate.
3. The UK currently spends less than most other countries on state pensions.
4. The forecast of future UK spend on state pensions is likely to prove unrealistically low and socially unacceptable.
5. The UK state pension system has become separated from the significantly improved capacity for longer working lives.
6. The UK state pension system works particularly badly for some groups, especially women.
7. The complexity of the UK state pension system makes it harder than it need be for people to understand what they are likely to receive from the state during later life.
8. The combination of low price-indexed state pensions and extensive means-tested benefits means that the UK state pension system disadvantages people as they grow old.
9. Private pensions are not filling the gap left by low state pensions, and many of the causes of this can only be resolved once state pensions have been reformed.

A major programme of work is required to move state pensions policy forward in the most positive way. A clear sense of where the reform is heading (the long-term objective) needs to be balanced with ideas for how to get there (the transition practicalities). There are no 'off the shelf' solutions available from other countries.

The PPI proposes these questions by which possible models for state pension reform should be tested. It is unlikely that any solution will score a clear 'yes' on all tests. Choosing future pension policy is about making tradeoffs to find the best balanced solution.

#### **Tests for a reformed state pension system**

1. Is the reformed policy capable of being sustained for at least 30 years, and preferably 40 years?
2. How would the number of pensioners at risk of poverty in the UK change? How would pensioner poverty compare with that in other countries and with that in other age groups in the UK?
3. How much would the total 'economic cost' to the state – including state pension benefits, contracting-out rebates and tax relief – be in the short term?
4. By how much would the total 'economic cost' to the state increase in the long term?
5. Does the reformed UK state pension system recognise past and likely future improvements in health and longevity and is it flexible for different working arrangements and retirement choices?
6. Is the reformed UK state pension system fair to all groups?
7. Is the reformed UK state pension system simple? Does it help people to understand what income they will receive from the state during later life?
8. Does access to the reformed UK state pension system become easier (or at least not harder) for people as they grow old?
9. Does the reformed UK state pension system enable individuals to meet their personal objectives for additional retirement income through occupational and personal private pensions?

## Commentary on the proposed tests

1. **Sustainable.** The long-term sustainability of the reform is important – to be financially sustainable and to be socially acceptable given the increasing number of longer-living pensioners. Long-term financial projections are unlikely to turn out to be exactly accurate, but at least 40 years' worth is necessary to understand the long-term trends.

Political sustainability is much sought after in pensions so that changes over a lifetime are minimised. A reform model that has been properly analysed and tested against others in an open debate should have more chance of political sustainability.

2. **Pensioner poverty.** Given concerns over the adequacy of the current state pension system, the relative position of total average pensioner income in the UK compared to other countries, and the prospects for private pensions, testing a reform model for the possible reduction in pensioner poverty seems appropriate. Currently, the UK has an average proportion of pensioners at risk of poverty compared to EU countries and a higher proportion of pensioners at risk of poverty than people of working age.

An alternative test could be defined in terms of a minimum state pension amount. Many other statements of objectives for state pensions refer, for example, to a 'subsistence amount'. But the proposed test is in terms of outcome rather than benefit design, so it retains flexibility in possible pension designs, for example different amounts for different pensioner groups. There is much debate about the appropriate definition of poverty level. A number of different established measures should be used, as well as research on actual incomes compared to incomes thought to be needed.

3. **Economic cost to the state (in the current year).** The review should test options for increasing state spend, because the current focus on constraining the headline spend on state benefits to 5% GDP seems unrealistic. This is not to advocate raising the current level, but to test the cost/benefit tradeoffs in proposed models and compare with that in the current situation.

In calculating the total cost of any system it is appropriate to include the 'cost' of state support of private pension saving as well as the spend on state benefits. Spend on contracted-out rebates implies lower spend on state benefits later, so to be consistent, the full cost/saving from contracting-out should be included in all years. Tax relief is not a strict cost, but is still a significant amount of revenue foregone in any one year, net of deferred tax paid. Comparison with other countries could be misleading unless full account is taken of all pension-related economic cost to the state.

For brevity, the phrase *total economic cost* is used for the more correct phrasing: *the cost in the latest year of available figures of paying state benefits, plus expenditure on contracting-out rebates, plus revenue foregone from tax relief in support of private pension saving, net of tax received from private pension income*. It is recognised that these are different types of 'cost' item.

Currently, the total economic cost to the state on pensions (so far as can be estimated on the definition proposed) is around 7.5% GDP. To illustrate a potential upper limit, 8% GDP would be sufficient to bring the UK more in line with more countries in the OECD, although not the highest spending countries such as Italy, France and Germany. A further 0.5% GDP could make a difference. For example, 0.2% GDP would be enough to take over-80s off means-tested benefits<sup>84</sup>.

For further context, 0.5% GDP is 10% of the budget for the NHS, or 25% of the education budget<sup>85</sup>, so spending this much extra on pensions may be pushing at the edges of the politically likely. More work would clearly be needed to identify an appropriate upper limit for pensions spend.

Note also that this definition does not include the cost of other specific benefits currently paid to pensioners, mostly Housing Benefit, Attendance Allowance, Disability Living Allowance and Council Tax Benefit which add up to 1.2% GDP. Any state pension reform is likely to have consequences for these benefits and additional costs, or savings, should be taken into account.

4. **Cost over time.** It is likely that the spend will need to increase over time, because of the increasing number of longer-living pensioners. The review should test this. It is not clear from current data what the future total economic cost to the state of pensions would be on current policy, as for example, the cost of tax relief is not projected forwards.
5. **Work and retirement.** State pension policy has not yet reflected significant improvements in total and healthy life expectancy, nor does it adequately recognise forecast future improvements. There is a risk that the money available for state pensions favours healthy younger pensioners at the expense of older pensioners in poor health.

At the same time, flexible working arrangements and retirement choices are important elements of current government policy. State pensions are already flexible and this flexibility should not be lost.

<sup>84</sup> House of Commons Public Accounts Select Committee (2003)

<sup>85</sup> HM Treasury (2003)

6. **Fairness.** Much of pension poverty derives from the strong link between labour market experience and level of state pension, and the imperfect compensation for people who do not have the 'ideal' work history. Women, the majority of pensioners, are very likely to be affected by this currently. It seems appropriate to explore ways to reduce the impact of that link, or remove it altogether. A proposed reform model should also be tested to see whether other unreasonable outcomes are likely for any particular group.
7. **Simple and understandable.** The complexity of the UK system has an administration cost. Also, recognising that there is a political risk in all state systems so that future state benefits can never be fully guaranteed, it must be desirable that the system helps people to understand what the state is likely to provide. But the current UK state pension system prevents people ever being able to see the full picture of what they are likely to get from the state in future, even with full information. This cannot help in encouraging people to save. The ease with which the benefits of a reformed state pension system can be understood is therefore an important test. This is not to argue for the simplest possible system. Some complexity may be desirable to make a system fairer, for example credits for carers in a contributory system.
8. **Access to benefits as people grow old.** The current structure makes it harder for people to obtain benefits the older they get, as they are more likely to need to claim means-tested benefits as they age. This seems an anomaly, and improvement on this outcome should be tested. The security of income provided by the state should at least stay the same as an individual ages, not reduce.
9. **Private pension market.** The state system will never provide a satisfactory pension for everyone, so it is important to encourage the provision of good private pension arrangements. But private pension saving appears to be stalling at a time when it should be increasing.

Some critical private pension issues are integral to state pensions reform. These include the level at which private saving is 'expected' to top-up state pensions; ensuring that state pensions are not a barrier to save; providing appropriate incentives to save; and clarifying the future of contracting-out. Other current issues, such as complexity of private pensions and regulation of the private market, should be considered, but need a reform of state pensions to be secured before taking full effect.

The state policy review should clarify the role of private pensions and make it possible for people to plan with some certainty for their own retirement choices, so far as they – and their employers – can afford.

## Chapter 6: Reform models for the UK

This chapter suggests that there are five possible reform models worth focusing on and sets up the critical issues for further analysis on each.

### Proposals seek to move the UK to be more like other countries

Recent proposals for reform of the UK state pension system attempt to simplify it and make it more adequate: by better coverage, higher benefit levels and so less means-testing. That the proposed reforms seek to make the UK state pension system more universal and more generous reflects that all want to reverse the likely future trend if there were no intervention.

The proposals fall into three broad types (Table 7):

- The Institute for Public Policy Research (IPPR) and others propose simplifying the current system by abolishing one component (the earnings-related contributory State Second Pension) and raising the level of the other (the flat-rate contributory Basic State Pension). The Pension Reform Group (PRG) proposes a variation of this type where part of the benefit is funded and part remains PAYG.
- The National Association of Pension Funds (NAPF) suggests a residency-based flat-rate pension, similar to the models of New Zealand or the Netherlands.
- The Association of British Insurers (ABI) propose maintaining the State Second Pension, but enhance it and make it flat-rate.

**Table 7: UK state pension reform models from various organisations<sup>86</sup>**

Methods	Current UK	ABI	Help the Aged	IPPR	Mercer	NAPF	PRG	TUC
Universal flat-rate PAYG pension						*		
Universal flat-rate funded pension								
Affluence-tested flat-rate PAYG pension								
Means-tested flat rate PAYG pension	*	*	*	*	*	*	*	*
Contributory flat-rate PAYG pension	*	*	*	*	*		*	*
Contributory flat-rate funded pension							*	
Contributory earnings-related PAYG pension	*							*
Contributory earnings-related funded pension								

<sup>86</sup> See *State Pension Models*, published by the PPI for more detail on each proposal, and sources

Any of these proposals could be implemented by keeping the 5% GDP spent on state pensions, and mitigating the increased costs by, for example raising the state pension age. The IPPR model suggested the SPA rise to 67 by 2030, NAPF suggested age 70 by 2030 and PRG age 70 for all new entrants to the scheme from age 25.

It would obviously be feasible to implement such reform models without raising SPA – this is just one of the tradeoffs to be explored.

As with the models in other countries, the proposals vary in the detail. None of the proposals have been fully costed. Even if some costings have been attempted, the distributional impact has not been fully estimated (that is, how the reforms would benefit richer pensioners as compared to poorer pensioners). The practical details of transition have generally not been examined.

Therefore an off the shelf solution does not currently exist for the UK. There is no alternative but working out a programme of analysis to determine the best future state pension system, given our starting point and objectives.

#### **Proposed reform models for further analysis**

The following are the five reform models proposed as worth further review.

##### **State pension reform models to be tested in the PPI review**

1. **Status quo:** A multi-component system with extensive means-testing. The current system with minor changes should be compared with other possible reform models.
2. **Reform S2P:** Make the State Second Pension flat-rate and/or increase accruals to it for lower earners. This would keep the overall system structure, but increase redistribution to the poorest during their period of working age.
3. **Much higher BSP, scrap S2P:** Keep the contributory link and the structure of the Basic State Pension, but at a much higher rate, so that there is less means-testing. Stop accruals to the State Second Pension, so that the system is simplified to one main component.
4. **Citizen's Pension:** As the previous option, but instead of eligibility being built up by contributions during working life, eligibility is based on citizenship or residency criteria. This would be particularly beneficial to women, and others who spend time out of the labour market, or working at low levels of earnings.
5. **Age additions:** Increase Basic State Pension to the means-tested level (Model 3 or 4 above) but only for the oldest pensioners, say, age 80 and over. This reflects that people get poorer as they get older.

For each model, further options should be considered:

- A. Increase the economic cost to the state of pensions, and/or allocate costs differently by:
  - a) Changing state pension age
  - b) Raising tax or National Insurance contributions
  - c) Reshaping tax incentives (or relief) to the private market
- B. Link, or part-link, the pension to GDP, or to earnings rather than to prices (where the method of linking is not defined in the model).
- C. Streamline the means-testing process by affluence-testing instead, where state pension is withheld from the richest through the tax system instead of the poorest having to claim additional benefit.
- D. Introduce some element of funding, in order for the state system to benefit from long-term investment returns, and with the potential for clearer personal 'ownership rights'.

#### **Commentary on each of the five models, including the four options**

1. **Status quo.** Keeping the current system has the merit of avoiding transition difficulties. With an increase in the level of benefit, adequacy issues would improve. Alterations to eligibility rules could improve the compensation system of credits<sup>87</sup>. But the current system sets up a conflict between minimising poverty and maximising reward for saving, favouring the former. It is not clear that additional spend on the current system would resolve this conflict any better way. Further, the complexity of the system would remain.

No organisation has actively promoted the status quo. The House of Commons Work and Pensions Select Committee considered it as one of their two alternatives, but recommended that ways to reduce the disincentive to save from increased means-testing be investigated, in particular by replacing means-testing with affluence-testing (Option C).

The TUC supports the status quo provided that the Basic State Pension is indexed to earnings and employers are compelled to contribute to an occupational scheme. Increasing the BSP to the level it would be if it had been indexed to earnings from 1998 would cost £3.5bn in 2004 (0.3% GDP) with an increasing cost thereafter<sup>88</sup>.

<sup>87</sup> See for example the response to the DWP 2002 Green Paper from Age Concern and the Fawcett Society

<sup>88</sup> HM Treasury (2003)

Encouraging take-up of means-tested benefits would have to remain as a key part of the current system, but it may be that there will always be pensioners who do not take up their entitlement. There are additional administration costs in means-testing. State pension benefits cost £5.40 per case to deliver, compared with £53.70 for means-tested benefits including Minimum Income Guarantee<sup>89</sup>.

2. **Reform S2P:** Make the State Second Pension flat-rate and/or increase accruals to it for lower earners. This would keep the overall system structure, but increase redistribution to the poorest during their period of working age. Transition would not be difficult, probably involving a phasing-out of the Savings Credit part of Pension Credit as S2P is enhanced over a number of years.

Complexity will remain. The complexity of the system would be reduced by less means-testing, but there would still be two state pensions. If S2P becomes flat-rate (it is assumed to do so by the ABI which supports this model, although the government's suggestion that it will do so has not been confirmed), then there would be different rules on how contributions build up accrual to benefits in the two pensions BSP and S2P. And, contracting-out could remain for S2P (and is expected to be made more generous under the ABI's proposals).

3. **Much higher BSP, scrap S2P:** Keep the contributory link and the structure of the Basic State Pension, but at a much higher rate, so that the extent of means-testing is reduced. Stop accruals to the State Second Pension, so that the system is simplified to one main component.

This is consistent with the proposals from IPPR, the Pension Reform Group (PRG), Mercer and Help the Aged. It was the second alternative considered by the House of Commons Work and Pensions Select Committee. By raising the contributory pension to the means-tested level, the conflict present in the current system between minimising poverty and maximising rewards for saving is dampened.

Raising the level of BSP to the means-testing limit (that is the level of the current Minimum Income Guarantee) is estimated to cost 0.5% of GDP, without making any other changes<sup>90</sup>. If the BSP were then earnings-linked, which would be logically required in order to keep it clear of the means-testing limit, costs would increase fast. Raising state pension age could mitigate the costs as could reshaping tax incentives (or relief) to the private market. In addition, contracting-out rebates would no longer be needed.

<sup>89</sup> House of Commons Public Accounts Select Committee (2003)

<sup>90</sup> House of Commons Work and Pensions Select Committee (2003) p.52

The Pension Reform Group proposed a variant that partly mitigated the costs by investing contributions in a pooled fund, selected to increase overall returns. This is consistent with recognising that the choice between pay-as-you-go and funding is of secondary importance compared to the overall objective and design of state pension schemes, but investment in growing economies can increase returns and smooth the trend of contributions needed<sup>91</sup>. Norway and New Zealand introduced an element of funding for these reasons. The PRG version also allows for individual 'accounts' to be designated, potentially improving ownership rights.

A concern with Model 3 could be that the increased costs would not be well targeted; that people with private income who do not 'need' a higher state pension would still receive it. But this is only true during a transition period when SERPS/S2P accruals are still being paid. A more important concern is that people without full contribution records would not see any benefit and would still need means-tested benefits. The link to the labour market is maintained so people taking career breaks, mostly women, would still lose out.

4. **Citizen's Pension:** As the previous Model 3, but instead of eligibility being built up by contributions during working life, eligibility is based on citizenship or residency criteria. This would be particularly beneficial to women, and others who spend time out of the labour market, or working at low levels of earnings.

Such a system is proposed by NAPF. The pension is kept as a constant percentage of NAE each year so that it stays equivalent to the means-testing limit. So that state expenditure and National Insurance contribution rates are broadly unchanged (allowing for the abolition of contracting-out rebates), the proposal raises SPA to 70 by 2030.

This model is clearly the simplest. It would be much easier for an individual to know what the state will provide in future, compared to the current system. It should also be very cheap to administer. It removes conflict between minimising poverty and maximising reward for saving.

The concern is that in order to afford the better benefit and coverage, there has to be a difficult tradeoff, in SPA and/or contracting out rebates as proposed by the NAPF, in higher taxes or in lower tax incentives for private pensions, in the New Zealand model.

<sup>91</sup> Barr, in IMF (2002) and IMF (2000)

5. **Age additions:** Increase BSP to the means-tested level (Model 3 or 4) but only for the oldest pensioners, say, age 80 and over. This model has been proposed instead of increasing means-testing in order to simplify the system and to reflect the likelihood that people get poorer as they get older<sup>92</sup>.

It may be thought that this model would be less accurately targeted than the current system, as it would give extra money to those over 80s who have higher income. But in fact, targeting by age is a very good proxy and can improve redistribution significantly<sup>93</sup>. It is also a cheap system, and is consistent with the role of state pensions being to protect the oldest.

This option would cost around 0.2% of GDP (£2 billion) in the year in which it were implemented (costs would increase as the mean-tested limit increased with earnings)<sup>94</sup>. For the same cost, the BSP could be increased by £10 a week for all above SPA (£5 a week for the married women's rate) or the MIG could be increased by £8 a week for single and married pensioners<sup>95</sup>. But in the former case, increasing BSP only fully helps those with full contribution history and in the latter case it only helps if the benefit is taken up.

In both of these alternative cases, there would still be the increased likelihood of needing to claim mean-tested benefits with age. This model should guarantee that every 80 year old never has to go through a means-testing process, as all over 80s get some BSP whatever their contribution history<sup>96</sup>.

Comments are invited on whether these are an appropriate five models to test, the relative advantages and disadvantages, and what specific issues should be analysed.

<sup>92</sup> For examples see House of Commons Hansard Debates 25 March 2002 Col. 597

<sup>93</sup> Dash and Webb (1999)

<sup>94</sup> House of Commons Public Accounts Select Committee (2003) Appendix 1

<sup>95</sup> House of Commons Work and Pensions Select Committee (2003) p.48

<sup>96</sup> Although it is not clear exactly what the costing above assumes on this point

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