Will the Pensions Bill solve the problems of state pensions?

PPI Briefing Note Number 36

Introduction
The Pensions Bill currently being scrutinised in Parliament aims *to put in place a state pension system that is fit for the 21st century.*[1]

Previous PPI research brought together over 80 pensions experts from over 40 organisations to build up a picture of the possible shape of a consensus pensions solution that could work for the long term.[2]

The research found that there are four widely-accepted problems with the current pensions system:

- It generates unequal outcomes
- It is highly complex
- It is unsustainable
- It places too high expectations on private savings

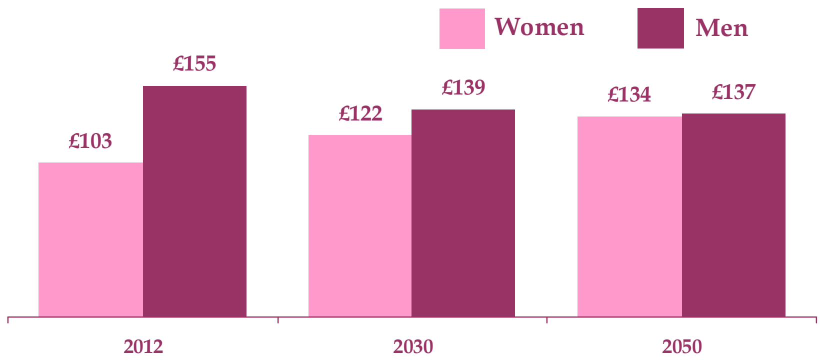
This Briefing Note examines how well the Bill, if introduced as proposed, would alleviate these four problems.

Unequal outcomes
The Government has recognised the need to increase state pension incomes for some groups who are currently disadvantaged in the system, particularly women and those with caring responsibilities.

The Bill would reduce the number of years required for a full Basic State Pension (BSP) from the current level (39 for women, 44 for men) to 30. The system of credits for carers would also be strengthened. The effect will be to increase the proportion of women who receive the full BSP.

Chart 1: Pension outcomes become more equal in future

Income from BSP and SERPS/S2P for median-earning men and women reaching SPA in different years under the proposed reforms (in £ per week, 2006/7 earnings terms)



The changes will apply for people who reach State Pension Age (SPA) after 6 April 2010. People already over SPA and those reaching SPA before 2010 would see no change in the proportion of the full BSP they receive as a result of the proposals.

Only 30% of women currently reaching SPA receive the full amount of BSP. In the absence of reform, this could grow to 50% by 2010 and to 80% by 2025. With reform, 70% of women reaching SPA in 2010 could receive the full amount, rising to 90% by 2025.[3]

The Bill would also require the BSP to be uprated with average earnings rather than prices, possibly from 2012 or from 2015 at the latest.[4] This would prevent the value of the BSP further eroding relative to average earnings.

State Second Pension (S2P) is an earnings-related pension, so that entitlements are higher for those who earn more. Men earn more than women on average, so men typically receive more from S2P.

S2P is gradually becoming flat-rate, so that outcomes no longer depend on earnings. The Bill would speed this process up, with S2P becoming flat-rate for benefits built up after 2030 rather than after 2050.

The overall package will mean that outcomes between men and women converge, although full convergence will take decades. For example, a median-earning man who reaches SPA in 2012 could have around £50 a week more in BSP and S2P combined than a median-earning woman (Chart 1)[5]. This reflects their earnings and also the woman stopping work to care for a child and working part-time.

PPI Briefing Notes clarify topical issues in pensions policy.

This difference would reduce to around £17 a week for those reaching SPA in 2030, and to around £3 a week for those reaching SPA in 2050.

These median-earning individuals qualify for S2P for most of their working life, either through working or credits. However, around 25% of working age people would not have qualified for S2P if the reforms had been in place in 2004/5.[6] Therefore, some people will receive less income from S2P at SPA than these individuals do.

Complexity

The state pension system has evolved over many years. Successive Governments have changed the rules and requirements, making it extremely complex. As a result, many people do not have a clear idea of how much state pension they can expect to receive.

The Bill would leave the pensions system very complex, although it would simplify some aspects.

Overall, there would still be two state pensions, private pensions and means-testing (Chart 2). A new system of Personal Accounts is also proposed (see below).

The two state pensions would have different rules:

- Under the reforms, an individual would need 30 qualifying years to be entitled to the full BSP in future. But to be entitled to the maximum amount of S2P, he or she would need to qualify for a full working life.
- And while BSP would be increased with earnings, incomes from S2P would increase with prices once in payment.

The Government has decided to retain the current contributory system of basing state pension entitlements on National Insurance contributions and credits, rather than on residency which may have been simpler for individuals to understand and given greater certainty about state pension incomes.

The Bill simplifies some aspects of the system. For example, the reduction in the number of years needed for a full BSP to 30 may make it easier for people to predict how much they will receive.

The Bill removes the facility to contract out of S2P into a Defined Contribution (DC) scheme.

The calculation of S2P would be simplified with the aim of allowing S2P to be presented as a flat-rate top-up to the BSP, giving a pension income of £1.40 a week for each future qualifying year. Currently, the value of S2P depends on when it was earned and when SPA is reached.

This is a technical change to the calculation that is likely to alter only marginally the amount of S2P that people receive.[7]

Unsustainability

Experts also identified unsustainability as a problem with the current system. This was due to the expected growth in the means-tested Pension Credit, and expected future state spending.

1) Pension Credit was introduced to target extra state spending where the need was greatest. But it causes uncertainty about what people will receive from the state and the value of saving.

Chart 2: The pensions system would remain complex

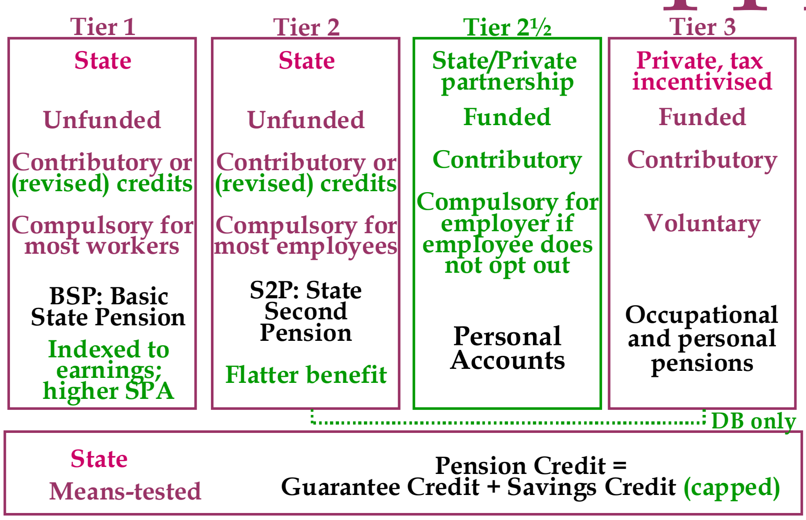
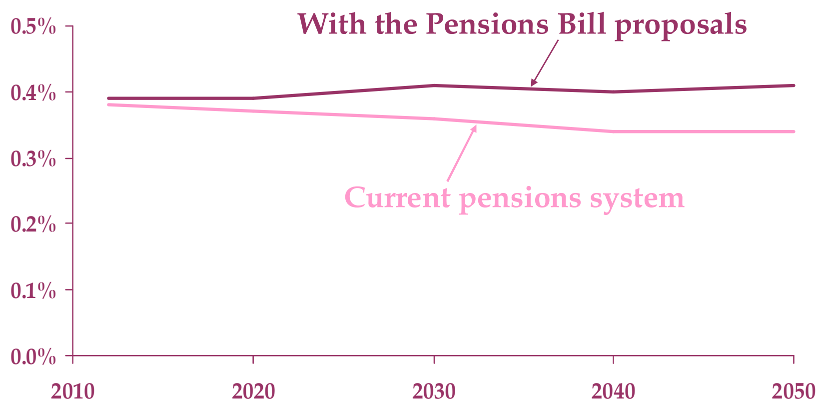


Chart 3: Pensions spending per head stays level under the proposals

State expenditure on pensions per head, as % of GDP per million people over state pension age



Without reform, the proportion of households eligible for Pension Credit was expected to grow from its current level of 45-50% to 70-85% by 2050. The reforms will reduce the proportion eligible in 2050, to between 30-45%, although it could be higher if private pensions perform badly.[8]

The reduction means the reformed system appears more sustainable, although 30% of households being eligible would be historically high for Pension Credit and its predecessor benefits.

2) *State spending* on pensions was previously expected to stay a constant proportion of GDP. However, a large increase in the number of people over 65 is expected, so spending per head would fall.[9]

The cost of proposed improvements to state pensions would largely be offset by lower spending as a result of the higher State Pension Age (SPA). Spending per pensioner is now projected to stay level (Chart 3)[10], which appears more sustainable.

SPA is currently 65 for men and 60 for women, and is increasing to 65 for women between 2010 and 2020. The Bill would increase SPA further, in recognition of anticipated improvements in life expectancy, to 66 by 2026, to 67 by 2036 and to 68 by 2046. This change would affect people aged 46 or younger on 6 April 2006.

Some organisations have expressed concern about the disproportionate impact raising SPA might have on people in lower socio-economic groups. One possible way of mitigating this impact would be to set the minimum age for eligibility for Guarantee Credit below SPA. PPI analysis suggests this would not have excessive cost.[11]

Expectations of private saving

The fourth major problem was that Government expectations of private saving were too high. It was expected to do two things: make up for inadequacies in the level of state pension <u>and</u> provide private income in retirement.

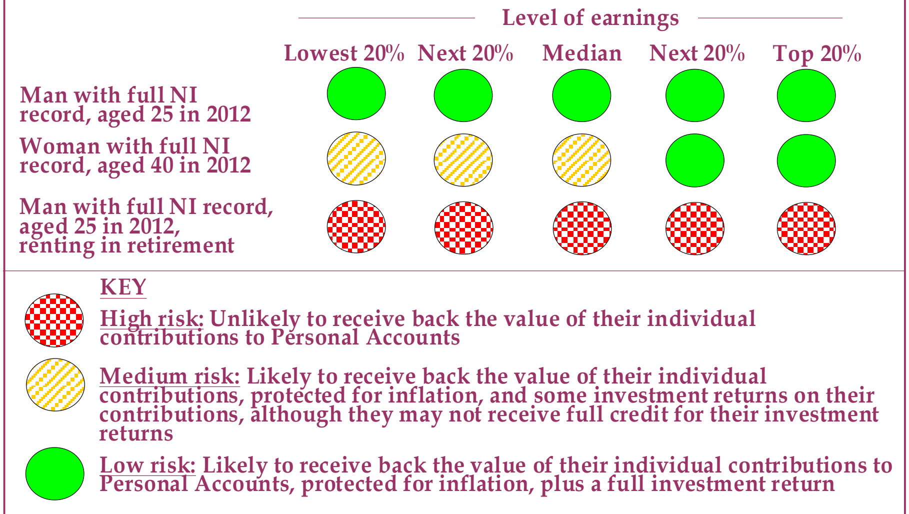
The proposed Personal Accounts are a low-cost, national pensions savings scheme. Employees over 22 who earn more than £5,000 a year would be auto-enrolled, but could opt out. Those who stay in would contribute at least 4% of their salary, which would be matched by 1% from Government and 3% from employers.

The lack of a solid state pension foundation means that saving in a Personal Account could replace means-tested benefits that people would otherwise receive, e.g. Pension Credit, Council Tax Benefit, or Housing Benefit.

However, the matching contributions from employers and the Government could compensate for the impact of means-testing. Personal Accounts could give millions of employees access to a low-cost pension saving scheme with an employer contribution for the first time.

Returns from saving in Personal Accounts will vary from person to person. For example, a median-earning man, aged 25 in 2012 with a full work history, could lose means-tested benefits as a result of his saving, but the matching contribution would make up the difference.

Chart 4: Incentives to save in Personal Accounts will depend on individuals' circumstances



For other types of individuals—notably people in their forties and fifties in 2012 with no prior saving, and those who are likely to rent in retirement—incentives to save could be considerably lower (Chart 4)[12].

People may still want to save in a Personal Account, even if returns seem relatively low. It depends on individual preferences towards consumption.

The Government has stopped short of compulsory saving, giving individuals the option to opt out of Personal Accounts. Given the complexity of the decision that individuals will have to make, this underlines the importance of information to help people make the right choice.

Conclusions

If enacted, the Bill would alleviate many of the problems with the current state pensions system, although none will be solved completely:

- Outcomes between men and women would converge, although over decades.
- The system would remain complex with two state pensions, although some aspects would be simplified.
- The system would be more sustainable. But future levels of means-testing, while uncertain, are likely to be historically high.
- Private saving would be expected to make up for the inadequacies of the state system as well as provide additional private income.

Support for the Bill

A PPI stock-take, of 24 key stakeholders' views on the main elements of the Government's reform proposals, found broad support for elements of the state pension reforms.[13]

There was strong support for re-linking the BSP to average earnings. And a majority of the 24 organisations now accept that, due to increases in longevity, an increase in SPA is necessary. However, there is a widespread view that the system remains complex, with too much reliance on means-tested benefits.

This suggests that, while there is broad support for the Bill, many organisations would like to see the Government go further.

For more information on this topic, please contact
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1 James Purnell, speaking in the Public Bill Committee for the Pensions Bill, House of Commons *Hansard* 23 January 2007 Col 4
2 PPI (2006) *Shaping a stable pensions solution* and individual seminars
3 DWP (2007) *Pensions Bill Regulatory Impact Assessment* Figure 2.5
4 The Government stated that its objective, subject to affordability and the fiscal position, is to restore the link between the level of BSP and average earnings by 2012 but in any event by the end of the next Parliament
5 See PPI Briefing Note 31
6 See PPI Briefing Note 32
7 See PPI Briefing Note 35
8 PPI (2006 WP) *An evaluation of the White Paper state pension reform proposals* Chapter 4
9 See PPI Briefing Note 26
10 PPI projections using the Aggregate Model. Includes BSP, SERPS/S2P, Pension Credit, and other pensioner benefits such as Winter Fuel Allowances. DWP figures are similar.
11 Analysis for the TUC. See the PPI website.
12 PPI (2006) *Are Personal Accounts suitable for all?* This Briefing Note should not be used as the basis for financial decisions.
13 PPI Briefing Note 34. The White Paper responses of 24 organisations were mapped in Oct 2006, including charities, unions, pension providers, and representative bodies for consumers, business and pensions industry.