

Introduction

This Briefing Note examines some of the necessary conditions needed for the current pension policy to be as good as alternative policy reform options for the average new female and male pensioner¹.

Following recently published research by the PPI², two 'overnight' reform options have been selected here as possible pension models: the Citizen's Pension (CP) and the Higher Basic State Pension (HBSP).

The reform options

The CP and HBSP benefit levels are £105 a week – 22% of national average earnings. Individuals need to pass a set of criteria to be entitled to such benefits. The CP eligibility criterion is based on residency and the HBSP on National Insurance contributions paid or credited.

From 2004, future accruals to the State Second Pension (S2P) are

scrapped and the Savings Credit is gradually phased out over a 10 year period. Although pension schemes might change name, pension entitlements accrued before the change continue to be paid under the new policies.

The payments of alternative options are made differently. The CP is only paid if the sum of accrued Basic State Pension (BSP) and S2P - or contracted out equivalent - is lower than £105 a week. This is known as the 'offset' method. The HBSP is always paid in 'addition' to individual S2P entitlements³.

These two policy options are very different from one another. The CP (with the 'offset' method) is less regressive. It is more beneficial for people, such as the 'average new female pensioner', with interrupted working and contribution histories. Higher income people do not lose out but do not immediately

gain (Chart 1).

The HBSP delivers better pension incomes for people, such as the 'average new male pensioner', who do well out of the contributory system (Chart 2). The HBSP gives most rewards to those with a full Basic State Pension. Transition to the HBSP option (with the 'addition' method) is therefore more expensive.

The claiming issue

The current pension policy – Status Quo (SQ) - appears at least as good as any other policy option, only if the Pension Credit (PC) is claimed by eligible pensioners⁴.

As the number of people becoming entitled to PC is increasing over time⁵, pension income under the current pension policy seems to be more uncertain than any other policy option. Since the current take-up rate is around 74%⁶, there are concerns

Chart 1: The Status Quo could be as beneficial for the average new female pensioner if PC is claimed

Pension income as % of national average earnings for the average female pensioner, retiring in 2004

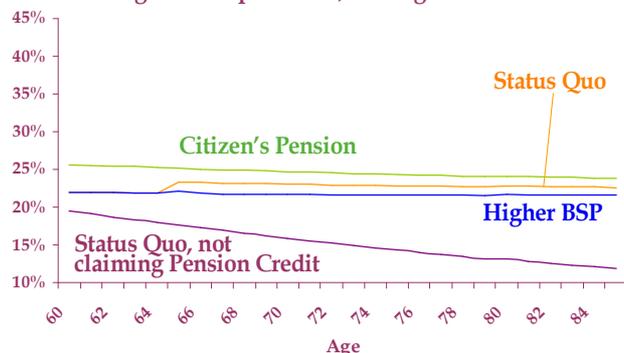
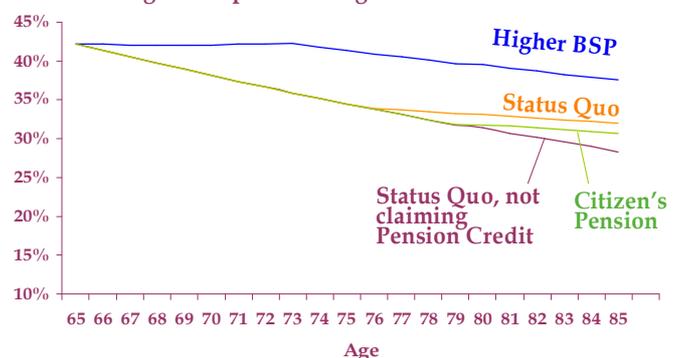


Chart 2: The Status Quo seems a less attractive option for the average new male pensioner

Pension income as % of national average earnings for the average male pensioner aged 65 in 2004



Can current pension policy be as good as the alternatives?

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Chart 3: The average new female pensioner gains if Pension Credit is claimed and the Guarantee Credit is linked to earnings

Pension income as % of national average earnings for the average female pensioner, retiring in 2004

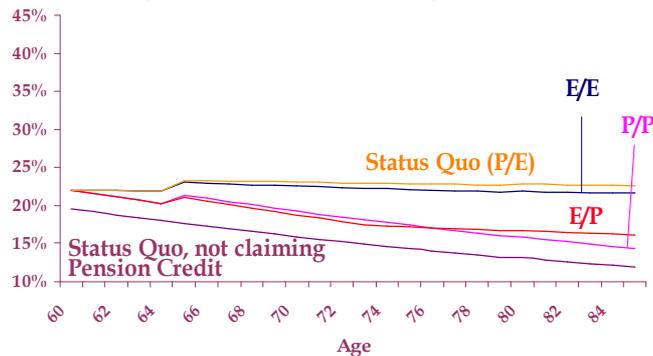
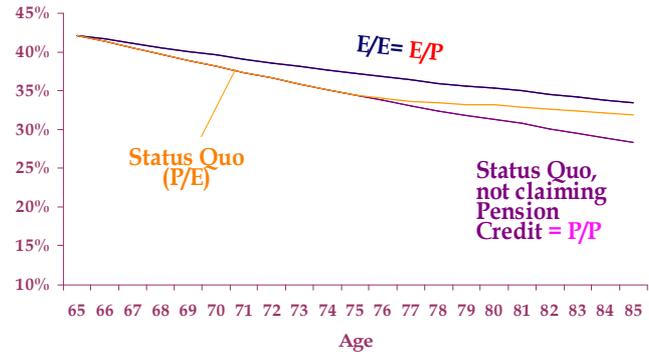


Chart 4: Linking BSP to earnings and GC to prices helps the average new male pensioner only during first years after retirement

Pension income as % of national average earnings for the average male pensioner, retiring in 2004



about the number of pensioners not claiming their entitlements. If PC is not claimed, these pensioners will be increasingly poorly off through their retirement and would receive a much lower pension income relative to any other alternative.

What other variants of the Status Quo could be considered?

Current policy is for the BSP to increase in line with prices, but the Guarantee Credit (GC) to increase in line with earnings (shown as P/E in Charts 3 and 4). However, it is not set down in legislation that the GC threshold will increase each year at least in line with earnings, although it is in legislation that the Basic State Pension and State Second Pension benefits will increase each year in payment at least in line with prices. The

current government have promised to keep the GC threshold increasing in line with earnings at least until the end of current Parliament (2006 at the latest)⁷.

It is crucial for the GC to continue to be linked to earnings as this threshold is supposed to keep people out of poverty. If it were to be linked to prices instead (P/P), then those currently claiming GC would become increasingly poorly off during retirement under current policy compared to others. This means it could be politically impossible to keep the threshold falling below earnings indexation for any length of time.

A variant of the current pension policy could be to index the BSP to earnings, but the GC level to prices (shown as E/P in Chart 3 and 4). Most women receive less

than the full BSP (or S2P) and much lower private pensions than men. So this policy variant only benefits such women relative to the SQ if they do not claim PC. On the contrary, people who do well out of the SQ gain from such policy changes.

Conclusion

This analysis suggests that the current pension policy could be as good alternative as other policy option **only if** people, whenever eligible, claim the Pension Credit **and** the Guarantee Credit continues to be linked to earnings.

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¹The average male pensioner aged 65 in 2004 receives a BSP of £77 a week, £62 a week of SERPS/S2P and £67 a week of private pension. He receives a total pension income of £206 a week. The average female pensioner aged 60 in 2004 receives £55, £20 and £18 a week of BSP, SERPS/S2P and private pension respectively. Her total pension income is £93 a week. Source: PPI's own calculations based on data provided by DWP.

²For further details, see *State Pension Reform: Managing Transition*, PPI, 2004.

³For further details see O'Connell *Note on Transition to a Citizen's Pension*, PPI, 2004.

⁴For further discussion, see *The Pension Primer*, PPI, 2004

⁵See *Briefing Note 10*, PPI, 2004.

⁶See *Submission to the House of Commons Work and Pension's Committee's inquiry into the introduction of Pension Credit*, PPI, 2004 www.pensionspolicyinstitute.org.uk

⁷The common expectation is that the GC will increase in line with earnings, as 50-year projections of state expenditure on pensions published by the government make this assumption. This analysis adds weight to that conclusion.