

Shaping a stable pensions solution: What should be the role of means- testing in state pensions?

On 14 November 2005 the PPI and the Nuffield Foundation held the fifth seminar in the *Shaping a stable pensions solution* series at the Nuffield Foundation.

Around 30 people attended the seminar, which was chaired by Andrew Young (Government Actuary's Department, The Pensions Regulator and Pension Protection Fund).

Professor Ruth Hancock (University of Essex) presented key findings from the background paper *What should be the role of means-testing in state pensions?* This looked at where we are now and where we are heading in the UK, and challenged the conventional wisdom on means-testing by presenting alternative angles on the issue.

Discussants gave contributions to the debate before questions and contributions were taken from the floor.

Please note that the PPI has not checked any facts referred to in the following, and we may not agree with the opinions expressed. All discussants spoke in a personal capacity and any views should not be seen as representing their respective organisations.

Professor David Miles (Morgan Stanley) explained that it is useful to think of the means-testing taper as a tax rate on pension savings. Determining the right level of means-testing then depends on what is thought to be the optimal marginal rate of tax on saving. It is not clear what the optimal rate is, but it is unlikely to be zero. The argument that lots of people will be on means tested benefits, and therefore effectively face a marginal tax on the first bit of saving, and that this shows that means testing must have gone too far, is simplistic. It is not much more plausible than the argument that because most people face disincentives to work created by income tax then we must scrap income taxation.

Means-testing entails making trade-offs. Decisions need to be made on issues such as the level of state expenditure, market distortions that may occur as a result, and how best to target resources on the less well off.

Simon Douglas (Standard Life) considered whether means-testing is a disincentive to save in a private pension. The answer just now is 'no', not because it isn't a disincentive (which it clearly is) but because the private pension industry has not got to the point where means-testing is an issue. Private pensions are 'sold' in two ways: either through a financial advisor, or through the workplace typically without advice given on an individual basis. The people who seek advice are unlikely to be those who will need a means-tested benefit. It is very difficult for the private pension industry to give advice to low earners, and it is these people who are more likely to be means-tested in retirement.

However, it is clear that people are not saving enough. If we address this successfully then the issue of means-testing will increase in prominence when those mid to high earners seeking advice do face the risk of means-testing in retirement. Compulsion through the state pension system provides the best solution. A higher Basic State Pension, at the level of the Guarantee Credit, would raise everyone above the poverty line and would eliminate many of the disincentives to private saving.

Points raised in discussion included:

- There is a specific trade-off concerning uncertainty, as people do not know how much they will receive in retirement. This makes planning on an individual level very difficult. It also demands that decisions be made on the appropriate mix of risk sharing between pensioners, Government and the private pension industry.
- The impact of means-testing on existing pensioners must be considered independently from that likely to be felt by future pensioners. Pension Credit can rescue existing pensioners from poverty when they are no longer able to change their savings and consumption behaviour. Future pensioners, especially women, are most at risk of losing the benefit of private saving because of the means-testing system.
- Other ways of targeting spending include participation in the workforce and state pension age. The age at which benefits are made available is fundamental. Policies that encourage working longer must also tackle age discrimination in the workplace and re-training opportunities for the older workforce. For example, people who lose their jobs in their 50's are particularly susceptible to means-testing in retirement. However, on its own, an increased economic activity rate will not entirely alleviate the need for means-

testing. It may be better for older pensioners to be means-tested, as the benefit is then less likely to act as a disincentive to work. On the other hand, focusing means-testing on younger pensioners has the advantage that they are more likely to know when they become entitled.

- Because of the uprating policy, people become entitled for Pension Credit during their retirement. As more people are living longer, this will become an increasing issue. The problem of low take-up is exacerbated because it is difficult for a pensioner to know when they have become entitled.
- One seemingly attractive alternative to target resources on the poor is through affluence testing, where the state withholds state pension from, say, the richest 20% via the taxation system rather than making the poorest 80% have to claim it. However, affluence testing is likely to be politically controversial. Those most affected are likely to be those who are the most politically articulate. For example, the 'Surcharge' affluence test in New Zealand was controversial and eventually abolished. Further, as affluence testing is targeted on a small group, it is not likely to raise a great deal of money to redistribute to the larger group.
- The UK State Earnings Related Scheme (SERPS) gave more state pension to people on high incomes. The current State Second Pension (S2P) is intended to move towards a more flat-rate distribution, but this will take some time. Targeting additional resources to the poorest pensioners is therefore complicated by there being in place a system which channels more resources to richer pensioners.
- Some people may not be taking up their means-tested benefits because they are entitled to only a small amount of money. But we should still be concerned about increasing take-up. There are ways to design the system to reduce the stigma associated with means-testing and therefore to increase take-up. One way would be to make the application process automatic, for example, with a claim for one benefit, such as Pension Credit, automatically triggering a claim for another benefit, such as Council Tax Benefit. Or take-up may increase simply as means-testing becomes more prevalent, such as in the Australian system where means-testing is seen as socially inclusive, rather than as socially divisive.

Conclusions (synthesised by the PPI after the event):

- Means-testing has to be considered against alternative ways to target state resources, for example, by raising state pension age or affluence-testing.
- Means-testing is an effective short-term method of targeting resources to the poor. However, in the long-term it forces a number of problematic trade-offs.