

## Should state pensions be contributory or universal?

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Before I start to talk about the particular subject for today, I would like to remind you of the mini-survey we carried out at the last seminar in this series. You are of course a very small sample, but as you are invited to these seminars because you have some expertise in the subject, you are at least an interesting group to survey.

As well as asking you about the definition of contributory and universal pensions, of which more later, we asked you what you thought the role of the state should be in delivering or enabling pension provision. Those of you who responded were, perhaps surprisingly, strongly in agreement.

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Most people thought that the state should deliver a state pension that alleviates poverty. A clear majority said that the state pension should go further to be a guarantee against poverty.

Beyond that, when we get to a higher level of pension – more of an earnings-related objective – a majority thought that the role of the state was not to deliver, but to enable or incentivise people to make their own provision. Only a couple of people in this group thought compulsory savings is the answer.

This suggests that for this small group at least, the state role should have two distinct parts. The state should deliver a first-tier pension at least at the poverty level. The state should then stop delivering pensions, but instead get involved in initiatives to help people get second-tier earnings-related pension provision outside of the state.

For this paper, we are concerned with the first tier of state pensions – preventing poverty – and asking only whether the eligibility criterion for that pension should be on a contributory basis or on a universal basis.

- Under a contributory system, eligibility for state pension is decided by how many National Insurance contributions you have paid or been credited.
- In the universal system, eligibility is determined by how long you have lived in the UK.

This choice has intensified as debate about pension reform has grown ever more fervent over the last months. Analysis of a sample of proposals for pension reform made by the major organisations over the last couple of years **CHART** suggests strong support for the Universal Pension and fewer organisations actively supporting the retention of the contributory principle.

As you will know, the PPI published a paper looking at the Citizen's Pension in Spring 2004. The interest in and support for the idea took us a bit by surprise. We were not writing the paper in order to generate support for a Citizen's or Universal Pension – it was just one of a number of options we were analysing. This paper is a logical extension of that programme of work, as it compares the Universal Pension to the other main option - improving the current contributory-based Basic State Pension.

This research paper was fascinating to write because of the historical perspective. **CHART**

As you will know, the PPI looked at New Zealand's Citizen's Pension as a case example. New Zealand has been the comparator for UK pension policy in all 3 eras: for Beveridge, in the 1970s and now. I was also delighted to discover a Nuffield connection.

One of my New Zealand contacts remembered a report sponsored by Nuffield in 1971 which compared the UK plans for a state earnings-related pension with the scheme that was then new in NZ. We tracked down that paper, and discovered that the author was an official from the DHSS, who wanted to be anonymous.

His paper is a very good review of the overall issues. The writer came out strongly against the UK plans and the NZ scheme, having come to the view that residence-based pensions were better than contributory pensions, and that the state should not have a role in earnings-based provision. I wonder what he would have made of not only the introduction and subsequent development of SERPS in the UK but also the U-turn in NZ that scrapped the earnings-related contributory pension there.

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One of the things we learn from the history of pensions is that the same questions tend to pop up. The question of contributory or citizenship has always been with us, and many of the same questions have been considered many times. Adequacy for all, accrued rights and a reward for work still resonate today.

But three issues are different now.

- First, the idea that women should have an equal pension in our own right is a big part of today's debate, in a way that has not been considered before.
- Second, there is a strong feeling that after decades of change to the state pension system, with all the complexity that has brought, a simple state pension system is a prize to be keenly sought.
- Third, there is a strong attachment to the contributory *principle*, but perhaps what we want from it is changing. It was very difficult to find quotes that explained why organisations support the contributory system as concrete as the reasons organisations give to say why they support changing to a residency-based system.

The contributory principle seems a bit like the EU constitution: people can be passionately for or against it, but nobody really knows how it works. The quote *maybe it's because I'm a Conservative that I'm inclined towards reforming the contributory principle* seems to sum this up. It gives an ideological opinion, and no less valid for that, but doesn't really say what it is about the contributory method that people value.

The contributory system works differently in practice from how most people assume the contributory principle should work in theory. This was evident from our mini-survey. We offered you various definitions of the contributory principle, and few of you got it right. **CHART**

You all came up with very different answers which are inconsistent in themselves. The actual way in which the system works in practice is described accurately by the second and last statements only. All of the others you might think ought to be true in the theory of the contributory principle, but that is not how it works in practice.

You also marked most of the definitions differently for how they apply in theory compared to how they work in practice. This suggests that you know that the system isn't working as the principle should in theory.

To show the same question for the universal pension **CHART**: nearly all of you chose one definition, which perhaps makes a point about simplicity.

This paper ends with a synthesis of what we see as the points at issue today in the contributory vs. universal debate.

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These are summarised in the paper, and I would like to spend a few minutes on each.

First, the issue of whether rights under a universal pension can be protected against political interference in the same way that a contributory pension is thought to be.

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The paper makes reference to the myth that some suggest it might be useful for the population to believe in: that contributory rights are protected by being accrued. Few seem to know that NICs or credits give a right to a unit of future benefit, but legislation can change the value of that unit at any time, and indeed have done so.

The legal arguments for turning down the Carson case – where an ex-pat in S. Africa thought she should have the same indexation as ex-pats in other countries – spelt this out. There is a question about how long this myth can be sustained, as well as the morality of relying on a myth in the first place.

The other benefit some see in the contributory system is that the future level of pensions is better assured. We have seen this argument made both ways: that with a universal pension Governments are more likely to reduce the pension, or more likely to give in to voters and increase the pension.

But in practice, what Governments do on the level of any pension depends on political judgements at the time. They could choose to change a contributory or a universal pension, but are constrained by the same thing – getting elected. This always means we avoid losers in any change and a good thing too – but this is not unique to the contributory system.

And the value of both the contributory and universal pension can be protected to the same degree by having the same mechanism of hypothecated NI contributions – not a pure fund like a funded system would be (which I’m sure Frank will talk about), as we are assuming a Pay-as-you-go system here. Oversight can be taken as far out of politics and into independent Bank of England-type structures as you like. There is nothing inherently linking the contributory system to having that approach – it could work just as well under a universal pension.

When it comes to safeguarding against political manipulation, there is a strong argument that the best way is to have as few parameters as possible for politicians to manipulate. With the current system having over 100 parameters, a single contributory pension having over 30, and the universal pension having 2, the universal pension would be best if you believe the simplicity argument. Although we can still hugely simplify by moving to one contributory BSP, provided it is above the means-testing level.

The next major question is whether the universal pension should be chosen for reasons of inclusion and fairness, because the contributory system even when modernised would leave gaps in coverage. This is an issue often discussed for women, but it is not only about women.

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A modernised contributory pension can never be as inclusive as a universal pension, so there will always be more people on Pension Credit with a contributory system, even after reforms to close some of the gaps in the contributory pension.

Our best estimate is that by reforming the contributory system the numbers on Pension Credit would fall, but slowly as the changes in crediting take effect year on year. The end result could be, instead of the current 50% of people on Pension Credit, between 10-20%. With a universal pension there could be an immediate drop to around 5%.

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The other analysis we did in the paper was to make some assumptions about how modernising the contributory system to tackle the issues important to women, such as low earnings and caring patterns, would reduce the number excluded from the system.

We think that of the 4.5m we highlighted as currently not in the system, 2.3m would be left even assuming those reforms could be done practically. So there would always be people left out, even in a better contributory system.

New data on this split was published by the DWP – just after we went to press! The method of counting whether people are credited or contributing is technically different, so these are not like-for-like comparisons, but you may hear 3m being quoted instead of the 4.5m. It's not possible to do the same analysis as we have done on these new numbers.

What the new numbers emphasise is that, perhaps surprisingly, the numbers of people credited are quite large compared to the numbers actually contributing. It would be good to be able to predict how this would work through over time, a longitudinal approach as work and caring patterns change, but we do not have the data to do this yet.

But it is interesting to see a historic analysis of the proportions contributing and being credited. **CHART**. Even when the nature of credits and work has been changing significantly for women, the proportion of people contributing to the contributory system has always been around 60%. This means a large part of the contributory system is not about contributions; it is actually about defining who gets what benefits.

People have different ideologies of what is 'fair'. Some would take the view that the most equal and inclusive pension would be, by definition a universal pension. The problem with that is pension is given to people who some might think don't deserve it – rich non-working spouses being the usual example.

Others would say that it is important to have contributions linked to work to reinforce a sense of the activity the state prefers. The problem with that is that pension isn't given to people who some might think of as 'deserving'.

It is the case that with both systems, the "ne'er do wells" get the pension anyway, and if they don't they would get Pension Credit in any case.

We have to ask whether the complexity of all the credits in the contributory system is worth it, if the end result can never be exactly what was intended.

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There are issues with administration for both the contributory and universal pensions. Complications in determining residency for a minority of mobile people exist with the current contributory system. In a universal system, there will be a trade-off between a shorter residency period for which it will be more practical to prove eligibility, and a longer period that would exclude more people who have moved around.

Although the simplicity of the universal pension is appealing, there is a natural scepticism that transition will throw up unexpected problems, and the universal pension will not work exactly as intended either. The 'devil we think we know' is always the safe choice.

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Having worked through these issues and read very carefully what has been written on both sides of the debate, we came to the conclusion that, factually, the universal pension can be at least as good as the contributory pension at adequacy and protecting 'accrued rights'. It would be better at equality for women - and other groups, particularly low earners - and would be simpler.

But the universal pension is not a reward for work as the contributory principle is. And as we do have an enduring notion of the contributory principle as something good even if, given the way the contributory system operates in practice, this is largely a myth.

Any state pension system has to last, and as John Denham and Richard Brooks argued very powerfully in the Fabian pamphlet published this week, it has to be based on what the electorate trusts and believes is fair. Has the electorate's view of a mutual, fair benefit changed to be more like an equal universal pension rather than a variable amount based on a set of complex criteria? The NAPF survey, with 80% saying that *women should get the same pension as men even if they have stayed at home* is significant.

We have a complicated set of comparisons and policy choices available. **CHART** I hope the paper made some sense of the issues and that this seminar will help to round out the arguments. We would like to hear more discussion for and against either continuing with the status quo, reforming the contributory system or making the change to a universal pension.