



## Should state pensions be contributory or universal?

Seminar 3 in the series:  
*Shaping a stable pensions solution*  
July 2005



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## Introduction

Pension policy is at a critical juncture. Previous PPI research has shown that there is consensus on the UK's pensions problems and that reform of the state pension system is needed. Yet Government was preoccupied with private pension provision until *Principles of Reform*, published in February 2005, set out the Government's commitment to seeking a consensus for reform. The pensions community wants a simple and sustainable solution.

The aim of *Shaping a stable pensions solution* is to build up a picture of the possible shape of a consensus pension solution that could work for the long-term, through a series of seminars to debate the most critical pension issues on the interaction of state and private pensions. Expert individuals from a wide range of backgrounds, and who between them have a variety of perspectives, will be able to make an important contribution to the debate.

Each seminar will examine a critical and topical pension policy question. This paper *Should state pensions be contributory or universal?* is the third issue to be considered.

### ***Should state pensions be contributory or universal?***

The contributory principle has underpinned state pensions since the Beveridge Report. But it has lost its lustre over the years to the extent that many organisations now support a state pension partly or fully based instead on the principle of universality or citizenship.

This PPI paper compares the 'contributory' and 'universal' methods of determining eligibility for a state pension:

- The objectives of both methods.
- How well the systems meet or could meet their objectives.
- How the methods compare on the PPI tests for pension reform.

Other seminars in the series tackle other current major issues such as:

- What should be the balance between state and private pensions?
- How does the interaction of state and private pensions affect incentives to work and save?
- Should earnings-linked pensions be voluntary or compulsory?
- What should be the role of means-testing in state pensions?

Feedback from the papers presented at each seminar, and each seminar discussion will be consolidated into a report to be published in 2006. The report will contribute new facts, analysis and insights to the public debate highlighting where consensus lies and where and why the areas of disagreement exist.

## *Should state pensions be contributory or universal?*

### Summary of conclusions

The principal objective behind the UK's contributory pension system has changed from Beveridge's 1940s ideal of 'adequacy for all' through the reforms of the 1970s which placed more emphasis on accruing rights based on reward for work.

The current system is only partially successful at achieving the contributory objectives:

- **Adequacy for all** has been lost as there are unequal outcomes, with 4.5 million people not accruing a right to the Basic State Pension each year.
- The idea that the contributory system protects the expected value of **accrued rights** is hard to substantiate as the National Insurance Fund does not operate in that way.
- The contributory pension as a **reward for work** is becoming less true, with a weakening link between contributions made and benefit received.

A universal pension has always been a valid alternative to a contributory pension.

- There are different ways in which a universal pension could work, but the objective is similar to the original Beveridge concept of 'adequacy for all'.
- The universal pension has been considered as an alternative to the contributory pension before in the UK, but the preference has been to keep the contributory system.

Recognising that state pension reform is now needed in the UK, the options for eligibility criterion are either to introduce a universal pension or to modernise the current contributory pensions.

- A universal pension has support as it is simple and inclusive.
- Linking contributions and pensions to work still has support, despite some uncertainty as to what that means in practice.
- The contributory method could be modernised to deliver better against the contributory objectives.

A universal pension is still likely to be better than a modernised contributory pension in delivering adequacy for all:

- There will still be at least 2.3 million people a year who fail to accrue rights to a contributory pension, even after the modernisation of credits. Some of these people would 'deserve' to be covered.
- A more complicated set of credits would make it more difficult for people to understand how their pension is calculated.
- Because of the gaps in coverage, means-tested benefits will be needed by more people over state pension age with a modernised contributory system than with a universal pension.
- The modernisation of the contributory system is likely to take a long time to be effective. Transition to a universal pension can be better for the current generation of people (mostly women) with an 'unfairly' incomplete contributory record.
- The current method of collecting revenues (National Insurance contributions) can be maintained for both systems. Complexities of administration exist in both cases: for mobile workers with the universal and contributory systems and for carers in the contributory system.
- The state 'promise' of future benefits can be clearer with a universal system, and protected under both systems by better ring-fencing contributions.

Current preferences appear to be with the universal pension, although the contributory method has the advantage of requiring least practical change. The main points at issue now are:

1. Can a universal pension be set up to be perceived to be no more susceptible to future **political interference** than the contributory system is, or is there still a potent perception that the contributory principle will better protect rights?
2. Could the **improvements for women** and other disadvantaged groups from a modernised contributory pension be, if not as good as a universal pension, good enough?
3. Could switching to a universal pension introduce a more appropriate notion of **fairness**? Is it better to make judgements on whether a life history 'deserves' a state pension or not to have to do so?
4. Could the **administration** of a universal pension with a residency criterion be easier for more cases, and so cheaper, than a contributory system with extensive detailed credits, or will the latter work well enough?
5. **Transition** to a universal pension appears possible, but would there be unintended consequences, so that modernising the contributory system seems less risky?

## Chapter 1: How has the contributory system evolved in the UK?

This chapter explains how the contributory system evolved through the last half century.

The principal objective behind the UK's contributory pension system has changed from Beveridge's 1940s idea of 'adequacy for all' through the reforms of the 1970s which placed more emphasis on accruing rights as a reward for work.

### **1940s: Adequacy for all**

Beveridge's 1942 report, *Social insurance and allied services*, proposed a wide-ranging reform of health services and social security. A basic state pension founded on the contributory principle was subsequently introduced.

Beveridge's proposed contributory pension scheme was underpinned by six principles (Box 1):

#### **Box 1: The key principles of Beveridge's contributory pension**

1. **Flat rate of contribution:** *all insured persons, rich or poor, will pay the same contributions for the same security.*
2. **Flat rate of subsistence benefit:** *irrespective of the amount of the earnings which have been interrupted by unemployment or disability or ended by retirement.*
3. **Unification of administrative responsibility:** *in the interests of efficiency and economy...All contributions will be paid into a single Social Insurance Fund and all benefits and other insurance payments will be paid from that fund.*
4. **Adequacy of benefit:** *in amount and in time. The flat rate of benefit proposed is intended in itself to be sufficient without further resources to provide the minimum income needed for subsistence in all normal cases.*
5. **Comprehensiveness:** *in respect both of the persons covered and of their needs. It should not leave either to national assistance or to voluntary insurance any risk so general or so uniform that social insurance can be justified.*
6. **Classification:** *to denote adjustment of insurance to differing circumstances of each of these classes [different ways of life and different sections of the community] and to many varieties of need and circumstance within each insurance class. But the insurance classes are not economic or social classes in the ordinary sense; the insurance scheme is one for all citizens irrespective of their means.*

<sup>1</sup> Beveridge (1942) paras 303-309 pp. 121-122



The key objective was **adequacy for all**: those who were in work and able to do so would contribute, and all members of society would receive a retirement income sufficient to eradicate pensioner poverty without means-testing.

However, this was compromised at the start, and means-testing expanded.

- Beveridge's contributory principle had a flat-rate contribution and a flat-rate benefit:  
*Contributory principle... a material part of the total cost of maintaining income under the plan shall be met from monies contributed by citizens as insured persons, on the basis of each individual paying the same contribution for the same rate of benefit. Contribution means that in their capacity as possible recipients of benefit the poorer man and the richer man are treated alike.*
- But to be affordable to the low-paid, the flat-rate contribution had to be set low. This limited the funds that the Government was able to raise, and subsequently, the level of benefit available.
- To add to the financing difficulties, the Government chose to give the benefit to current pensioners immediately, rather than build up the scheme over time, as Beveridge envisaged<sup>3</sup>.
- By the time the pension scheme was introduced in 1948, benefit rates were only one third of Beveridge's envisaged level<sup>4</sup>.
- The number of pensioners eligible for means-testing increased. As one third of pensioners entitled to means-tested national assistance in the 1960s did not claim<sup>5</sup>, pensioner poverty became an increasing problem.

The new contributory pension introduced three features which have become fixtures at the heart of the debate today:

- **National Insurance (NI) Fund:** Beveridge introduced what was then called the Social Insurance Fund for administrative ease of handling and recording contributions. It was intended to be ring-fenced so that contributions could be hypothecated, and not used for purposes other than the contributory benefits<sup>6</sup>.
- **Classifications:** Society was easily classified by Beveridge into only 6 groups. It was not envisaged that anyone would not get (or would not deserve) a benefit. Everyone was either employed, self-employed, temporarily unemployed, unable to work through illness or a wife or widow<sup>7</sup>. Later, a system of credits had to be set up to 'count' those that were not paying contributions but would be receiving benefits.
- **Qualifying years:** Contributions and credits in a year count towards the number of qualifying years needed to receive a full pension (currently 44 for a man and 39 for a woman – increasing to 44 by 2020). Partial pension can be paid for less than the full number of years.

<sup>2</sup> Beveridge (1942) para 273 p. 108

<sup>3</sup> Timmins (2001) p. 135

<sup>4</sup> Abel-Smith p.16 in Timmins (2001) p. 136

<sup>5</sup> Timmins (2001) p. 224

<sup>6</sup> Beveridge (1942) para 389 p. 147

<sup>7</sup> Beveridge (1942) para 310 p. 122

**1970s: Accruing rights as a reward for work**

Debate grew through the 1950s, focused on how the state pension related to pre-retirement earnings. In the early 1960s, contributions became earnings-related and in 1978 the State Earnings Related Pension Scheme (SERPS) was introduced.

There were two main reasons for the debate<sup>8</sup>.

- First, it followed on from the concerns over inadequacy of the level of the state pension. Earnings-related contributions brought more money in to enable a more generous pension.
- Second, some believed that occupational pensions were not widespread enough, so the idea grew that the state should provide an alternative. So grew the notion that the state should provide - on top of the poverty avoidance first tier - a second tier retirement benefit that was 'earned' through work. It helped to justify earnings-related contributions by 'getting out more if you put in more'.

Retention of the contributory principle was very much part of the 1970s debate. It was supported for a number of reasons linked to the themes of the day around earnings-related contributions and benefits (Box 2). It was also thought be more convenient to administer than the alternative, which will be discussed in Chapter 3.

**Box 2: Reasons put forward in the 1970s for supporting the contributory principle**

1. That the link between individual contributions and benefits secured that benefits were paid 'as of right' and offered the best...safeguard against unilateral action by a Government, in times of financial stringency, to reduce the rate and coverage of social security benefits.
2. That without a demonstrable link between benefits and contributions, there would be irresistible pressure towards the payment of benefits higher than the economy could properly afford.
3. That people were readier to pay a contribution towards their own benefits than a tax for general purposes, so that the contributory system increased the total amount of 'taxable capacity'.

<sup>8</sup> See also PPI Briefing Note Number 20 *Should the state provide an earnings-related pension?*

<sup>9</sup> From an analysis by an anonymous researcher working on a grant from the Nuffield Foundation (1971)

So the contributory principle became ever more linked with the ideas of 'getting out what you put in', and accruing rights based on a 'reward for work':

- **Accrued rights:** *The contributory principle... gives people confidence that, through the payment of their contributions, they can establish a right to benefit that will be honoured when they are unable to work and when the time comes for them to retire*<sup>10</sup>.
- **Reward for work:** *The contributory principle... governs the conditions on which benefits are payable and ensures that benefits only go to those who have sustained membership of the scheme*<sup>11</sup>.  
*... since the ordinary man or woman would rather pay £1 a week as an insurance contribution than as income tax, and so feel that he or she had earned their own pension, the contributory principle was right...*<sup>12</sup>

These issues still resonate today, as will be explored in later chapters. The next chapter considers to what extent the contributory principle, as defined by Beveridge and modified through the latter half of the 20<sup>th</sup> century, exists in practice today.

<sup>10</sup> DHSS (1971) para 19 p. 7

<sup>11</sup> DHSS (1971) para 19 p. 7

<sup>12</sup> Jay, *Change Fortune*, pp. 250-1 in Timmins (2001) p. 194

## Chapter 2: Is the current UK pension system contributory?

This chapter brings the contributory story up to date and asks to what extent it applies today.

It finds that the current system is only partially successful at achieving the contributory objectives:

- **Adequacy for all** has been lost as there are unequal outcomes, with 4.5 million people not accruing a right to the Basic State Pension each year.
- The idea that the contributory system protects the expected value of **accrued rights** is hard to substantiate as the National Insurance Fund does not operate in that way.
- The contributory pension as a **reward for work** is becoming less true, with a weakening link between contributions made and benefit received.

### **Adequacy for all**

‘Adequacy’ refers to both the level of benefit and the number of people covered. The level of the current contributory pensions is below that defined to be adequate by reference to the minimum income from means-tested benefits:

- The level of the Basic State Pension (BSP) is currently at 16% National Average Earnings (NAE), and if price indexation continues could fall to 9% NAE by 2030.
- The second tier pension does not necessarily help people get to an adequate level of income. Only a recent pensioner who was a high earner with a full contribution record on SERPS, its replacement State Second Pension (S2P) and BSP receives state benefits of 40% NAE in total<sup>13</sup>. On average for people now reaching state pension age, men receive 24% NAE and women 15% NAE<sup>14</sup> from these contributory benefits.
- Pension Credit is a means-tested benefit, not part of the contributory system. The Guarantee Credit element aims to ensure that all people over state pension age<sup>15</sup> receive a minimum income of 21% NAE (£109.45 pw for a single person in 2005/6). However, imperfect take-up means around 20% of all households entitled to Guarantee Credit are currently not claiming (around 0.5 million households)<sup>16</sup>.
- The use of Pension Credit to provide adequate retirement income is expected to increase. By 2025, up to 64% of all people over age 65 could be entitled to Pension Credit, compared to around 50% today<sup>17</sup>.

<sup>13</sup> PPI analysis

<sup>14</sup> DWP (2005 SPSS), including contracted-out equivalent

<sup>15</sup> Over age 60 until 2010 when an increase in the age of eligibility to 65 starts, to be completed by 2020

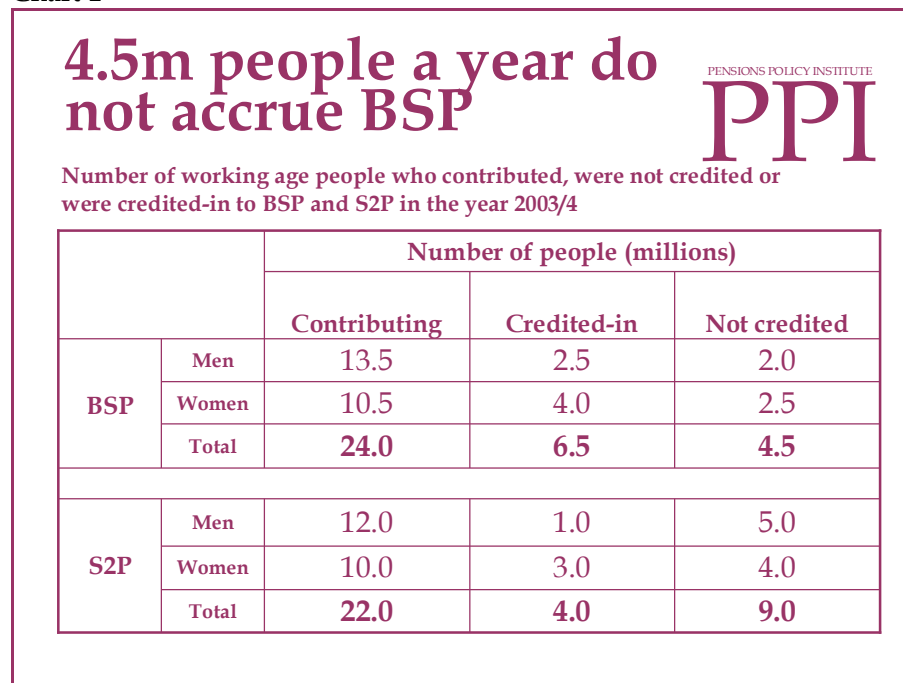
<sup>16</sup> Written Ministerial Statement, 3 February 2005 House of Commons *Hansard* Column 68WS

<sup>17</sup> Emmerson & Disney (2004)

But it is not only the level of the contributory pensions that raises concerns about adequacy. The coverage is also an issue. Credits for both BSP and S2P have become extremely complex and do not include everyone.

Only just over 60% of working age people actually contribute to both contributory pensions: the 'contributory' system is as much about defining the benefits as it is about contributions. And, despite the credit system, there are still gaps in coverage: 4.5 million and 9 million working age people are not entitled to accrue BSP and S2P (or the contracted-out equivalent) respectively (Chart 1).

**Chart 1**<sup>18</sup>



Credits are used to include non-contributors in specific circumstances:

- Home Responsibilities Protection (HRP) reduces the number of years that a person with caring responsibilities has to contribute. HRP is awarded to people caring for a child who they receive child benefit for, people caring and receiving Income Support, and people caring for more than 35 hours a week for someone who receives a disability benefit.
- Men aged between 60 and 64 automatically receive credits.
- People receiving Job Seekers Allowance, Working Tax Credit, Disabled Persons Tax Credit, Statutory Sick Pay, Statutory Maternity Pay, Carers Allowance or on Government Training Schemes also receive credits.
- A person with insufficient contributions may also be able to claim based on their spouse or ex-spouse's pension.

<sup>18</sup> PPI calculation based on Family Resources Survey 2003/4. The figures are based on one particular week. Credited-in figures include people receiving HRP. Figures rounded to the nearest 0.5 million.

Gaps in coverage occur for both technical and judgemental reasons, but the net result is that people who might be judged to be 'deserving' do not accrue a contributory pension.

- **Technical gaps** exist where the credit is defined for administrative reasons to exclude what most would probably agree should be included. For example: people caring for elderly or disabled people who do not claim or receive a disability benefit; people who combine low paid part-time work (below the Lower Earnings Limit - LEL) and caring for less than 35 hours; and people who care for part of the year (in particular HRP is unlikely to cover the first or last year that a child receives Child Benefit as the caring needs to coincide with a full financial year).
- **Judgement gaps** exist where there are different points of view on where the line should be drawn to define a 'deserving' credit. For example those not receiving credits include: people caring but for less than 35 hours a week; people with a youngest child aged older than 5 are not credited for state second pension; students over age 18; and those working but earning less than the LEL.

Overall, of the 4.5 million people not accruing BSP, 2.2 million are in identifiable situations which some may see as 'deserving': working, caring, studying or a combination of these (Table 1).

There are a further 2.3 million people not accruing for other reasons, and it may be that half of these are also in situations that some might consider 'deserving'. For example, people who are unemployed but not receiving an unemployment benefit, or sick or disabled and not receiving a disability benefit<sup>19</sup>. Most of the remaining 'undeserving' group are looking after the home (but without caring responsibilities) or retired<sup>20</sup>.

<sup>19</sup> This could be because they do not have a good enough contributory record, they may not meet all the criteria for a benefit, they have other income to live on, or because a partner is in work or claiming benefit

<sup>20</sup> For men this is retired and below 60 as any man aged 60 or older automatically receives a credit to the BSP

**Table 1<sup>21</sup>: Number of working age people who are not accruing BSP for different reasons, 2003/4**

<b>(millions)</b>	<b>Men</b>	<b>Women</b>	<b>All</b>
<b>Student</b>	0.4	0.3	0.7
<b>Cares for too few hours</b>	0.1	0.2	0.3
<b>Does not earn enough</b>	0.5	0.6	1.2
<b>Combination of low earnings and caring</b>	*	0.1	0.1
<b>Sub-total</b>	<b>1.0</b>	<b>1.2</b>	<b>2.2</b>
<b>Unemployed but not receiving benefit</b>	0.2	0.1	0.3
<b>Sick/ disabled but not receiving benefit</b>	0.5	0.4	0.9
<b>Sub-total</b>	<b>0.7</b>	<b>0.6</b>	<b>1.2</b>
<b>Looking after family/ home</b>	*	0.3	0.3
<b>Retired</b>	0.1	0.2	0.3
<b>Other reasons</b>	0.2	0.3	0.5
<b>Sub-total</b>	<b>0.3</b>	<b>0.7</b>	<b>1.1</b>
<b>Total</b>	<b>2.0</b>	<b>2.5</b>	<b>4.5</b>

<sup>21</sup> PPI estimates based on the 2003/4 Family Resources Survey. Figures rounded to the nearest 0.1 million.

\* represents less than 50,000.

**Accrued rights**

The National Insurance Fund (NIF) is not a perfectly ring-fenced fund in which contributions are hypothecated to pension benefits. The contributory system provides less protection for the expected value of accrued rights that might be believed to be the case.

*It is...the words "insurance" and "contributions" which suggest an analogy with a private pension scheme. But, from the point of view of the citizens who contribute, national insurance contributions are little different from general taxation which disappears into the communal pot of the consolidated fund. The difference is only a matter of public accounting.<sup>22</sup>*

The NIF is used to administer all contributory benefits, not just those for retirement<sup>23</sup>. Pension benefits are by far the largest part of the NIF, accounting for more than 85% of NIF benefit expenditure<sup>24</sup>.

The National Insurance Fund is not a 'Trust Fund' like the US Social Security fund, in which contributions are totally ring-fenced to provide benefits (albeit on a pay-as-you-go basis rather than funded) and trustees are responsible for financial management. In the UK, parliament is accountable for the NI Fund<sup>25</sup> and the intention was for it to have some degree of 'hypothecation' – that is, contributions paid in to the fund are only used to pay for specific contributory benefits<sup>26</sup>. However, in reality there are significant disjoints between NIF benefits and contributions:

- In recent years more has been paid in to the NIF in contributions than has been needed to pay out benefits and maintain a reasonable working balance<sup>27</sup>.
- It is possible for employers and employees to 'contract-out' of the NIF for part of their pension provision<sup>28</sup>.
- The NIF also contributes to private pension schemes indirectly through employers receiving NI relief on their scheme contributions.
- A series of reductions have been made to employer NICs as direct offsets to taxes that encourage environmentally friendly behaviour, or 'Green Taxes'.

<sup>22</sup> Lord Hoffman, House of Lords Opinions of the Lords of Appeal for Judgement in the Carson case, [2005] UKHL 37, 26 May 2005, para 24

<sup>23</sup> Other major contributory benefits include Job Seekers Allowance, Incapacity benefit and Bereavement Benefits

<sup>24</sup> PPI calculation based on GAD (2005)

<sup>25</sup> House of Commons Select Committee on Social Security (1999) para 21

<sup>26</sup> Excluding contributions specifically allocated to the NHS

<sup>27</sup> Paul Flynn MP, Westminster Hall debate on the National Insurance Fund, House of Commons *Hansard*, 21 October 2003 Column 217WH

<sup>28</sup> Until 2003 employers and employees could contract-out of SERPS. From April 2003, employers and employees can contract out of all or part of S2P.



Despite this weakening link between individual contributions paid to the National Insurance Fund, there is still a perception that the contributory pensions are accrued and this gives protection against governments cutting pension benefits. In fact, the contributions give right to a unit of benefit but the value of that unit can be changed by legislation.

*..no-one is entitled to anything beyond that which the legislation may from time to time prescribe.<sup>29</sup>*

Governments have changed the value of the contributory pensions. Although a public perception of accrued rights may force Government to think twice, benefit cuts have happened<sup>30</sup>:

- Future accruals in SERPS were made less valuable in 1986 and 1995. The impact was a cut in the level of the final benefit receivable by an individual with a full employment record by 15-20%.
- The value of past and future accruals was cut when:
  - The indexation of the contributory pensions in payment was changed from the greater of earnings and prices to just prices, effective 1980.
  - The rules for the amount of SERPS a widow could inherit were changed, effective 2002.
  - The state pension age for women will be increased from 60 to 65 between 2010 and 2020 (legislated in 1995).

Even if contributory pensions did give some protection against change, this is being eroded as the pensions become a smaller part of total state expenditure on older people:

- Contributory benefits accounted for virtually all state spending on state pensions and benefits for people over state pension age until the early 1970s. This has since fallen to 85% of the total, and if current policy continues will fall further to 75% over the next 50 years<sup>31</sup>.
- This is due to the cuts in the value of the contributory pensions, and the rise of non-contributory means-tested benefits for people over state pension age to over half of people over state pension age.
- The parameters defining the level and eligibility of means-tested benefits can be changed at short notice, for example in a Budget.

<sup>29</sup> Lord Hoffman, House of Lords Opinions of the Lords of Appeal for Judgement in the Carson case, [2005] UKHL 37, 26 May 2005, para 12

<sup>30</sup> See PPI *The Pensions Primer* (Updated 2005)

<sup>31</sup> PPI calculations based on DWP expenditure figures and long-term projections [www.dwp.gov.uk/asd/asd4/expenditure.asp](http://www.dwp.gov.uk/asd/asd4/expenditure.asp)

**A reward for work**

The idea that the state pension should be a reward for work was enhanced by SERPS, which gave more contributory pension to people who had earned more. This feature is now being gradually withdrawn. The successor to SERPS, State Second Pension (S2P), introduced in 2002, provides a more generous pension for people on low to moderate earnings than SERPS did.

Over time, S2P will become even less earnings-related if current indexation plans are maintained<sup>32</sup>. The effect is that over the next 50 years, S2P will become essentially a flat-rate benefit, giving the same pension to people of different earnings history with the same contribution record (Chart 2).

This means that the contributory pension system will no longer reward high wages. There is currently quite a correlation between the level of benefits received and the level of contributions made, except at low income levels where the flat-rate BSP is a higher proportion of benefit (Chart 3). Over time, the flattening of S2P means that this correlation breaks down, and contributory pension benefits become the same for most people with the same contributory record, regardless of earnings (Chart 4).

This does not mean that there is no longer any reward for work in the contributory system. As benefits are linked to contributions paid while working, the system is work-based. However, because of the increasing use of credits, this type of 'reward for work' is also declining.

There may also be a perceived incentive to work from this 'reward'. Someone with 43 qualifying years may think it worthwhile to work another year to get the full pension. However, the marginal gain is small and the wage incentive from working is probably more important to an individual. At older ages, any incentive is further diminished by credits being paid to men aged 60-64 who are not working.

<sup>32</sup> The Lower Earnings Threshold (LET), which marks the upper bound of the flat-rate part of S2P, is currently indexed to earnings. The Upper Earnings Limit (UEL), which marks the maximum earnings on which benefit is accrued, is indexed to prices. Over time, assuming earnings grow faster than prices, the LET catches up with the UEL.

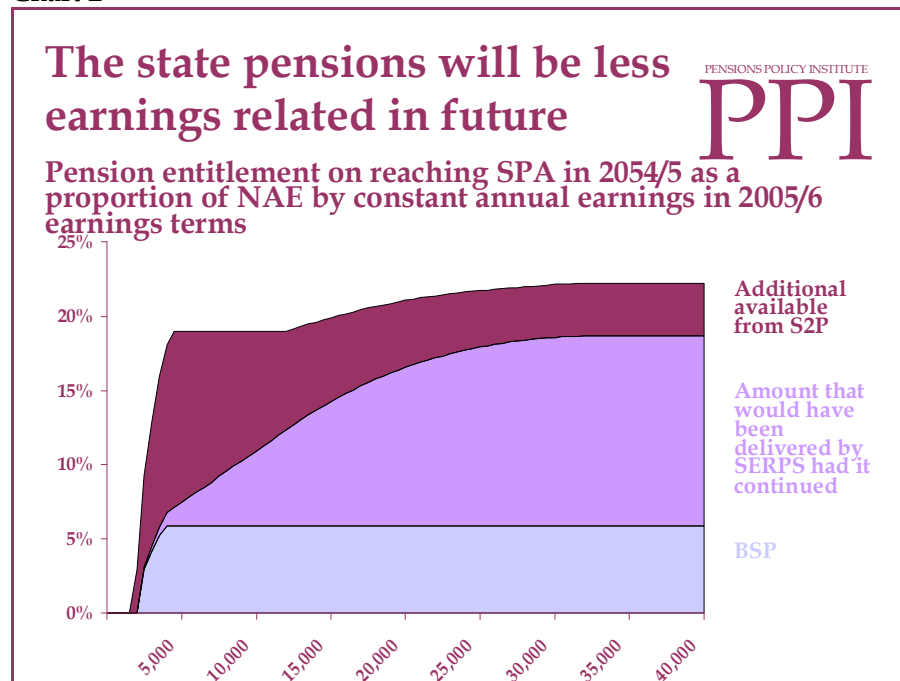
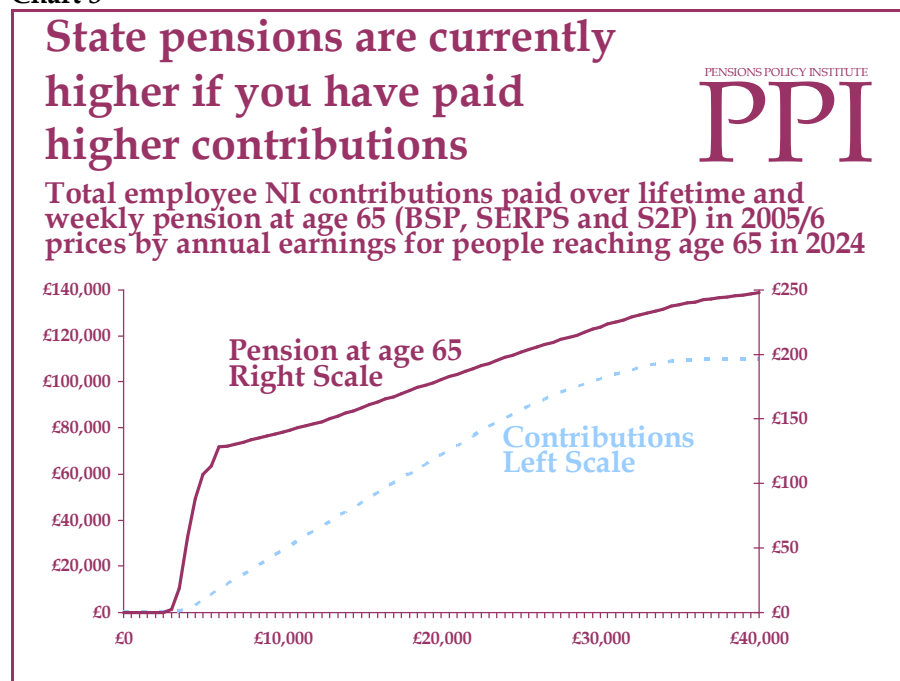
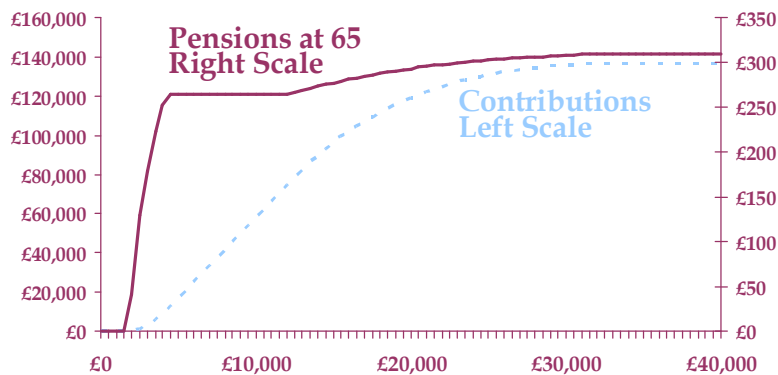
Chart 2<sup>33</sup>Chart 3<sup>34</sup><sup>33</sup> PPI analysis<sup>34</sup> PPI analysis based on individuals earning at the same level relative to national average earnings from age 16 to age 64

Chart 4<sup>35</sup>

## In future, state pensions will not depend so much on contributions paid

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Total employee NI contributions paid over lifetime and weekly pension at age 65 (BSP, SERPS and S2P) in 2005/6 prices by annual earnings for people reaching age 65 in 2054



<sup>35</sup> PPI analysis based on individuals earning at the same level relative to national average earnings from age 16 to age 64

## Chapter 3: Why has a universal pension been considered as an alternative?

The previous chapter considered the objectives behind the contributory principle and discovered that the current UK pension system is only partially successful at meeting them. This chapter investigates an alternative: the citizenship or universal pension.

A universal pension has always been a valid alternative to a contributory pension.

- There are different ways in which a universal pension could work, but the objective is similar to the original Beveridge concept of ‘adequacy for all’.
- The universal pension has been considered as an alternative to the contributory pension before in the UK, but the preference has been to keep the contributory system.

### **Universal objective is similar to original contributory principle**

The basic objective of the citizenship or universal model is to give every person over state pension age who qualifies by a residency criterion the state pension benefit, emphasising the ‘all’ in ‘adequacy for all’.

Different models are used around the world<sup>36</sup>. For example, in Denmark and the Netherlands it is part of a multi-tier state system and in New Zealand it is the only state pension. One detailed proposal has been made for the UK, by the NAPF<sup>37</sup>.

These different models (Table 2) show that choices are possible on:

- **Eligibility:** How to define the residency criterion.
- **Benefit level:** Depending on the state’s policy objective and other state intervention in pensions, how high the universal benefit should be, and therefore the definition of ‘adequacy’. Also, whether everyone gets the same level of benefit, or whether that should vary e.g., by marital status.
- **How paid for:** Whether the pension should be paid for on a ‘universal’ basis i.e. by general taxation, or whether certain revenues should be hypothecated to pay for the universal pension.

<sup>36</sup> See PPI (2003 SPM) for more details of how other countries are placed on the spectrum between universal and contributory

<sup>37</sup> Refer to NAPF (2004) for details on how a universal pension could work, including measuring residency, costs and distributional effect and transition practicalities

**Table 2: Universal pension models<sup>38</sup>**

	<b>Denmark</b>	<b>Netherlands</b>	<b>New Zealand</b>	<b>Proposal for the UK (NAPF interim<sup>39</sup>)</b>
<b>Eligibility</b>	Full benefit after 40 years residence. Pro-rata for shorter periods.  Reciprocity rules for residence in other countries.	Full benefit after 40 years residence. Pro-rata for shorter periods.  Reciprocity rules for residence in other countries.	Full benefit after 10 years residence since age 20, 5 of which must be after age 50. No pro-rata for shorter periods.  Reciprocity rules for residence in other countries.	Full benefit after 10 years residence in 20 year period before or after age 65. No pro-rata for shorter periods.  Reciprocity rules for residence in other countries.
<b>Benefit level<sup>40</sup></b>	Level 1 (poverty alleviation)  Married individual receives less than single.	Level 2 (poverty avoidance)  Married individual receives less than single.	Level 3 ('social inclusion')  Married individual receives less than single.	Minimum of Level 2; if possible Level 3 (22%-25% NAE).  Married individual receives same as single.
<b>Other state pension benefits</b>	A means-tested flat-rate top-up, small compulsory occupational pensions and tax-incentivised voluntary occupational pensions.	A means-tested top-up, tax-incentivised occupational pensions (some mandatory) and limited tax incentives for voluntary savings.	No further state pension, compulsory pensions or tax incentives for voluntary savings.	Tax incentives to continue for voluntary occupational and personal pensions.
<b>How paid for</b>	General tax revenue.	Hypothecated contributions (up to an earnings cap) plus top-up from general tax revenue.	General taxation, with hypothecated invested fund to smooth tax requirements.	Hypothecated National Insurance contributions (between earnings limits).

<sup>38</sup> PPI analysis from various country-specific sources; PPI (2003 SPM)<sup>39</sup> NAPF (2004). The PPI were commissioned by the NAPF to do the underlying analysis for this report. The proposal is interim – parameters are under consideration.<sup>40</sup> For definition of levels see the PPI paper for the first of this seminar series, PPI (2005 SEM1) p. 28

### **Universal has been considered as an alternative to contributory before**

The universal pension has been considered as an alternative to the contributory pension before in the UK, but preference has been to keep the contributory system.

#### **1940s**

The New Zealand universal state pension is very similar in outcome to the model Beveridge proposed for the UK in 1942. In fact, Beveridge explicitly based his plan on the contemporary New Zealand state pension: *Broadly the two schemes [Beveridge's and the 'precedent' of New Zealand] are plans on the same lines to solve the problem of passage from pensions based on need to pensions paid as of right to all citizens in virtue of contribution.*<sup>41</sup>

#### **1970s**

New Zealand was again a model for the 1970s UK reforms that culminated in SERPS, but while New Zealand scrapped that reform, the UK continued with it.

- The New Zealand government added an earnings-related contributory tier in 1975, in response to concerns that only a minority of people were able to achieve a continuation of income in retirement through occupational schemes<sup>42</sup>.
- However, two years later this SERPS look-a-like was scrapped, to be replaced by a higher single universal pension.
- One reason for doing so was fairness towards women<sup>43</sup>. The earnings-related contributory tier was seen as unfair to women who spent less time in the labour market and earned less.

In the 1970s UK debate, it was thought that the universal pension was administratively difficult compared to a contributory system, and not to offer any obvious other benefits (Box 3).

- The advantage of simplicity in using residence as the criterion for benefit eligibility was seen, but NI contributions were thought to be the easiest (and most acceptable for confidentiality reasons) for collecting revenues. Therefore NICs could also be used for the eligibility criterion<sup>44</sup>. The option of using residence as the eligibility criterion and NICs as the revenue collecting mechanism does not appear to have been considered.

<sup>41</sup> Beveridge (1942) para 16, p. 9

<sup>42</sup> New Zealanders are mainly self-employed or employed in small businesses, so there have been relatively fewer large employers providing pension schemes compared to the UK

<sup>43</sup> St. John & Gran (2001). The anonymous Nuffield paper (1971) gives more details, and an in-depth assessment of the UK 1970 reform proposals compared to the then current New Zealand scheme, coming to the view that the UK should not follow the New Zealand approach (which was itself later scrapped).

<sup>44</sup> DHSS (1971) para 21 p. 7

- Women tended to be mentioned in early policy documents only as widows with a spouse's pension, or as non-working wives to whom it was thought to be too expensive to give a universal pension<sup>45</sup>. It was assumed in the introduction of SERPS that the contributory system would be a sufficient and easy way of dealing with women<sup>46</sup>.
- Contributory pensions were also assumed to be better at encouraging private pension saving in occupational schemes than universal benefits. But this was confused by two factors not wholly relevant to the contributory vs. universal debate. First, in comparisons with other countries such as New Zealand the different levels of state pension were not properly taken into account<sup>47</sup>. Second, in the UK the large size of the existing occupational schemes meant that the potential contracting-out requirements became a critical part of the debate.

**Box 3<sup>48</sup>: Reasons put forward in the 1970s for the UK to continue with contributory principle rather than switch to a universal pension**

1. That without the link between benefits and contributions, alternative tests would need to be devised in terms of 'residence' or citizenship...and the administration of such tests might prove to be as rigid, time-consuming and unsatisfactory as any tests under a 'contributory' system.
2. That benefit authorities would still need information about the personal circumstances of potential beneficiaries, and that in view of traditional attitudes towards confidentiality, it was not reasonable to suppose that a single set of records could be used for tax and benefit purposes.
3. That a non-contributory system would not be as satisfactory in dealing with the special circumstances of groups such as the self-employed, the non-employed and married women.
4. That the existence of state benefits regardless of the contribution record might have a damaging effect on the development of alternative means of saving for old age e.g., through occupational pension schemes.

This chapter has shown that universal pensions have always been an alternative to the contributory method, although contributory has generally been preferred for reasons reflecting the assumptions of the time. The next chapter examines why the contributory vs. universal debate has become more active today.

<sup>45</sup> DHSS (1971) para 21 p. 8

<sup>46</sup> DHSS (1974) p. i

<sup>47</sup> From analysis by an anonymous researcher working on a grant from the Nuffield Foundation (1971)

<sup>48</sup> From analysis by an anonymous researcher working on a grant from the Nuffield Foundation (1971)



## **Chapter 4: What arguments are made now for contributory and universal?**

This chapter examines the arguments for contributory and universal pensions in the context of today's intensive pension reform debate.

Recognising that state pension reform is now needed in the UK, the options for eligibility criterion are either to introduce a universal pension or to modernise the current contributory pensions.

- A universal pension has support as it is simple and inclusive.
- Linking contributions and pension benefits to work still has support, despite some uncertainty as to what that means in practice.
- The contributory method could be modernised to deliver better against the contributory objectives.

**This paper focuses on whether the 'foundation' state pension should have the eligibility criterion of contributory or citizenship.** This 'foundation' pension may not be the same as the current BSP. The multi-component structure of the pension system may well need to be changed. This paper does not look at a particular structure for state pensions, or consider whether, if there were to be a universal pension, a contributory second tier could co-exist<sup>49</sup>.

### **Universal system supported as simple and inclusive**

The need for state pension reform to provide a better foundation pension to prevent poverty is now widely recognised<sup>50</sup>. The concerns are a very complex system, inadequacy of the contributory pensions in level and coverage (particularly for women) and doubts over the increasing reliance on means-tested benefits which seem to act as a barrier to private saving<sup>51</sup>.

Advantages of a universal pension compared to the current contributory pension system have been put forward (Box 4). In today's debate, simplicity and fairness to women are more important than they ever have been.

### **Linking contributions and pensions to work has support**

There is still plenty of support for the contributory system instead of the universal alternative (Box 5).

<sup>49</sup> The next PPI/Nuffield seminar in the series will look at the issue of whether the state should provide an earnings-related tier, which would be contributory

<sup>50</sup> See, for example, the PPI's Stocktake analysis Briefing Note Number 18 *Pension reform: An update*, and the discussion from the first seminar in this series, on the PPI website

<sup>51</sup> See for example PPI (2004 SPR Summary)

**Box 4: Reasons put forward in support of a universal pension in the current UK debate**

1. **Simplicity:** *We believe the State would offer greater clarity via a single, State pension for all, linked to earnings, based ideally on a clear residency test....Communicated regularly, this structure would give much more clarity to consumers about what the pension 'promise' is from the State...*<sup>52</sup>
2. **Less pensioner poverty:** *There seems little reason to operate a complex accounting system to track NI contributions and credits over each person's working life in order for them to qualify for a full or partial basic state pension which in any case will be supplemented by means-tested benefits...We therefore recommend that the basic state pension should be paid on the basis of citizenship rather than contribution record.*<sup>53</sup>
3. **Every individual would be treated fairly** in the sense that the same state pension would be received regardless of life history, and without making judgements about which circumstances 'deserve' a credit. *Virtually all citizens make positive contributions to the economy and society through their paid and unpaid work in the period between the end of their formal education and their retirement... a shift to citizenship-based entitlement will do much to protect and enhance the interests of current women pensioners who have derived rather than individual entitlements.*<sup>54</sup>
4. **Cheaper to administer** ...44 year histories of National Insurance contribution records would not need to be so detailed and accrued benefit calculations would no longer need to be updated annually...<sup>55</sup>
5. **Future state pension expenditure can be planned with more certainty.** *The cost of [a universal pension] is a direct function of the number of older people....so sensitive to demographic changes only..... In the UK system there are ... major areas of future cost uncertainty...*<sup>56</sup>

A recent public attitudes survey found strong support for the principles of a universal pension<sup>57</sup>:

- Over half the respondents supported the view that everyone should receive a flat rate of state pension (rather than the state pension being earnings-related).
- 80% of respondents agreed with the statement that "women should get the same state pension as men, even if they stayed at home instead of going out to work".

<sup>52</sup> Aviva/Norwich Union (2005)

<sup>53</sup> House of Lords Select Committee on Economic Affairs (2003) para 8.10

<sup>54</sup> House of Lords Select Committee on Economic Affairs (2003) paras 8.10 – 8.12

<sup>55</sup> NAPF (2004) page 7

<sup>56</sup> O'Connell (2004 CPNZ)

<sup>57</sup> NAPF (2005) page 5

**Box 5: Reasons put forward in support of a contributory pension in the current UK debate**

1. **State pension benefits should be linked to contributions paid:** *'National Insurance' is still a good brand name....There is much to be said for a system that conveys this idea [of redistribution across people's lifecycles.] Given the imperfection of the system, this is close to saying that the system is a myth, but a useful myth for the population to believe in.*<sup>58</sup>
2. **Accrued rights prevent political manipulation.** *The citizen's pension would be set at an arbitrary level by the government of the day. At any time, pensioners, who are forming an increasing proportion of the electorate, could vote for its increase.*<sup>59</sup>
3. **State pension benefits should be a reward for work:** *The government should provide a contributory or credit-based flat rate non-means tested first tier pension at a level which aims to ensure that nobody who has worked, undertaken unpaid caring duties during their working life, or has for some other good reason undertaken little or no paid work, should be faced with absolute poverty in retirement.*<sup>60</sup>
4. **Coverage can be extended by widening the eligibility criteria:** *We want to reform the way the contributory system works to help the many people who at present are not able to build up a contributory basic state pension because they are low earners or because they take career breaks to care for children or sick relatives.*<sup>61</sup>
5. **A residency eligibility criterion might not be straightforward:** *There are a number of issues which need to be considered before full-hearted support is given to [a Citizen's Pension]... 'who is a UK citizen? In an increasingly open EU labour market when would it be fair to grant a full UK BSP to those who had worked or lived for only a short period in the UK?*<sup>62</sup>
6. **Ideological attachment:** *Maybe it's just because I'm a Conservative that I'm inclined towards reforming the contributory principle rather than abolishing it.*<sup>63</sup>

*Most people want to see a bit of redistribution but they want to see themselves as having some rights as well and in a rough and ready way National Insurance is, I think, appealing to basic beliefs about social justice*<sup>64</sup>.

<sup>58</sup> Hills (2004) pp. 353-4

<sup>59</sup> Booth and Cooper (2005) p. 28

<sup>60</sup> SPC (2005)

<sup>61</sup> Conservative Party (2005)

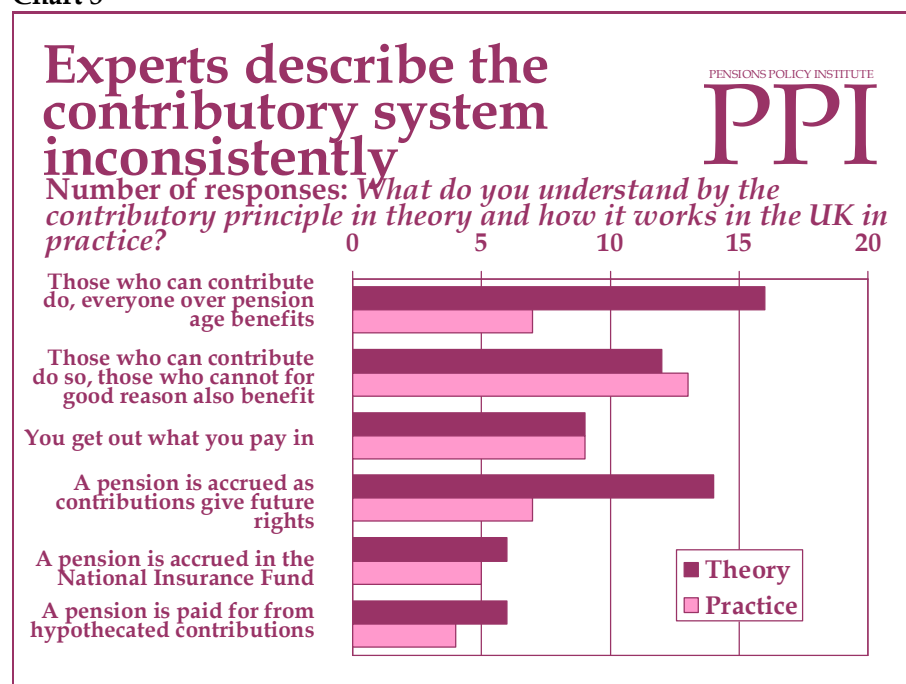
<sup>62</sup> ACA (2005)

<sup>63</sup> Conservative Spokesman on Work and Pensions, David Willetts, in a speech at IPPR on 13 December 2004

<sup>64</sup> TUC, quoted in House of Lords Select Committee on Social Security (1999) para 39

This support for the contributory principle has to be seen in the context of some uncertainty on what the contributory principle actually means in practice – among the general public<sup>65</sup>, and even among people involved in pensions. In a small survey asking pension experts to pick out what they understood by the contributory principle, and how it operates, a variety of answers were given, not all of which can be true (Chart 5).

Chart 5<sup>66</sup>



Public attitudes to the contributory principle are thought to be generally positive overall, but research on this reflects that<sup>67</sup>:

- The public tend not to know or understand how the contributory system works.
- The public like National Insurance Contributions because they believe that NICs fund the NHS.
- A perceived willingness to contribute more in NICs than in taxation has rarely been tested, as they are compulsory. However, NICs were increased in 2002 by 1%, with the message that this was to pay for the NHS.

<sup>65</sup> Hills (2004) p. 353

<sup>66</sup> PPI survey of 29 multi-disciplinary people involved in pensions at a Nuffield seminar May 2005

<sup>67</sup> House of Commons Select Committee on Social Security (1999) para 52

### The current system could be modernised

As highlighted in previous sections, it is recognised that the contributory system needs reform. The main issue for men is that self-employed people are currently outside of the State Second Pension (S2P), although inside the Basic State Pension (BSP). For women, the problem is around low earnings and caring situations for the BSP. As there are more women than men at all adult ages, and 60% of people aged over 70 are women<sup>68</sup>, the gender issue has received a great deal of attention.

Beveridge based his report on the 1931 Census that showed more than seven out of eight married women did not work. The assumption was that after the war, women would go back to being housewives. The contributory system evolved, assuming women would rely on their husband's retirement income<sup>69</sup>.

However, the role of women in society has changed considerably since the assumptions of that time<sup>70</sup>:

- 71% of working age women are in work today; 72% of married women.
- 44% of working age women work full-time; 39% of married women.
- 27% of working age women work part-time; 33% of married women.

Although successive governments have attempted to adapt the pensions system to meet these changes, it is still not seen to be sufficient.

- Currently only 13% of women receive a full Basic State Pension in their own right<sup>71</sup>, and 50% of women over state pension age receive less than a full BSP<sup>72</sup>.
- The average weekly amount of SERPS and S2P received by women is £13, compared to £39 received by men<sup>73</sup>.
- The changes already made will not mean that women eventually have the same pension as men. By 2020 the projected average entitlement to BSP of women reaching state pension age is expected to be 85% of the full rate<sup>74</sup>, eventually reaching 90%. The average entitlement for men is assumed to remain at over 95% of the full rate<sup>75</sup>.

<sup>68</sup> GAD (2004) 2003-based population projections

<sup>69</sup> Timmins (2001) pp. 54 - 56

<sup>70</sup> PPI analysis of the Family Resources Survey 2003/4. In work, full-time and part-time are based on the ILO definitions of employment status.

<sup>71</sup> PQ Sir Archy Kirkwood, House of Commons *Hansard* 8 December 2004, Column 574W

<sup>72</sup> PQ Jim Cousins, House of Commons *Hansard* 17 March 2005, Column 425W

<sup>73</sup> PPI calculation based on DWP (2005 SPSS), including contracted-out equivalent

<sup>74</sup> Curry & O'Connell (2004 TPL)

<sup>75</sup> GAD (2003 QR)

Proposals have been considered to reform the contributory framework to alleviate these gender inequalities<sup>76</sup>:

- Reduce the Lower Earnings Limit (LEL) to bring more low-paid workers into the National Insurance system. People earning below the LEL currently do not make NI contributions, so do not accrue benefits unless eligible for a credit.
- Abolish the '25% rule' which only allows any BSP to be paid if at least 25% of the necessary qualifying years have a contribution or credit (so that at least 10 years of contribution record are necessary for any BSP to be paid).
- Replace Home Responsibilities Protection (HRP) with a positive credit calculated by counting the number of hours caring each week, with hours over a certain number, in specific circumstance such as caring for a child of a certain age, or an older person in need of care. HRP is currently not a credit, but operates by reducing the number of qualifying years needed for a full pension.

The effect of these proposals would be gradually to include more women in the contributory Basic State Pensions, but not all would automatically be included:

- There would still be 'judgement gaps' where for example, some may think a credit is appropriate when caring for children aged 6-16 (as is currently the case for BSP but not S2P), but others may think a credit should be given only when caring for children aged under 6. Similarly, different judgements would have to be taken on the number of hours caring a week, or on the appropriate level of the LEL. There are no proposals to extend credits to unemployed or disabled people not receiving specific benefits, who represent over 1 million of those currently not being credited.
- There would still be 'technical gaps', such as when a caring credit cannot be obtained for the year unless the caring starts and ends coincident with the tax year. Even a system of weekly credits is likely to mean weekly gaps. If credits are not linked to the benefit system, or other information already collected, they may have to rely on a system of self-reporting where entitlement could be hard to prove and susceptible to low levels of take-up. Further, caring by more than one person, each doing fewer than the weekly hours limit, will not give rise to credits, even though the caring might be sufficient to prevent each carer from working.

*...the complexity of caring arrangements does not lend itself to a formula that you can encompass by national insurance credit.<sup>77</sup>*

<sup>76</sup> For example, Age Concern and Fawcett Society (2004), and EOC (2005). Age Concern suggests these are first steps and supports more radical reform.

<sup>77</sup> Baroness Hollis of Heigham, House of Lords *Hansard* 25 May 2005 Column 504

- Basing contributions on all earnings, in effect removing the LEL, would give entitlement to another 0.7 million women and 0.5 million men<sup>78</sup>.
- The abolition of the '25% rule' would give more pension to around 100,000<sup>79</sup> people, as the majority of women over state pension age receive some BSP, even if it is not based on their own contributions. The additional entitlement to a small benefit would probably be offset in many cases by reductions in means-tested benefits.
- Making HRP a positive credit could be introduced retrospectively, but extending coverage of HRP retrospectively would be extremely difficult, as people probably do not have records of how many hours a week caring they spent in past years. If it could be administered effectively, extending the system of HRP could give up to further 0.4 million people some entitlement today<sup>80</sup>.

Even assuming that a weekly positive credit system with no LEL could be introduced and effectively administered, over half of the people currently not accruing BSP (2.3 million) would still be outside of the contributory system. Of these, up to 1.2 million unemployed and disabled people may be considered to be 'deserving'. In reality, the administrative complexity of running an expanded system makes it likely that at least some of the 2.2 million people brought into the extended contributory system would fall in to 'technical gaps'.

Therefore, an optimistic estimate of what a contributory system modernised in this way could achieve is, instead of the current 4.5 million people not accruing a right to the Basic State Pension each year, at least 2.3 million would still be outside the system. But the number paying contributions would of course stay the same (Chart 6)<sup>81</sup>.

Other ways of crediting in more people to the contributory system could also be investigated. For example, the number of qualifying years required for a full pension could be reduced from 44 to, say, 20. This would include more people, but will still leave some outside the system. Because it would not cover a full working life, it would be much less like the contributory principle and more like a universal pension.

<sup>78</sup> All figures are PPI estimates based on the 2003/4 Family Resources Survey unless otherwise stated

<sup>79</sup> PQ Baroness Greengross 18 December 2003, House of Lords *Hansard* Column WA179

<sup>80</sup> This is the maximum assuming that any hours of caring qualified for HRP

<sup>81</sup> Assuming those below the Lower Earnings Limit do not pay contributions (as is the case today for people earning between £82 and £94 a week)

Chart 6<sup>82</sup>

# Modernising the contributory system still leaves gaps

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The number of working age people who contributed, were not credited or were credited-in to the BSP under the current system in the year 2003/4 compared with estimated figures under a modernised system

		Number of people (millions)		
		Contributing	Credited-in	Not credited
Current BSP	Men	13.5	2.5	2.0
	Women	10.5	4.0	2.5
	Total	24.0	6.5	4.5
Modernised BSP	Men	13.5	3.5	1.0
	Women	10.5	5.2	1.3
	Total	24.0	8.7	2.3

<sup>82</sup> PPI calculation based on Family Resources Survey 2003/4 and analysis in page 27. The figures are based on one particular week. Credited in figures include people receiving HRP.



## **Chapter 5: How should we decide between contributory and universal?**

Previous chapters suggest that the modernised contributory and the universal systems for state pensions might meet the same objectives. However, perceptions of what the two methods ‘mean’ – as opposed to what they would actually achieve in practice – will inevitably cloud judgements. This chapter attempts an evidence-based approach to such a policy decision.

It may be that the question comes down to is it ‘better the devil we know’?

- A universal pension is still likely to be better than a modernised contributory pension in delivering adequacy for all.
- Current preferences appear to be with the universal pension, although the contributory method has the advantage of requiring least practical change.

### **Universal likely to be better than modernised contributory**

The PPI has previously identified 10 tests for any pension reform option. The Government’s principles for reform are very similar. These tests are set out in Appendix 1.

Table 3 summarises the results of applying these tests to a universal pension and a modernised contributory pension:

- To compare like-for-like it is assumed that both the universal and contributory single tier pension are at the level of the means-tested benefit and indexed in line with earnings, the rate at which the means-tested minimum income is indexed. If this is not the case, then the level of pension will be inadequate<sup>83</sup>. What is being investigated here is not so much the level of pension but how eligibility is defined.
- The modernised contributory pension assumes that the extension of coverage is extended as suggested in the last chapter (lower LEL, abolish 25% rule and weekly credits for carers).
- Other options and issues to do with transition from the current system are discussed in the table where relevant.

<sup>83</sup> See PPI Briefing Note Number 15 *Can current policy be as good as the alternatives?* and PPI (2004 MT)

**Table 3<sup>84</sup>: Assessment of a modernised contributory pension and a universal pension against the PPI 10 tests for pension reform**

	<b>Modernised contributory</b>	<b>Universal</b>
<b>1. Poverty prevention</b>	<p>Provided benefit level is high enough, adequacy depends on success of the contributory crediting system.</p> <p>In the long-term there could still be 10% to 20% of people over state pension age with means-tested income as even extending coverage would leave people outside of the system<sup>85</sup>.</p> <p>In the short-term, there would be minimal change in the number of people on means-tested benefits as the improvements to the contributory system could not be made retrospectively.</p>	<p>Provided benefit level is high enough, adequacy depends on the actual residency criterion used and how many people over state pension age would not satisfy it.</p> <p>A universal pension could immediately take eligible people over state pension age above the means-tested income level. Around 5% of people could still need means-tested income. 10%-20% of people might need to be tested against reciprocity agreements with other countries, but most of those would have private pensions as well as other state pensions<sup>86</sup>.</p>
<b>2. Incentive to save</b>	<p>Organisations involved in UK pensions agree that to encourage saving a simple state foundation tier is required. Whether that tier is contributory or universal seems to be less important than the benefit level being above the means-tested level, and the availability of incentives for additional voluntary provision<sup>87</sup>.</p> <p>There will be more means-testing with a contributory pension than a universal pension of the same level, and this may give rise to more of a barrier to saving than a contributory pension.</p>	<p>The simplicity of a universal pension could mean that the Informed Choice agenda is more likely to work as the state underpin will be more easily understood.</p> <p>On transition to a universal pension some Defined Benefit schemes will redefine their benefits. Some (but not generally the schemes themselves) see this as a risk to the continuance of DB schemes<sup>88</sup>. But this risk - if it exists - is a consequence not of a universal foundation state pension, but of ending S2P and contracting-out. DB may also decline for other reasons.</p>

<sup>84</sup> PPI analysis. See Appendix 1 for a longer description of the tests. See also O'Connell (CPNZ).

<sup>85</sup> PPI estimate based on analysis in Chapter 4. This examines means-testing for basic income (Pension Credit). Housing Benefit and Council Tax Benefit will still be needed, depending on the level of pension benefit.

<sup>86</sup> PPI estimates

<sup>87</sup> See PPI Briefing Note Number 18 *Pension reform: An update*. ABI (2005) compared a universal pension with no incentives for further saving (including in that definition contracting-out) with a targeted state pension with incentives to save; but incentives to save could be the same in both cases.

<sup>88</sup> See NAPF (2004) Chapter 3 and PPI Briefing Note Number 18 *Pension reform: An update*

<b>3. Short-term cost (additional to the current system)<sup>89</sup></b>	<p>Apart from the cost from increasing the <u>level</u> of the pension, extending coverage will cost very little in the short-term, as it makes little impact on current pensioners.</p> <p>Increasing the level of the BSP to the level of the means-tested minimum income could cost around 1% of GDP; £15bn a year extra in the short-term.</p>	<p>As coverage would be extended immediately, there is a short-term cost, covered to some extent by savings on means-tested benefit.</p> <p>Introducing a universal pension at the level of the means-tested minimum income could cost around 1.5% of GDP; £20bn a year extra in the short-term<sup>90</sup>.</p>
<b>4. Long-term cost (additional to the current system)<sup>91</sup></b>	<p>By 2050 a BSP at the level of the means-tested minimum income could cost around the same as the cost of a universal pension at the same level.</p> <p>This is because BSP would continue to be paid to pensioners living overseas. Less money would be paid to pensioners residing in the UK through BSP than through a universal pension.</p> <p>People without a full contribution record would receive a lower BSP. For 10% to 20% of pensioners this could be offset by the Pension Credit.</p>	<p>By 2050 the additional cost of a single universal pension at the level of the means-tested minimum income could be around 3.5% of GDP; £100bn a year (in current prices)<sup>92</sup>.</p> <p>The administration cost of a universal pension would be expected to be lower than that for the current contributory pension even if NI contributions are retained to collect revenue, especially if S2P and contracting-out are stopped (which could also be done with a single contributory pension).</p>

<sup>89</sup> Figures are PPI estimates, unless otherwise stated

<sup>90</sup> This cost assumes that a universal pension replaces the existing BSP. If a universal pension were 'offset' against accrued S2P and contracted-out rights there would be no additional cost in the short run (see NAPP (2004) for further details). It may also be possible to reduce the cost of increasing the BSP using the 'offset' method.

<sup>91</sup> Figures are PPI estimates, unless otherwise stated

<sup>92</sup> Assuming that S2P remains on top of the universal pension/BSP. If S2P and contracting-out were abolished, the additional net long-run cost would be around 1.5% of GDP.

<b>5. Longer lives and later working</b>	<p>The contributory system has one parameter linked to longevity – state pension age – and one connected with length of working – the number of contributions (or credits) needed to be eligible for the full pension. In theory, these parameters could be changed to react to longer lives, although changes to either would be politically difficult if not signalled well in advance.</p>	<p>The universal system has one parameter linked to longevity – state pension age. In theory, state pension age could be raised to react to longer lives, although this would be politically difficult if not signalled well in advance.</p> <p>The universal system does not necessarily help or hinder the trend to later working compared to contributory.</p>
<b>6. Fair to all</b>	<p>The notion of fairness underlying the contributory principle is that the state pension should be given to groups that are judged to ‘deserve’ it, either by contributing or by being credited in.</p> <p>The risk of a contributory method is that the credit system does not achieve this objective appropriately. For example, some people believe it is wrong that some carers do not get the current contributory pension, but the unemployed do. A modernised contributory system would attempt to put this right, but as shown in Chapter 4 would not be able to do so perfectly.</p> <p>It could also be said that this fairness principle is in practice impossible as means-tested benefits would always be expected to give a minimum income to people over state pension age with no other income.</p>	<p>The notion of fairness underlying the universal pension is that everyone of pension age should receive the same state pension regardless of activity during working age.</p> <p>This does not exclude the possibility of some exceptions, e.g., people in prison.</p> <p>The risk of a universal method is that the residency criterion excludes people that ‘should’ receive the pension, and includes people that ‘should’ not, because such a criterion cannot cope with mobile people. The choice of residency criterion is therefore critical: a short period may be easier to administer without necessarily costing more.</p> <p>As other EU countries have a universal pension, and existing reciprocity arrangements could work, mobility (which affects a minority of people) appears to be manageable<sup>93</sup>.</p>

<sup>93</sup> NAPF (2004) Chapter 4

<b>7. Simple &amp; under-standable</b>	<p>It is difficult for individuals to work out what contributory pension they will get in future as it depends on the outcome of over multiple parameters (conservatively, over 30 for the current contributory system)<sup>94</sup> over their lifetime e.g., country of residence, whether in work, type of employment, earnings level, marital status, and eligibility for credits, which could involve counting how many hours caring (in specific circumstances) were spent each week.</p> <p>There can be errors and time delays in calculating contributory pension amounts<sup>95</sup>.</p> <p>Individualised pension forecasts are possible, but if people cannot understand where the figure comes from, they may not trust the outcome.</p>	<p>A universal pension is simpler than a contributory pension as it can be described by two parameters: the £ amount (or % of NAE) and state pension age. Individualised state pension forecasts are not needed.</p> <p>The only lifetime parameter that would change the future pension is country of residence. Marital status would do if the benefit level for married people were chosen to be different from twice that of a single person.</p> <p>There will be some cases of people with multiple spells abroad where determining periods of residency will be complicated. But the same difficulty exists with the current contributory system, as residency is necessary to determine reciprocal arrangements with other countries.</p>
<b>8. Access for oldest</b>	<p>The contributory method itself does not hinder access for oldest (which is a particular problem if benefits are indexed to something less than earnings).</p> <p>The current oldest with an incomplete contributory record would not benefit from modernising the credit system, as the changes could not be made retrospectively.</p>	<p>The universal method itself does not hinder access for oldest.</p> <p>The current oldest with an incomplete contributory record would benefit from an immediate transition to a universal pension.</p>

<sup>94</sup> PPI analysis

<sup>95</sup> The NIRS2 system does not always have up to date contribution records at the time of paying the pension, and, as over 40 year histories are required, some records have errors

<b>9. Sustainable</b>	<p>Some suggest that the contributory method protects against the threat of adverse political changes, either that older people vote for too high a pension, or Government cuts pension benefit.</p> <p>But:</p> <ol style="list-style-type: none"> <li>1. There will always be a lobby for higher state benefits, whatever the system.</li> <li>2. Contributory rights are not actually purchased and held in the NI fund.</li> <li>3. A Government can legislate to change the value of 'accrued rights'. They are constrained in doing so not by the contributory principle, but because it would be unacceptable to the electorate in any system.</li> <li>4. The continued 'myth' of accruing rights of value may not be trusted by the electorate for ever.</li> </ol>	<p>Some believe that the transparency of simple universal pension could be the best guard against political interference: the electorate would be able to tell very easily if cuts were proposed.</p> <p>Other mechanisms could be set up to make the system more stable, e.g., an 'Accord' where political parties sign up to the principles and structure underlying the pension system<sup>96</sup>. A ring-fenced 'fund' for National Insurance contributions out of which the universal pension is paid, with a governing committee, could be made more explicit.</p> <p>Such mechanisms could also be used in a contributory system.</p>
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<sup>96</sup> See NAPF (2004) Chapter 6

<b>10. Transition</b>	<p>Transition to a modernised contributory system appears straightforward, in the sense that new coverage and crediting rules are building on an existing system.</p> <p>But, some circumstances will still be impossible to cover by credits e.g., how to count hours of caring when there is more than one carer.</p> <p>Transition by changing the crediting rules takes effect slowly, as accrued rights on the new system build up. It would be over 40 years before everyone's full accruals are on the new rules, unless the number of required qualifying years was cut.</p> <p>While a universal pension appears popular, there might be some tension from those who have paid voluntary National Insurance contributions who may feel misled (even though this would not be strictly the case). However, there are counter-examples such as married men who get additional benefits for a wife whereas single men pay the same contributions for less benefit.</p>	<p>Transition to a universal pension would require a new residency criterion to be chosen and implemented. There are residency tests used in the UK currently that could be adapted.</p> <p>It may be useful for other purposes to introduce a new residency test and a method of measuring residency (e.g., population registers as used in other EU countries).</p> <p>Immediate transition is possible, improving the pension income of those over state pension age with incomplete contributory records and preserving the expected value of accrued rights on the old system. Depending on the level of the new pension, it could take up to 15 years for 85% of people to be fully on the new rules<sup>97</sup>.</p> <p>While the method of checking eligibility would need to change, the method of collecting revenue need not. A universal pension could still be paid by hypothecated National Insurance contributions.</p>
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<sup>97</sup> This is a consequence of the 'offset' method. See NAPF (2004) page 16.

The assessments in Table 3 show that a modernised contributory system may still not be as good as a universal pension, largely because the universal system would resolve the problem of gaps in contributory records:

- There will still be at least 2.3 million people a year who fail to accrue rights to a contributory pension, even after the modernisation of credits. Some of these people would ‘deserve’ to be covered.
- A more complicated set of credits would make it more difficult for people to understand how their pension is calculated.
- Because of the gaps in coverage, means-tested benefits will be needed by more people over state pension age with a modernised contributory system than with a universal pension.
- The modernisation of the contributory system is likely to take a long time to be effective. Transition to a universal pension can be better for the current generation of people (mostly women) with an ‘unfairly’ incomplete contributory record.
- The current method of collecting revenues (National Insurance contributions) can be maintained for both systems. Complexities of administration exist in both cases: for mobile workers with the universal and contributory systems and for carers in the contributory system.
- The state ‘promise’ of future benefits can be clearer with a universal system, and protected under both systems by better ring-fencing contributions.

### **Preferences with universal; contributory is ‘least change’**

The analysis in this paper crystallises five main points at issue in the current UK contributory vs. universal debate (Box 6).

There is relatively little analysis of the two options available. This means that the debate is often in terms of opinion, perhaps based on ideology, rather than facts. Both principles, contributory and universal, have their supporters, so that the first three questions in Box 6 can be answered ‘yes’ or ‘no’.

At this stage of the debate, organisations making reform proposals<sup>98</sup> tend to prefer the universal pension over the contributory pension, with others agreeing that further analysis should be done. Few are actively supporting the contributory method (Chart 7).

As opinion appears to favour the universal approach, more analysis seems justified on the transition to and administration of a universal pension, to answer the last two questions in Box 6. Without such an analysis, such a significant change appears difficult and risky. This tends to give an advantage to the contributory system as the ‘devil we know’.

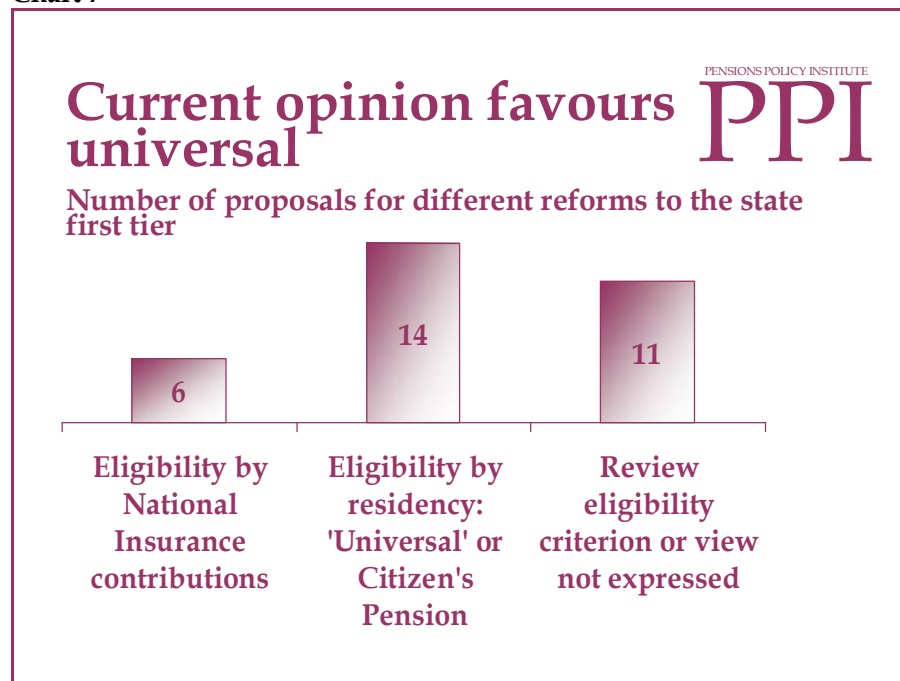
<sup>98</sup> From an analysis of pension reform proposals made late 2004/early 2005 by organisations involved in various pension-related fields. See PPI Stocktake analysis on [www.pensionspolicyinstitute.org.uk](http://www.pensionspolicyinstitute.org.uk) for further details.



#### Box 6: Main points of debate between universal and contributory state pensions

1. Can a universal pension be set up to be perceived to be no more susceptible to future **political interference** than the contributory system is, or is there still a potent perception that the contributory principle will better protect rights?
2. Could the **improvements for women** and other disadvantaged groups from a modernised contributory pension be, if not as good as a universal pension, good enough?
3. Could switching to a universal pension introduce a more appropriate notion of **fairness**? Is it better to make judgements on whether a life history 'deserves' a state pension or not to have to do so?
4. Could the **administration** of a universal pension with a residency criterion be easier for more cases, and so cheaper, than a contributory system with extensive detailed credits, or will the latter work well enough?
5. **Transition** to a universal pension appears possible, but would there be unintended consequences, so that modernising the contributory system seems less risky?

Chart 7<sup>99</sup>



<sup>99</sup> Based on PPI Stocktake analysis, Briefing Note Number 18 *Pension reform: An update*

## Appendix: The tests for state pension reform

### **Government principles<sup>100</sup>**

Tackle poverty effectively

Opportunity to build an adequate retirement income open to all

Affordability and economic stability

Fair outcomes for women and carers

A system that people understand

Based around as broad a consensus as possible

### **PPI tests<sup>101</sup>**

1. 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?
2. Does the reformed UK state pension system enable individuals to meet their personal objectives for additional retirement income through occupational and personal private pensions?
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. Is the reformed policy capable of being sustained for at least 30 years, and preferably 40 years?
10. Can transition from the current system be managed effectively?

<sup>100</sup> DWP (2005 PFR)

<sup>101</sup> O'Connell (2003 SPR)

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