

PPI

State pension reform: A Summary

State Pension Reform: A Summary

The following summarises the PPI's current view on pension reform.

1. The problems with the current pension system are:
 - **Inadequacy:** Around 20% of pensioners are in poverty, exacerbated by low Pension Credit take-up (75%).
 - **Inequalities:** The system accumulates disadvantage for many people, in particular women (eligibility by national insurance) and older pensioners (indexation).
 - **Sustainability:** Future state expenditure on pensions has a wide funnel of doubt; and makes assumptions that may be impossible to sustain as the number of pensioner voters increases (low take-up of benefits; decreasing state pension per pensioner).
 - **Complexity:** The system is highly complex for no good purpose, and the Pension Credit means-testing trap presents real barriers to private pension saving.
 - **Problems getting worse:** Private saving is flat but it needs to grow because state pensions are declining and pensions cost more as we live longer.
2. There is a **strong consensus** that the state pensions system should be modernised to prevent future generations retiring with lower retirement income than is seen today.
3. The consensus for reform is that **the foundation state pension should be above the means-testing level**. There are 2 ways of achieving this: increase the Basic State Pension or move to a Citizen's Pension.
4. The latter would be more effective at reducing poverty, inequality and complexity. Both are possible, affordable and sustainable, provided transition is managed in certain ways.
5. **Reform of the state pension system should happen first**, before further policy decisions are made on the private pension system. Whether compulsory private saving makes sense or not depends on what state pension system we have in future.
6. Crisis is not imminent, so we should **take some time** to find the right solution. All political parties and pension interest groups should be involved in an **open process to get some consensus and stability for the long-term**.

The following pages present the summary conclusions from PPI work on the subject.

A summary of conclusions from PPI state pension reform research

The Pensions Landscape (14 February 2003)

This paper reviewed the then current pensions situation and looked where state and private pension prospects were heading.

It concluded that:

Today's pensions landscape looks better than yesterday's – on average. But pensioner poverty remains, and there are no signs that tomorrow's landscape will look any brighter. To avoid the risk that tomorrow's pensioners are worse off than today's, reform of state pension policy has to be debated.

Pensioners' incomes have risen, but so has the gap between the richest and the poorest:

- Today's average pensioner is better off than yesterday's. The average income for a single pensioner is £9,500 a year, or 44% of National Average Earnings (NAE). Most income comes from the state. Pensioners' incomes have grown faster than earnings on average, and so have improved relative to those of working age.
- Private pension income makes the difference between rich and poor pensioners. Occupational pension income is important for many pensioners; personal pensions and investments for fewer. Recent growth in private pensions has widened the gap between the richest and the poorest. The richest fifth of single pensioners now have annual incomes of £19,000 a year (87% of NAE), and the poorest fifth £4,600 a year (21% of NAE).
- A quarter of pensioners are in relative poverty. Typically, older pensioners are poorer, as are women, people from ethnic minorities and those who have been self-employed.

The make-up of pensioners' incomes will change but there are no signs that future pensioners will be relatively better off than the pensioners of today:

- Both the state and employers are reducing their long-term pension commitment. More people will receive state pensions in future. But state pension income per pensioner will fall relative to earnings, despite the earnings-linking of means-tested benefits. Employers are changing the type of provision offered, and reducing the amount contributed.

- Today's pension saving behaviour seems unlikely to deliver more private pension income in future. Total contributions to private pensions have stalled. Only a minority save in personal pensions. Pension saving is starting at later ages and tends to be irregular.
- Pension alternatives are not widespread. Most people do not have significant amounts of non-pension saving or investments. Those without pensions are less likely to have other assets. Housing is a significant asset for many, but is rarely converted into retirement income.

To avoid the risk that tomorrow's pensioners are worse off than today's, reform of state pensions policy should be debated now:

- Problems of lower pension income will only become apparent in the long-term. The average pensioner income will continue to grow in the short-term. But inequalities will increase if means-tested benefits are not taken up and if private pensions remain focused on higher earners - as is likely. More than one-third of future pensioners face being disappointed with their future retirement income.
- The long-term problems are due to unclear responsibilities now. Current policy assumes individuals will take more responsibility for pension provision. But the responsibilities of the state, employers and individuals remain largely undefined. Current initiatives address only some of these issues. Many people are unable - or unsure of how - to act.
- The future cost to the state of current pension policy is not clear. Current UK pensions policy constrains the cost of state pensions, meaning relatively less per pensioner. The *total* state budget for pensions in the UK will rise in future, although by how much is not clear. The right balance between the cost to the state of paying state pensions and the cost to the state of encouraging private pensions should be debated.
- Reform of state pensions policy should be debated now. Even though the average pensioner income may not worsen in the short-term, the long-term issues require a new solution to be debated now. The debate should start where the problems lie - with the structure of state pensions. In an ageing society, what state pension do we want and how much are we prepared to pay for it?

A Guide to State Pension Reform (10 July 2003)

Following the suggestion in *The Pensions Landscape* that the first step should be reforming state pensions, this paper focused on the UK's state pension system. It confirmed the case for reform by comparing the UK system to a minimum objective standard and to state pension systems in other countries, and by considering how state pensions are interacting with private pensions.

It confirmed that a review of UK state pensions is needed because there are serious pressure points in the current system.

Summary of current pressure points in the UK state pension system

1. The UK has an uncomfortably high number of pensioners in poverty.
2. With no change, UK state pensions will become less adequate.
3. The UK currently spends less than most other countries on state pensions.
4. The forecast of future UK spend on state pensions is likely to prove unrealistically low and socially unacceptable.
5. The UK state pension system has become separated from the significantly improved capacity for longer working lives.
6. The UK state pension system works particularly badly for some groups, especially women.
7. The complexity of the UK state pension system makes it harder than it need be for people to understand what they are likely to receive from the state during later life.
8. The combination of low price-indexed state pensions and extensive means-tested benefits means that the UK state pension system disadvantages people as they grow old.
9. Private pensions are not filling the gap left by low state pensions, and many of the causes of this can only be resolved once state pensions have been reformed.

The paper suggested a major programme of work is required to move state pensions policy forward in the most positive way. A clear sense of where the reform is heading (the long-term objective) needs to be balanced with ideas for how to get there (the transition practicalities). There are no 'off the shelf' solutions available from other countries.

A Guide to State Pension Reform proposed those questions by which possible models for state pension reform should be tested. It is unlikely that any solution will score a clear 'yes' on all tests. Choosing future pension policy is about making tradeoffs to find the best balanced solution.

Tests for a reformed state pension system

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

By making international comparisons and building on proposals made by other UK organisations, the paper proposed five models of state pension reform to be evaluated against the proposed tests.

State pension reform models to be tested in the PPI review

1. **Status quo:** A multi-component system with extensive means-testing. The current system with minor changes should be compared with other possible reform models.
2. **Reform S2P:** Make the State Second Pension flat-rate and/or increase accruals to it for lower earners. This would keep the overall system structure, but increase redistribution to the poorest during their period of working age.
3. **Much higher BSP, scrap S2P:** Keep the contributory link and the structure of the Basic State Pension, but at a much higher rate, so that there is less means-testing. Stop accruals to the State Second Pension, so that the system is simplified to one main component.
4. **Citizen's Pension:** As the previous option, but instead of eligibility being built up by contributions during working life, eligibility is based on citizenship or residency criteria. This would be particularly beneficial to women, and others who spend time out of the labour market, or working at low levels of earnings.
5. **Age additions:** Increase Basic State Pension to the means-tested level (Model 3 or 4 above) but only for the oldest pensioners, say, age 80 and over. This reflects that people get poorer as they get older.

State Pension Reform: Consultation Response (10 March 2004)

Following on from *A Guide to State Pension Reform*, the PPI held a number of seminars with industry experts. *State Pension Reform: The Consultation Response* reported on the feedback collected and what it means for state pension reform. The findings are helping to shape the PPI's program of work on state pension reform.

The main conclusions were:

- There is widespread agreement on the problems with the current UK pension system. The issues on which there is most consensus are:
 - That the system is too complex, and
 - That state pensions are getting worse, because of the increasing extent of means-testing.
- The most important features of a future state pension model are:
 - **Sustainability**, as people wish there were political consensus to sustain a stable environment for pension planning and provision, and
 - **Simplicity**, as people want pension provision to be understood and pension planning able to be done with confidence.
- There was no widespread support for continuing with some form of the current pensions system. The most widespread support was for a Citizen's Pension or for scrapping the state second pension and increasing the Basic State Pension
- Policy reform should of course be based on the facts, and will have to challenge some common myths about the current system. The pension myths evident from the consultation include:
 - Everyone gets more or less the same state pension.
 - The state pension will be minimal in future.
 - Everyone has some private pension.

Citizen's Pension: Lessons from New Zealand (10 March 2004)

This paper was the next in the PPI series on state pension reform. Drawing on the long experience of a Citizen's Pension in New Zealand, this paper tested whether a Citizen's Pension could be advantageous in the UK. The main conclusions were:

- A Citizen's Pension of around 22-25% of national average earnings (£105-£115 pw) is a possible model for the UK. This level of benefit is not generous, but it would mean that hardly any pensioners need to be means-tested for their basic income.
- The Citizen's Pension passes the PPI tests for pension reform (as outlined in *A Guide to State Pension Reform*).
- The trade-off inherent in the Citizen's Pension is that it dampens the way the current state system favours high, consistent earners and instead simply gives senior citizens a basic income just above the poverty level. It suggests that the role of the state is to ensure that people have enough to live on in old age, leaving personal and occupational pensions to meet individuals' own ambitions for total retirement income.
- There appears to be no 'show-stopper' against the Citizen's Pension, so it should not be discarded as an option. Indeed, there could be significant advantages compared to the current pension system from adopting a Citizen's Pension in the UK, and it appears practically and economically feasible. It should be investigated further.

The PPI was subsequently commissioned by the National Association of Pension Funds to work on a major project *Towards a Citizen's Pension*, examining the practical and economic aspects of this policy. This project will publish an interim report at the end of 2004 and a final report in 2005.

State Pension Reform: Managing Transition (September 2004)

Managing Transition looked at the impact of the policy reform options identified in *A Guide to State Pension Reform* on pensioners in different financial circumstances, who retired before transition begins. The report drew heavily on analysis using the pension policy model developed by the PPI and funded by the Nuffield Foundation.

The main conclusions were:

- Transition to any new pension policy has been made more complex by the Pension Credit, specifically the Savings Credit element. This means that:
 - What to do with Savings Credit will be an important part of any transition plan.
 - As Savings Credit awards are increasing fast, reform will be easier to do sooner rather than later.

- The choice between increasing the Basic State Pension or moving to a Citizen's Pension depends in part on the decision on whether the new state pension should be paid in **addition** to accrued state pension entitlement or should be **offset**.
 - The addition method will be more regressive, giving windfall gains to richer pensioners.
 - The offset method will be more progressive, improving income immediately for poorer pensioners.

The logic of this choice is consistent with the choice between **contributory** or **citizenship** as the appropriate criterion for state pension entitlement: the former tends to favour people who do well at work, the latter protects people who are under-pensioned in the current system.

- Policy reform options that change the rate of accrual of the existing pensions - for example, to make State Second Pension more generous - avoid transition issues but will not improve pensioner incomes in the short-term.

- In practice, the choice of a new pension system, and the transition path, will be about making trade-offs between the potential 'winners and losers'. Given the complexity and range of outcomes possible from the current system, it is important to identify the real effects of reform.