NAPF

Towards a Citizen's Pension

Interim Report

December 2004

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Introduction

In October 2002 the National Association of Pension Funds recommended reform of the state pension system into a simple, universal 'Citizen's Pension' set at guarantee credit level (22% national average earnings). NAPF firmly believes a Citizen's Pension would have significant advantages over the current regime, which is the most complex state pension system in the world.

Our initial work suggested a Citizen's Pension would be affordable in the UK, but we wanted to do more work to show exactly how it could be introduced in practice. This report represents the first stage of that work, which began earlier this year.

The NAPF has asked the Pensions Policy Institute, under the leadership of Alison O'Connell, to undertake the detailed analytical work. The project is in two phases, and this report represents the output of the first phase.

We have set up a Steering Group to oversee the project. Members of the Group, who serve in a personal capacity and not on behalf of their respective organisations, are:

Tom Ross (Chair)	Former Chairman, NAPF
Rodney Bickerstaffe	National Pensioners Convention
Adrian Boulding	Legal & General
Ronnie Bowie	Hymans Robertson
John Hawksworth	PricewaterhouseCoopers
Deirdre Hutton	National Consumer Council
Paul Johnson	London School of Economics
Stewart Ritchie	Scottish Equitable
Rhoslyn Roberts	GUS plc, NAPF Benefits Council Chairman

Steering Group members have reviewed this report and commented on it. Whilst not every member of the Steering Group is entirely in agreement with everything in this report, the broad thrust of it commands their support. We are most grateful to the Steering Group, and especially to the PPI for their contribution to this important study.

The NAPF wants to promote an informed debate on the proposal that the UK should move to a Citizen's Pension system. Feedback on this report is warmly welcomed. Please send any comments you may have by the end of February 2005 to **Christine Farnish, Chief Executive NAPF, NIOC House, 4 Victoria Street, London SW1H 0NX** or email to **christine.farnish@napf.co.uk.**

We aim to produce a second report on the Citizen's Pension, which will take account of feedback and look in more detail at transition, costings and the implication of different levels of Citizen's Pension, next Autumn.

Christine Farnish

Christine Farnish
December 2004

Summary of conclusions

1. What is a Citizen's Pension?

1.1 A 'Citizen's Pension', also known as a Universal Pension, is a basic amount payable to every individual over state pension age who passes a residency test.

1.2 This report considers a Citizen's Pension of at least £105 a week in 2004 terms, indexed to earnings, as this is the current minimum level of income a person over pension age would have through Pension Credit.

1.3 The benefits of a Citizen's Pension would be adequacy, simplicity, inclusion, encouragement to save, efficiency and certainty.

1.4 Transition to a Citizen's Pension would speed up the change occurring anyway to the state pension system, while improving it.

1.5 With a Citizen's Pension, the role of the state in poverty prevention is clarified, making decisions on any further state role (including enhancing voluntary or compulsory saving) clearer.

1.6 No pension policy can satisfy all preferences, so a decision for a Citizen's Pension would be made because it gives the best package overall for the long-term.

1.7 There are perceived practical problems with a Citizen's Pension, but this report suggests that some of these are misplaced, and that others can be resolved.

2. A practical transition to a Citizen's Pension

2.1 Given that a Citizen's Pension replaces both Basic State Pension and State Second Pension, it is logical to 'offset' the Citizen's Pension against rights accrued in the current system. This allows the transition to a Citizen's Pension to be affordable, progressive (targets gains to poorer rather than richer pensioners) and immediate.

2.2 No pensioner should lose out; 8m pensioners currently receiving less than the Citizen's Pension level from the state would immediately gain.

2.3 Although 3.5m better-off pensioners would not receive windfall gains at C-Day (the day of transition to a Citizen's Pension) they would benefit from the more generous indexation of the Citizen's Pension.

2.4 As younger people gradually reach state pension age, the Citizen's Pension becomes more important than accrued rights so that in 15 years time, every new pensioner should be fully on the Citizen's Pension system.

2.5 To treat past decisions on contracting-out equally, the same offset should apply to contracted-out accrued rights. This could make any loss from the contracting-out decision more apparent, but there are possible ways of dealing with this.

2.6 Savings Credit is a particular complication in any transition and depending on the starting level of the Citizen's Pension, currently awarded Savings Credit amounts may need to continue.

2.7 Slower transition approaches are possible, but would not meet all the objectives, would cost more, and would be much more complicated.

2.8 National Insurance is envisaged to continue as a way of collecting contributions.

2.9 Any changes to National Insurance contributions introduced as part of the transition to a Citizen's Pension need not change the overall amount of contribution paid or overall benefits received by individuals; although the mix of benefits accruing in the state as compared to contracted-out pension funds may change.

3. The impact of a Citizen's Pension on saving

3.1 Despite concerns, especially about the ending of contracting-out, on balance this report suggests that the impact on occupational and personal saving with a Citizen's Pension should be positive.

3.2 A Citizen's Pension will allow the state to give a simple, reliable and consistent message on what it will provide as an underpin: *The state will provide £105 per week, and the saving you do on top of that is yours.* Individuals can then make better informed choices on what saving to do for their own retirement aspirations.

3.3 A Citizen's Pension at the level of £105 a week will not be generous enough to make private saving redundant. Some (lower income) people may need to save slightly less; some (higher income) slightly more.

3.4 By removing means-testing for basic income through Pension Credit for the majority over pension age, the Citizen's Pension ensures that it does pay to save. This should remove the 'regulatory reticence' of advisers to sell pensions, and schemes to enrol members, especially at low-middle income levels.

3.5 Accruals of contracted-out benefits would end on C-Day. Contracting-out is declining anyway and the pensions industry sees advantages and disadvantages in this feature of transition.

3.6 Although occupational and personal pensions would no longer receive revenue from contracting-out rebates, the funds would no longer have to provide the equivalent future benefit. This could be a better balance of risk between state and private provision.

3.7 Views differ on whether ending contracting-out would hasten the decline in private sector Defined Benefit schemes, but some believe that it could be positive for such schemes.

3.8 There is a view that contracting-out is not currently working as rebates are not generous enough. However, increasing them to the level that would make a difference would be an extra cost to the public purse to be borne by all taxpayers.

3.9 Moving to a Citizen's Pension without contracting-out would have significant simplification advantages in administration and regulation for occupational and personal pension schemes.

4. Eligibility criteria for a Citizen's Pension

4.1 A fair Citizen's Pension could work in the UK, based on residence.

4.2 The eligibility criterion could be similar to the current UK Category D retirement pension, which would simplify state pension administration for the significant majority of standard cases.

4.3 Social Security Agreements with other countries would cover non-standard cases, as they do now, with little additional 'unfair' liability for the UK.

4.4 Guarantee Credit could remain as the safety-net for residents over state pension age not eligible for the Citizen's Pension but with no other income.

5. Affording a Citizen's Pension

5.1 A Citizen's Pension at £105 a week could be afforded today and through transition, within current net expenditure on state pensions.

5.2 A Citizen's Pension would be easier and cheaper to administer than the current system of National Insurance contributions and means-tested benefits.

5.3 Future expenditure on the current pension system could be higher than expected. The increasing cost of a Citizen's Pension is within this 'funnel of doubt' of long-term state pension costs.

5.4 To afford the increasing long-term cost of a Citizen's Pension - or any other plausible pension system including the current one - change to one or more of the following is likely: the current level of state spend on pensions; tax or National Insurance contribution rates; state pension age; or, amount spent on tax relief.

6. A timetable for change

6.1 The timetable for change to a Citizen's Pension should reflect the need to get state pensions right for the long-term and the sense that reform would be better sooner rather than later, especially for current pensioners.

6.2 **C-Day**, the date of an overnight transition to a Citizen's Pension, could be on **6 April 2010**.

6.3 A simple Citizen's Pension could be more stable than the current UK pension system but consensus is important for the long-term stability of any pension system. Three mechanisms are suggested to develop and maintain consensus.

6.4 A State Pension Review Board with cross-party, pensions expert and pensioner interest group membership should be set up to review and advise on the work done within a government working group on state pension reform.

6.5 An 'Accord' on the structure and principles of state pension policy, to which political parties can sign up their agreement, should be drafted.

6.6 The setting up under statute of a regular independent state pension policy review process should be considered.

Who wins and who loses?
Exactly who 'wins' or not depends on decisions to be taken at transition, such as the exact level of the benefit and any changes in National Insurance contributions. Assuming a Citizen's Pension of £105 a week, as described in this report:

People already over state pension age
- **Good for**: those needing to claim Guarantee Credit and those with state pension income below £105 a week (women, the oldest) who benefit immediately either in £ terms and/or by not having to go through the Pension Credit claiming process.
- **Also good for**: those with state pension income above £105 a week, although the benefit comes from the more generous indexing of the Citizen's Pension over time rather than immediately at transition; and by averting the possibility of needing to claim Pension Credit in future.
- **Not so good for**: those claiming Savings Credit - unless they are reimbursed in the transition, although the more generous indexing will make it up during retirement.

People of working age
- **Good for**: all, in the sense that the pension system is stabilised; individual retirement planning can be done with simpler information and more certainty of outcome; and £ for £ value should be obtained from personal saving.
- **Good for**: the youngest (as the Citizen's Pension will be better than state pensions if current policy continues to 2050); the rich oldest (as their generous past rights will be preserved in transition).
- **Best for**: people of any age, especially women, with low income and interrupted work histories as they will not need to depend on Pension Credit.
- **Not so good for**: Highest income people in their 40s who will have a full work record, as future maximum accruals on the current system are expected to be better than a Citizen's Pension for the next 30 years.
- **Best for**: employees (and their employers) contracted-in to the State Second Pension or contracted-out into a personal pension.
- **Mixed for**: employees (and their employers) in a contracted-out occupational scheme, as their National Insurance contributions may increase, although their contributions to the pension fund could decrease to (more than) compensate.
- **Mixed for**: the self-employed, who are likely to be asked to pay higher National Insurance contributions in return for getting the same state benefit as everyone else (currently they pay less and get less).

Taxpayers
- **Good for**: all, in the sense that the administration costs of the pension system will be reduced and future state pension expenditure will be more certain.

Pension providers and employers
- **Good for**: all, in the sense that complex regulation and cost for providing occupational and personal pensions should be drastically reduced.
- **Good for**: pension business as the savings message is clearer and more consistent.
- **Not so good for**: providers with large revenues from contracting-out rebates.

1. What is a Citizen's Pension?

The universal flat benefit is given to everyone of pension age, regardless of income, wealth or employment history...Administratively this is the simplest structure, with the lowest transaction costs…It avoids the disincentive to work and save inherent in means-tested plans. Its universal coverage helps ensure that the poverty reduction objectives are met, and provides a basic income for all old people…

World Bank, 1994 p.240

Key points

1.1 A 'Citizen's Pension', also known as a Universal Pension, is a basic amount payable to every individual over state pension age who passes a residency test.

1.2 This report considers a Citizen's Pension of at least £105 a week in 2004 terms, indexed to earnings, as this is the current minimum level of income a person over pension age would have through Pension Credit.

1.3 The benefits of a Citizen's Pension would be adequacy, simplicity, inclusion, encouragement to save, efficiency and certainty.

1.4 Transition to a Citizen's Pension would speed up the change occurring anyway to the state pension system, while improving it.

1.5 With a Citizen's Pension, the role of the state in poverty prevention is clarified, making decisions on any further state role (including enhancing voluntary or compulsory saving) clearer.

1.6 No pension policy can satisfy all preferences, so a decision for a Citizen's Pension would be made because it gives the best package overall for the long-term.

1.7 There are perceived practical problems with a Citizen's Pension, but this report suggests that some of these are misplaced, and that others can be resolved.

The **key features** of a Citizen's Pension are:

- **One flat benefit, set at or above the means-testing level.** The lowest the Citizen's Pension should be in the UK is £105 per week as this is the level of the Guarantee Credit – the minimum income a person over pension age is currently thought to need to live on. A Citizen's Pension of £115 per week would be more consistent with the extra available to some from Savings Credit.
- **The benefit is indexed to National Average Earnings,** so the minimum pensioner income keeps pace with incomes in the rest of society. It could be defined by reference to National Average Earnings (NAE) e.g., 22-25% NAE.

- **The eligibility criterion is set by a residency test.** This paper suggests a possible criterion for the UK could *be 10 years in a continuous 20 year period before or after state pension age*. Agreements with other countries would continue to allow for mobile workers and retirees.
- **A Citizen's Pension is paid to every eligible individual in his or her own right**, whether single or married, and regardless of number of National Insurance contributions paid.
- **The benefit is paid from state resources,** and could continue to be paid out of revenues largely generated from National Insurance (NI) contributions.

The **benefits** of a Citizen's Pension would be:
- **Less pensioner poverty,** as by taking nearly all people over state pension age out of Pension Credit, the problem of low take-up of that benefit would cease.
- **A simple to understand system,** compared to the current multi-component system.
- **Every individual would be treated fairly** in the sense that the same state pension would be received regardless of work history. The scope for disadvantage under the current system, which falls particularly for women as the system does not adequately compensate for taking time off paid work to care for children or older relatives, would be eliminated.
- **Barriers to saving are removed**, particularly the current problems caused by the means-testing trap under Pension Credit. Occupational schemes and personal pensions could be freed from complicated regulation, and the message to would-be savers on what the state will provide would be consistent and clear.
- **Cheaper to run,** compared to the current system, as 44 year histories of National Insurance contribution records would not need to be so detailed, accrued benefit calculations would no longer need to be updated annually, and the complexity of contracting-out would disappear.
- **Future state pension expenditure can be planned with more certainty** than under the current system, which has a large 'funnel of doubt' because it depends on many factors outside government control.

Transition to a Citizen's Pension would speed up the change occurring anyway to the state pension system.
- Over the next 30-40 years, the current state system will evolve so that the current advantage to high earners is dampened.
- It will then give a roughly flat-rate state pension at all earnings levels (Charts 1 and 2)[1], between a minimum and maximum.
- The minimum state pension received by the individuals in Charts 1 and 2 is when the examples are entitled to zero Pension Credit as they have enough other income.
- The maximum state pension is when the Pension Credit award is the highest – when the person has made no saving[2].

[1] PPI modelling. See also Pensions Commission (2004) Figure 3.20.
[2] The maximum will be obtained by having some Guarantee Credit if needed to top up to £105 a week; and some Savings Credit. All the examples will be eligible for some Savings Credit as they have some state second pension or equivalent.

Chart 1[3]

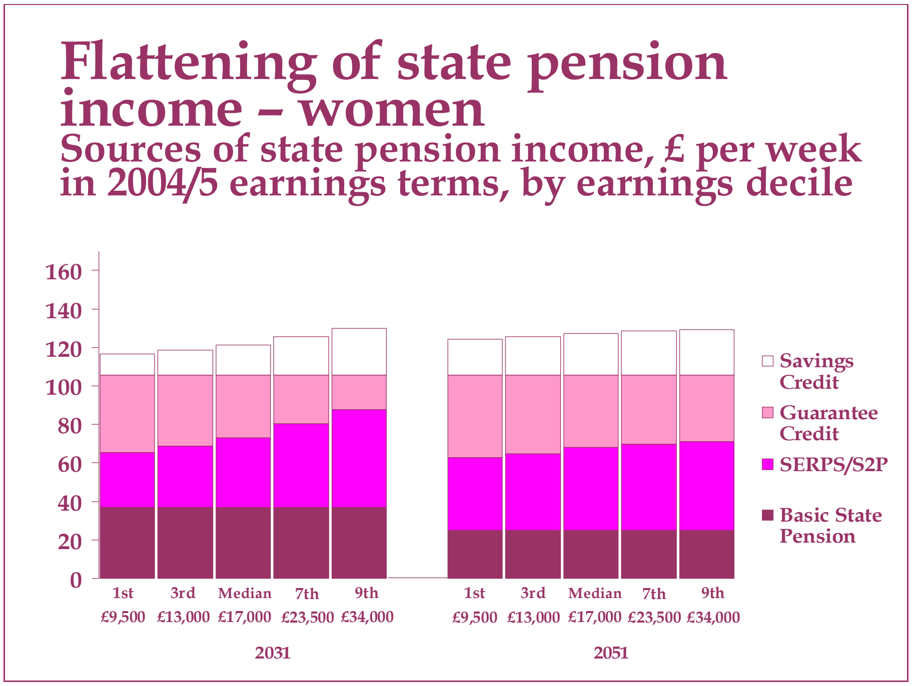
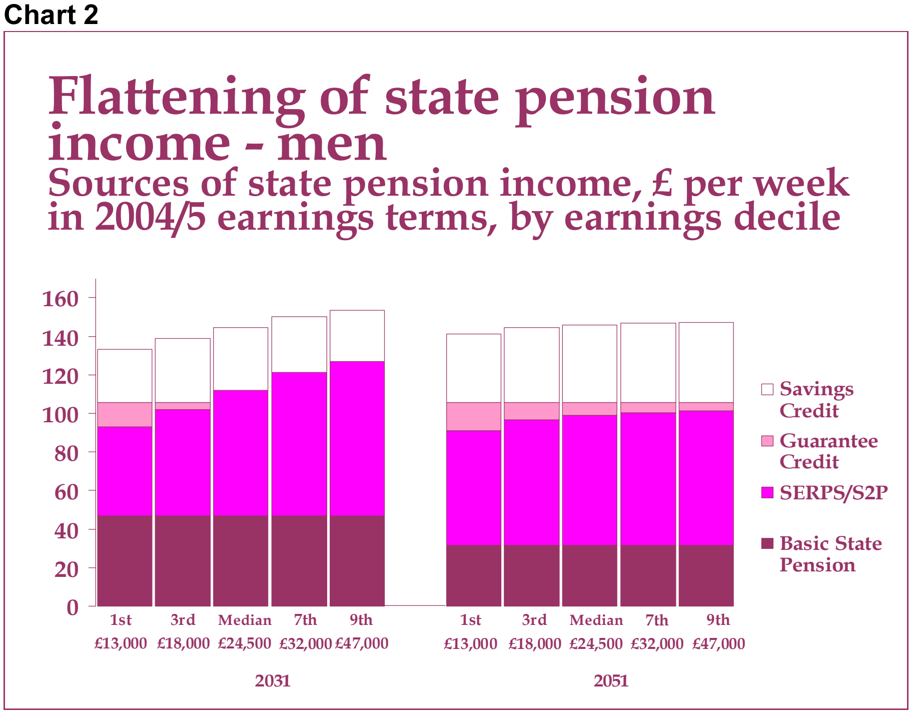


Chart 2



[3] PPI analysis using the Individual Model for an individual reaching age 65 in year shown. Individuals have typical career patterns: man mostly in full-time work; woman with caring breaks, some part-time and some full-time work. See Appendix 1 for further details. The earnings used for each example are the earnings at the decile point at each age. The earnings illustrated at the bottom of the columns are at age 50.

However, three main problems will remain with the current system as it evolves:

- **Complexity**: The system has multiple components. The Basic State Pension (BSP), State Second Pension (S2P) and its predecessor State Earnings Related Pension Scheme (SERPS) each have a different set of rules based on NI contributions paid or credited. Contracting-out of S2P adds further complexity. Then Pension Credit is a means-tested addition, with another set of rules requiring individual income and asset data and a separate application procedure.
- **Exclusion**: Many people are excluded from parts of the system. The contributory parts give less to people who have less than full contributory records. Low earners or people in non-earning roles that benefit society such as caring for children, older or disabled family members are 'under-pensioned'. The impact is significant: 50% of female pensioners do not have a full BSP and even by 2020 the average BSP of women pensioners is expected to be 15% below the full rate[4]. The credits for S2P are less generous than those for BSP. Further, of the pensioners eligible for Pension Credit, around one-quarter are excluded by not claiming, and this is up to one-half for the Savings Credit component[5].
- **Uncertainty**: As well as the ever-present political risk of change, there is uncertainty inherent in the system. The future level of the fastest growing component of the state system – Pension Credit – is not set by legislation but determined by the government of the day. The actual level of an individual's entitlement to Pension Credit will depend on factors known only at ages above pension age: the then current thresholds for eligibility; the formula for taking income and assets into account; and, the individual's actual income and assets at that time.

Transition to a Citizen's Pension will therefore speed up what will occur naturally as the current system evolves, while making the system immediately more simple, inclusive and certain.

- **Simple**: One system, with one rule set and one benefit level (for example £105 a week) for all. Some other rules will be necessary for the minority of people who live abroad before or after pension age, as in the current system.
- **Inclusive**: Nearly all residents and some previous residents are included.
- **Certain**: A formula determines future benefits; political risk of change is contained[6].

[4] Parliamentary Question Lady Hermon House of Commons *Hansard* 27 October 2004 Column 289W and Curry (2003 TUP)
[5] PPI (2004 SWPC)
[6] See Chapter 6

With a Citizen's Pension, the **role of the state** in poverty prevention is clarified, making decisions on any further role clearer.

- The current state pension system rewards people who did well at work (high, regular wages); disadvantage and uncertainty accumulate for others.
- Instead, the Citizen's Pension starts everyone on a level playing field. Everyone eligible gets the same foundation from the state. The benefits of doing better at work accrue through occupational or personal pensions.
- Having simplified and strengthened the foundation, the state can then decide whether it should have a role in encouraging further voluntary saving or in compelling further saving, and the extent of that role. For example, what Informed Choice initiatives should government sponsor? What tax incentives for savings are appropriate? These decisions will depend on the level and cost of the Citizen's Pension, and on the savings response generated by the new system.

A decision to introduce a Citizen's Pension in the UK would be made recognising that no pension policy can meet every ideal, but that the Citizen's Pension is the best package overall for the long-term. Compromises would have to be made on:

- **State earnings-related pension**: A state benefit giving more to people who earned more, on top of a Citizen's Pension, could only be afforded with much higher taxes or other ways to pay the additional cost. The flattening of the current state system over time recognises this[7].
- **Targeting state resources via means-testing**: A means-testing policy aims to target state resources at the poorest older people. But the contributory part of the current system means higher income people receive more. A Citizen's Pension is more redistributive. Further, the transition to a Citizen's Pension proposed in this paper is designed to target immediate resources to the current poorest. So, the Citizen's Pension targets better than the current system and better than the option to increase the contributory basic state pension, but does not target as well as a fully means-tested system with 100% take-up would.
- **Eligibility by NI contributions**: National Insurance contributions are still proposed to be the basis for paying for a Citizen's Pension. Setting eligibility by NI contribution history aims to prevent non-contributors getting benefits 'unfairly', but it requires a system of crediting in people in specific circumstances who are deemed to 'deserve' a state pension. The current system is thought to exclude too many, especially women. Improving the current crediting system is possible, but it would be complicated, and may still exclude people who society would wish to be included. Recognising that the state has to (and does under the current system) provide a basic income of at least £105 for everyone who is poor in old age however they got to that position, the Citizen's Pension simply provides at least the £105 as efficiently as possible. Straightforward exclusions are still possible[8].

[7] As shown in Charts 1 and 2
[8] For example, people in prison are excluded from New Zealand's Citizen's Pension; see also Chapter 4. See also Chapter 6 for the possible impact of the loss of eligibility by National Insurance on the long-term stability of pensions, and Appendix 2 for the weakening role of the National Insurance system in providing a link between work and benefits.

There are perceived practical problems with a Citizen's Pension, but this report suggests that some of these are misplaced, and that others can be resolved. The issues are that the transition to a Citizen's Pension might be:

- **Too difficult**: Chapter 2 describes a practical transition path that preserves existing rights and minimises the upheaval of change.
- **Too regressive**: The transition method in Chapter 2 has been chosen because it is the least regressive way of changing to a system that minimises means-testing, as compared to the main alternative of increasing the current Basic State Pension for everyone. The latter alternative favours higher income people, and gives windfall gains to higher income pensioners[9].
- **Damaging to the private savings sector**. Chapter 3 considers that although the loss of contracting-out would mean a different shape of private provision, a Citizen's Pension should help to encourage healthy occupational and personal pensions.
- **Impractical, as an eligibility criterion cannot work**. Chapter 4 suggests a practical eligibility criterion and way of coping with mobile workers and retirees.
- **Too expensive, especially as society ages**. Chapter 5 shows that a Citizen's Pension could be afforded in the short-term, and that any system will have to make changes to cope with the increasing number of more longer-living pensioners.
- **Too open to the risk of future change**. Chapter 6 describes a timetable with suggestions for ways to lock-in consensus to protect against future change.

In summary, a Citizen's Pension has support for its simplicity and likely effectiveness as a foundation income guaranteed by the state to ensure society's oldest residents are free from poverty. The details of transition will matter because the change is significant, and the starting point highly complex. The next chapter suggests a transition path.

[9] Explored in more detail in PPI (2004 MT)

2. A practical transition to a Citizen's Pension

This chapter describes how an immediate transition to a Citizen's Pension on 'C-Day' could work, in particular how it could:

- Take into account accrued state pension rights under the current system – 'the offset method'.
- Change National Insurance contributions and contracting-out for future accruals.

Key points

2.1 Given that a Citizen's Pension replaces both Basic State Pension and State Second Pension, it is logical to 'offset' the Citizen's Pension against rights accrued in the current system. This allows the transition to a Citizen's Pension to be affordable, progressive (targets gains to poorer rather than richer pensioners) and immediate.

2.2 No pensioner should lose out; 8m pensioners currently receiving less than the Citizen's Pension level from the state would immediately gain.

2.3 Although 3.5m better-off pensioners would not receive windfall gains at C-Day (the day of transition to a Citizen's Pension) they would benefit from the more generous indexation of the Citizen's Pension.

2.4 As younger people gradually reach state pension age, the Citizen's Pension becomes more important than accrued rights so that in 15 years time, every new pensioner should be fully on the Citizen's Pension system.

2.5 To treat past decisions on contracting-out equally, the same offset should apply to contracted-out accrued rights. This could make any loss from the contracting-out decision more apparent, but there are possible ways of dealing with this.

2.6 Savings Credit is a particular complication in any transition and depending on the starting level of the Citizen's Pension, currently awarded Savings Credit amounts may need to continue.

2.7 Slower transition approaches are possible, but would not meet all the objectives, would cost more, and would be much more complicated.

2.8 National Insurance is envisaged to continue as a way of collecting contributions.

2.9 Any changes to National Insurance contributions introduced as part of the transition to a Citizen's Pension need not change the overall amount of contribution paid or overall benefits received by individuals; although the mix of benefits accruing in the state as compared to contracted-out pension funds may change.

Why the offset method

A Citizen's Pension replaces the contributory pensions: Basic State Pension (BSP) and State Second Pension (S2P, or its predecessor State Earnings Related Pension Scheme, SERPS), including the contracted-out element of SERPS/S2P.

On transition to a Citizen's Pension, a decision has to be made on how to treat individuals' rights to these contributory pensions, accrued by:

- Paying National Insurance (NI) contributions or gaining credits to the BSP, and/or,
- Paying NI contributions or gaining credits to SERPS/S2P, or,
- Paying NI contributions instead to a contracted-out alternative to SERPS/S2P, and/or rebates being added by the state.

The SERPS/S2P element is still part of the 'state pension' although it can be delivered in one of two ways:

- By the state, if the individual has been contracted-in throughout his or her life and/or,
- By a private scheme (either an occupational scheme or a personal pension) if the individual has been contracted-out.

As a result, many people will accrue some pension on a contracted-in basis and some contracted-out.

The £ amount of state benefit given up by contracting-out is known and stored by the Inland Revenue[10]. For accruals prior to 1997 it appears on the pensioner's annual state pension statement, as the 'Contracted-Out Deduction (COD)[11]. The **total** of accrued BSP, and SERPS/S2P, on a contracted-out and -in basis, can therefore be identified for each individual on C-Day, the date of any overnight transition to a Citizen's Pension. This is referred to as **'accrued state rights'**.

The outcomes from two ways of treating these accrued state rights – **'offset'** and **'addition'** - are shown for an overnight transition on C-day to a Citizen's Pension of £105 per week. First, the immediate impact for people already over state pension age; then the increasingly favourable impact over time; and then what the impact is for people part-way through their working life when the Citizen's Pension reform happens.

People already over state pension age

A typical poorer pensioner is female, has less than full BSP and a small amount of SERPS/S2P. She needs to claim Pension Credit if she has no or little other income. A typical middle-high income pensioner has close to a full BSP plus a reasonable amount from SERPS/S2P. To illustrate, Charts 3 and 4 show the state pension income of the average new female pensioner (aged 60 in 2004) and the average new male pensioner (aged 65 in 2004)[12].

[10] National Insurance Services to Pension Industry
[11] Strictly speaking, the COD is the amount of state benefit given up by contracting-out that is not otherwise paid by the state under complex indexation and S2P rules
[12] Data from DWP

The choices considered for dealing with accrued state rights are:

- **'Offset'**: The Citizen's Pension replaces accrued state rights. The Citizen's Pension paid is the **maximum** of £105 (indexed to earnings) and the accrued state rights (indexed to prices). This means that any pensioner receiving less than £105 from the accrued state rights would immediately have that income increased to £105. Any pensioner receiving more than £105 from accrued state rights would carry on receiving the higher amount.
- **'Addition'**: The Citizen's Pension replaces BSP only, with S2P (or contracted-out) accruals paid in full in addition. Whatever amount a pensioner is receiving from BSP increases to £105.

The report recommends the offset method, the **immediate** effect of which would be as follows:

- The transition is **less regressive** than the addition method, as the gain is targeted on lower income pensioners[13].
    - Pensioners who are receiving accrued state rights lower than the new Citizen's Pension now receive a state pension at the new Citizen's Pension level. Pension Credit will no longer need to be claimed. For those currently eligible for but not claiming Pension Credit (around 1 million people) there would be an immediate financial gain (Chart 3).
    - 8m people currently over state pension age would be in a low income position and gain with a Citizen's Pension of £105 a week. At £115 a week, there would be around 9m immediate winners[14].
    - Pensioners who are receiving accrued state rights higher than the new Citizen's Pension carry on receiving the higher amount (Chart 4). 3.5m people currently over state pension age would be in this position, keeping the same state pension on transition to a Citizen's Pension of £105 a week[15]. At £115 a week, there would be around 2.5m.
- The offset avoids the 'deadweight' cost under the addition method where higher income pensioners could get a large increase in income as their full accrued SERPS/S2P carries on, as well as their BSP being increased to the new Citizen's Pension level.
- The offset transition is therefore **more affordable** than the addition method, initially saving around £5bn a year[16].
- No pensioner receives less from the state overall, provided:
    - Savings Credit awards are maintained or the new Citizen's Pension is at least as high as the maximum Savings Credit award. The average Savings Credit award is around £10 a week (and half of such pensioners claim it). A Citizen's Pension of £115 therefore should be high enough to avoid most Savings Credit issues.
    - The supplements to Guarantee Credit received by 0.5 million people[17] because of disability or caring are maintained.
- Contracted-out accrued rights will continued to be paid from the contracted-out 'private' pension (occupational or personal pension), so an individual may receive the total of £105 from different sources.

[13] PPI (2004 MT) explains this point in more detail, making the comparison with the option of increasing the Basic State Pension, which would be still more regressive.
[14] PPI calculation based on SERPS/S2P entitlements from DWP (2004 SPSS). See Appendix 5.
[15] PPI calculation based on SERPS/S2P entitlements from DWP (2004 SPSS). See Appendix 5.
[16] PPI estimates; see Chapter 5
[17] DWP Pension Credit summary statistics

Chart 3

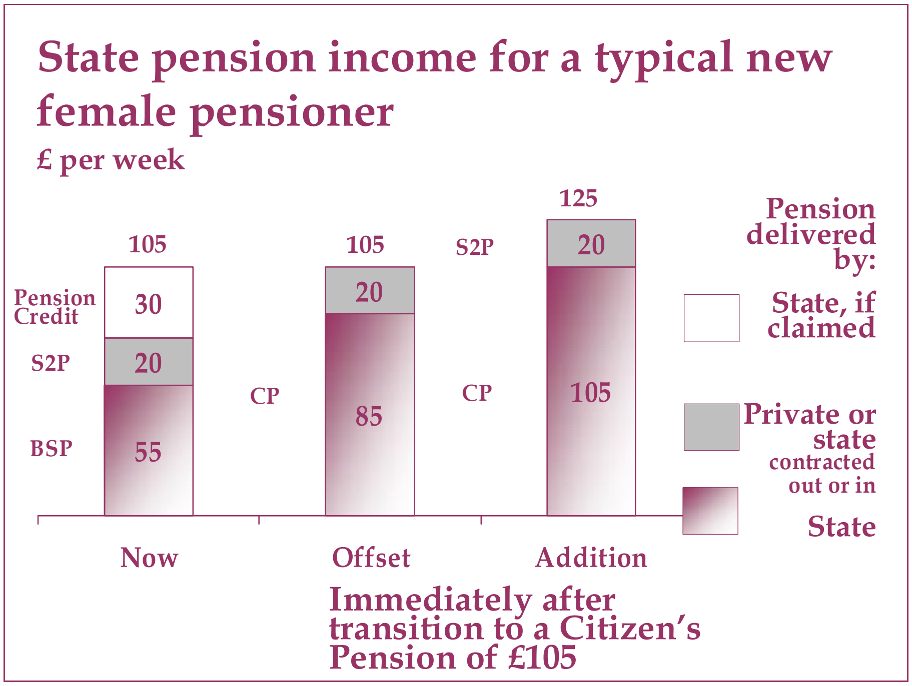
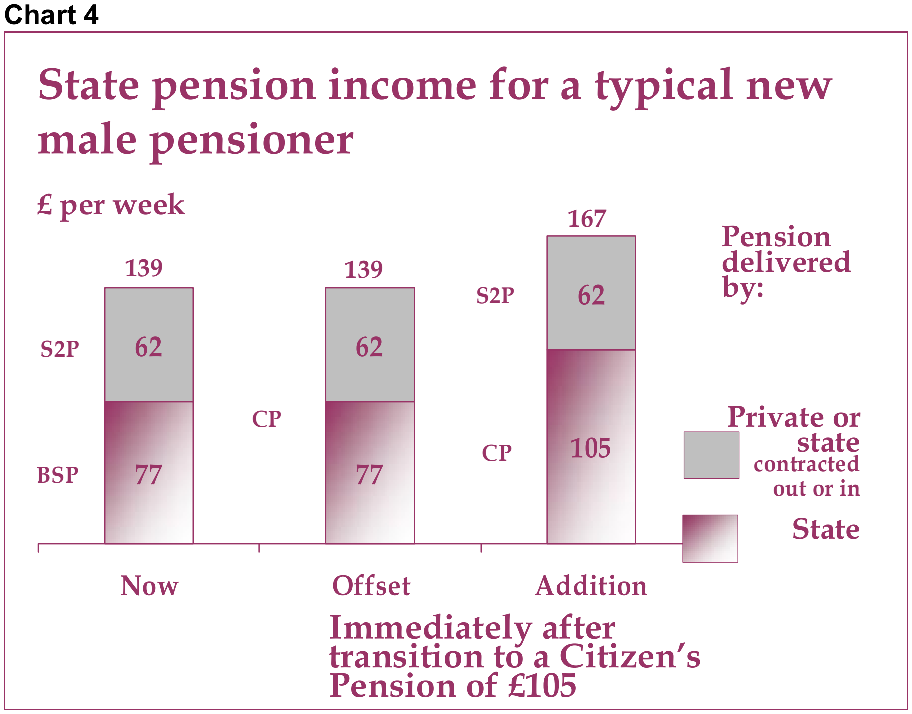


Chart 4

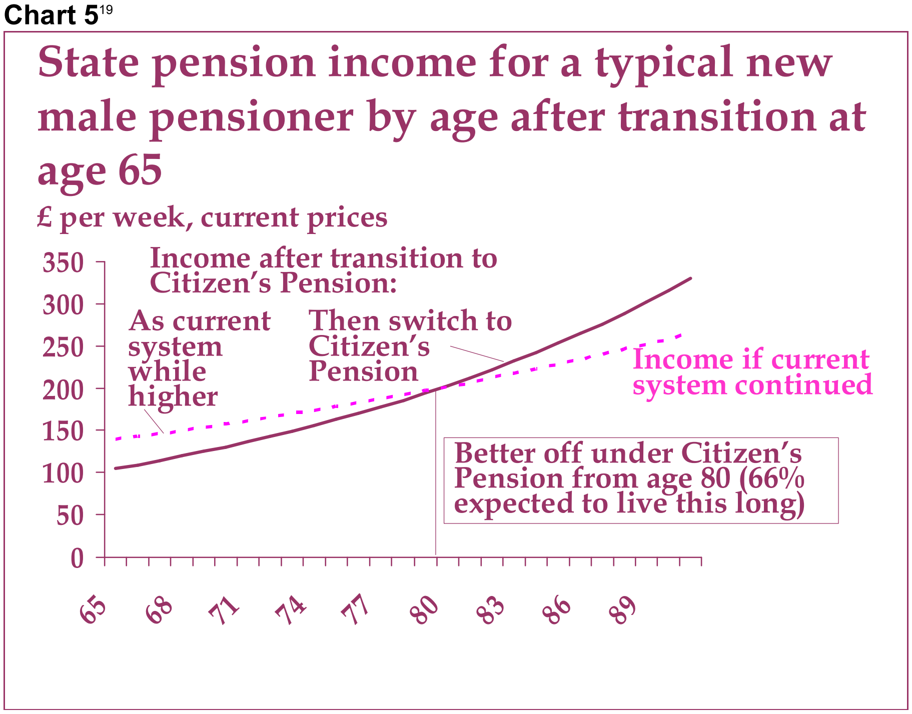


Impact over time

The Citizen's Pension becomes more beneficial for more pensioners as they grow older.

- The Citizen's Pension is indexed to earnings, but accrued state rights are indexed to prices, which tend to grow more slowly.
- Under the offset method, some pensioners will find that their accrued state rights drop in value, during retirement, relative to the earnings-inflated equivalent of £105. At the point when the Citizen's Pension is higher, they switch to getting the then current full Citizen's Pension, and continue to receive it for the rest of their lives.
- By age 80, the state pension of the new male pensioner in Chart 4 will switch to the full Citizen's Pension and he will begin to receive a higher state pension than he would under the current system (Chart 5).
- 66% of men in this generation are expected to live this long, so most pensioners of this income group would benefit from the Citizen's Pension.
- As current income increases, so individual pensioners would have to live longer to benefit from the offset introduction of a Citizen's Pension. This is another reason why this offset method of transition favours lower income people; as higher income people have a greater chance of living longer.
- The extreme transitional case for people already over state pension age at transition is for those with maximum possible SERPS/S2P and BSP. In this case it would take over 30 years for the Citizen's Pension to overtake the accrued state pension. In 85% of cases, transition will be complete within 10 to 15 years[18].

Chart 5[19]



[18] PPI modelling; assuming C-Day in 2010 and no changes to the current system in the meantime

[19] PPI analysis assuming earnings inflation at 2% pa above price inflation at 2.5% pa. Longevity expectations from GAD 2002-based projections.

Impact on people below state pension age: crystallising accrued rights
For people who are not yet pensioners, the calculation is exactly the same as the examples above, using accrued state rights up to C-day.

- No further state pension rights accrue on the current system from C-day.
- When people reach state pension age, their accrued rights are compared to the equivalent of the earnings-increased £105 of the day.
- The accrued rights can be calculated on C-day and 'crystallised'. Two numbers will need to be recorded by government (the contracted –in and –out amounts). It will then not be necessary to continue to keep additional detailed earnings and NI credit records.
- Over time, fewer new pensioners will have accrued rights worth more than the earnings-indexed future equivalent of £105, and eventually every new pensioner will get the Citizen's Pension immediately on reaching state pension age.
- By 2025, no-one reaching age 65 should have accrued rights above a Citizen's Pension at £105 a week[20], so every new pensioner is immediately on the new system.

Treatment of possible loss from having contracting-out
The offset method works for both accrued contracted-in and contracted-out portions of SERPS/S2P. It is possible that a contracted-out portion of accrued rights is in practice not as high as the contracted-in benefit given up, that is, the contracting-out decision caused a loss for an individual. This could become more apparent on C-Day. There are options for how to deal with this.

- If the contracting-out was into a Defined Benefit occupational scheme (as most contracting-out is) then the actual pension received from the scheme in lieu of SERPS/S2P should be at least as good[21].
- However, if the contracting-out was into a personal pension or a Defined Contribution occupational scheme, then the actual pension may be higher or lower. It will depend on, for example:
    - Whether the investment performance of that fund has been better or worse than expected, or,
    - The age at which people contracted-out, as the rebates are less generous at high ages.
- It might be that for some people, the 'state equivalent' pension actually paid by the private fund will be lower then the amount that would have been received if he or she had stayed contracted-in.
- The number of people who may have lost out is estimated by industry experts to be between 0.5 and 1.5 million. There could be more or fewer if investment performance worsens or improves in future[22].
- The possible ways to deal with this include:
    - Calculate the offset by reference to the actual contracted-out benefit rather than the contracted-in alternative. But this means the state underwrites any loss which was always possible from contracting-out.
    - Offset some proportion; say only half of the contracted-out portion.

[20] PPI modelling, assuming reform in 2010
[21] The scheme has to pass a number of hurdles in the Reference Scheme Test so that each pension will be of a minimum standard. There is no guarantee that every contracted-out pension in the scheme will be better than the contracted-in equivalent, but most would be expected to be so.
[22] Based on industry interviews. The range is very wide due to uncertainty surrounding the actual level of charges and investment returns across different companies.

- Give people affected an option to transfer back retrospectively into S2P, and so future benefits are calculated as if they had always been contracted-in. This would require a transfer value from the private sector to be paid to the state, and each individual would need advice.
- Recognise that any disparity has occurred anyway, and do nothing. Any loss is not caused by the transition to the Citizen's Pension but by the decision made previously to contract-out. If the current system continues unchanged, the people affected will have a pension lower than they would have done compared to remaining contracted-in to S2P. Note also that Guarantee Credit will remain available for those who, for whatever reason, have <u>total</u> income below £105 a week.

Managing Savings Credit in transition
Savings Credit is a particular complication in any transition and would not be expected to be in place after transition to a Citizen's Pension. In order to avoid sudden drops in state pension income for pensioners already receiving Savings Credit, and depending on the starting level of the Citizen's Pension, Savings Credit awards may have to continue.

- Savings Credit is a particular and special issue which makes transition to any other pension policy option more complicated than it would otherwise be[23].
- The calculation of entitlement to Savings Credit is complicated. The level of benefit varies by individual circumstances and changes every year according to parameters that could be changed at short notice. Removing such complexity is one reason for introducing a Citizen's Pension, so the Savings Credit should not continue with a Citizen's Pension in place.
- On the generally accepted assumptions that the Basic State Pension increases in line with prices, and the Guarantee Credit increases in line with earnings, the level of Savings Credit benefit will increase even faster than earnings.
- The number of pensioners entitled to Savings Credit is expected to increase by one-half from 3.4m to 5.1m over the next 10 years[24].
- Take up is low (50%), except where there is Guarantee Credit claimed as well (85%)[25], so there are 2m pensioners actually receiving Savings Credit currently.
- A Citizen's Pension of £115 a week will mean that most (lower income) pensioners receiving Savings Credit would not experience a drop in state pension income after a transition to a Citizen's Pension.
- If a Citizen's Pension of £105 a week is chosen, some pensioners receiving Savings Credit would be at risk of receiving less from the state than the Citizen's Pension would provide. The simplest way of overcoming this is to continue paying Savings Credit awards, frozen at the levels at C-Day. Gradually the earnings-linked Citizen's Pension will increase to above that which the Savings Credit would have provided.

[23] For more details, see PPI (2004 MT)
[24] PPI (2004 SWPC)
[25] PPI (2004 SWPC)

Slower transition paths
This report considers that an immediate transition to a full Citizen's Pension for everyone over state pension is possible and preferable. Two slower paths are briefly considered here:

The Citizen's Pension introduced at higher ages first, for example at age 75. This approach removes disadvantage for the pensioners most at risk of poverty, the oldest, while maintaining the current pension system for the youngest. This one change might seem easier than a change for all pensioners. However:

- The problems of the current system continue for people below age 75, for example, means-testing would still be prevalent.
- The system becomes more complicated rather than less, as no simplification is introduced below age 75 when a step change to a new system occurs.
- The transition will cost an additional net £2.6bn in the first year[26]. New money will have to be found from raising taxes or making savings elsewhere in the system. As explained in Chapter 5, an overnight transition for all above state pension age, counter-intuitively, can be afforded within current state spend on pensions, as cost is saved by ending contracting-out. If there is only a partial introduction of a Citizen's Pension, the state has to continue paying contracted-out rebates.

The Basic State Pension (BSP) is put on a citizenship basis. This approach ensures that every resident over state pension age is entitled at least to a low minimum income, regardless of National Insurance contribution history. However:

- The BSP is currently around £79 a week, indexed to prices, so would not be adequate to prevent poverty compared to £105 a week indexed to earnings.
- The system becomes more complicated rather than less, as a residency-based BSP adds another eligibility system while still needing National Insurance contribution history for continuing State Second Pension accruals.
- The transition will cost more than £5bn in the first year, rising to £8bn after five years[27]. New money would have to be found from raising taxes or making savings elsewhere in the system. Again, this additional cost cannot be met by the amount saved on contracting-out rebates, which the state would have to continue paying.

Both of these could be slow transition paths to the full Citizen's Pension, by either gradually decreasing the age at which it applies, or by gradually increasing its benefit level – but this means constant change in the pension system. The complexities of either approach would pose practical problems and would make it harder for people to see what is going on.

[26] Parliamentary Question Steve Webb House of Commons *Hansard* 4 May 2004, Col 1462W
[27] Parliamentary Question Sandra Gidley House of Commons *Hansard* 7 September 2004, Col 1111W. The answer assumes the pension continues to be price-linked; earnings-linking would increase the cost.

The change to National Insurance and contracting-out for future accruals

This section:

- Shows how complex the current National Insurance system is, mostly because of contracting-out[28].
- Explains options for change to National Insurance contributions after a Citizen's Pension is introduced and illustrates the possible £ impact on contributions and benefits under one option.

The current contracting-out system is complex

Contributory pensions in the current state pension system (the Basic State Pension (BSP) and State Second Pension (S2P)) are administered through the National Insurance fund. National Insurance contributions (NICs) are paid by:

- Anyone who is employed, aged between 16 and SPA and earning more than £91 a week, to accrue entitlement to BSP and S2P, and,
- Employers who employ anyone paying NICs, and,
- The self-employed, who pay lower NICs to accrue entitlement to the BSP, but not S2P.

It is possible to contract-out of S2P if an individual is a member of an approved occupational pension scheme, or has an approved personal pension.

- An individual who contracts-out will accrue a benefit within the occupational or personal pension, but no S2P entitlement[29].
- In return he or she pays a lower NIC (as does his or her employer), or at the end of the year has part of his or her NIC paid directly into a private pension scheme in the form of a 'rebate', that depends upon the age and earnings of the individual.
- The exact combination of S2P received, lower NICs and rebate paid direct to a pension fund depends on the type of pension arrangement the individual has, and how much the individual earns (Charts 6 and 7).

[28] There are also complicated systems of credits into BSP and S2P for people in specific circumstances. These are not discussed here but see The Pension Service (2004).

[29] In fact, people earning below £26,600 pa in an occupational scheme or below £11,600 pa in a personal pension do accrue some residual S2P in the state system. See PPI (2004 TPP).

Chart 6[30]

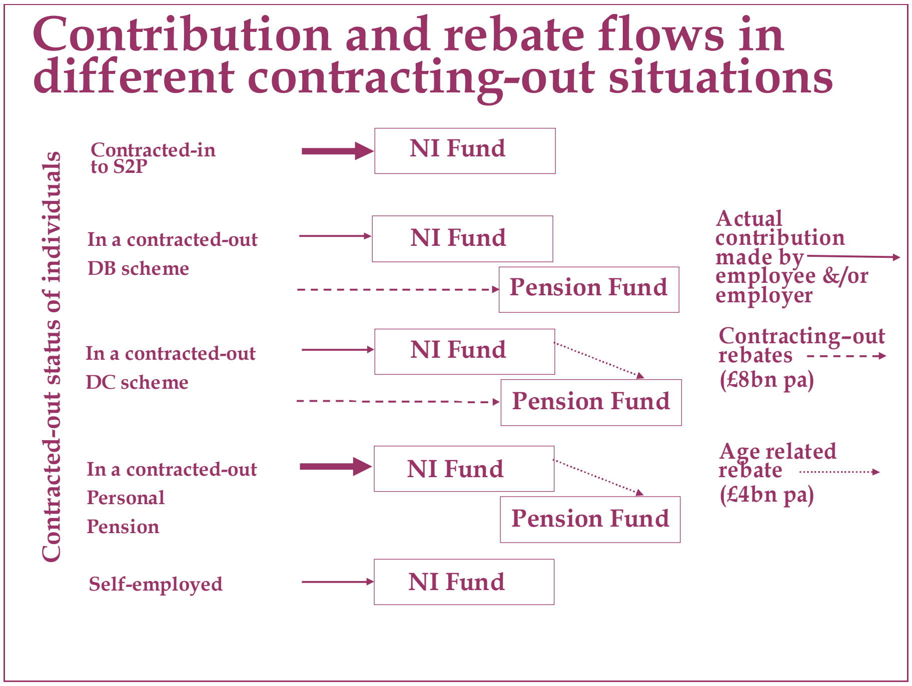


Chart 7[31]

The contracting-out landscape

Weekly contributions and rebates illustrated for a person earning £400pw 2004/5

Contracted in or out status	Number of people of working age of each status	Contributions to NI fund		Employer/ employee contribution to pension fund in lieu of S2P	NI rebate paid direct to pension fund	Pension benefit being accrued in state system
		Employee	Employer			
Not making NI contributions	8.5m	None	None	None	None	4.5m with BSP credits 2m with S2P credits
Contracted-in to S2P	9m	£34	£40	None	None	BSP and S2P
In a contracted-out Defined Benefit scheme	4.5m public 3.5m private sector	£29	£29	£16	None	BSP only
In a contracted-out Defined Contribution scheme	Fewer than 0.5m	£29	£36	£8	From £10 to £40 depending on age	BSP only
In a contracted-out Personal Pension	6m	£34	£40	None	From £16 to £40 depending on age	BSP only
Self-employed	2.5m	£27	None	None	None	BSP only

[30] DB=Defined Benefit; DC=Defined Contribution
[31] PPI calculations based on 2004/5 National Insurance rates. Around half of full-time employees earn less than £400 a week.

It has not been considered whether the Citizen's Pension should be paid for out of general taxation. This would have some logic, but is not necessary[32]. In this paper it is assumed that **the National Insurance contribution system remains in place** as a way to pay for state pensions.

Any changes to National Insurance contributions introduced as part of the transition to a Citizen's Pension need not change the overall amount of contribution paid or overall benefits received by individuals; although the mix of benefits accruing in the state as compared to contracted-out pension funds may change.

- This is because the overall NI contribution made by employees and employers combined on behalf of each employee is the same (£74 per week from Chart 7) whether contracted-in or contracted–out.
- The differences are in the way the contributions are paid:
    - For individuals contracted-in or contracted-out into a personal pension, all of the contributions are paid to the state.
    - For individuals contracted-out into a Defined Benefit or Defined Contribution scheme, some of the contribution is assumed to be paid directly to the pension fund.
- For individuals contracted-out into a Defined Contribution scheme or a personal pension, age-related rebates are paid back by the state from the NI fund into the pension fund. The size of the rebate actually paid depends on the age and earnings of the individual concerned.

Options for change for National Insurance contributions
At the introduction of a Citizen's Pension, contracting-out would be abolished for future accruals. The pattern of National Insurance contributions and rebates could change. The options for change considered here are:

- Leave NIC rates unchanged
- Align NIC rates at the contracted-in rate
- Increase the amount paid by the self-employed
- 'Rebalance' the NIC system

Unchanged NI rates
Under this option the government would collect the same amount of revenue in National Insurance contributions as in the current system.

- Under this option no-one would see any change to contributions.
- But some previously contracted-out employers (including government) and employees would be paying a lower NI contribution for no obvious reason.
- No additional revenue would be raised.

[32] See Appendix 2

Align NIC rates at the contracted-in rate
In the absence of S2P to contract-out of, there would no longer be a rationale for any employees or employers to pay a lower rate of NIC than any other so everyone could pay at the contracted-in rate.

- This would provide a level playing field for contributions, and would free all of the £12bn currently spent on rebates to help pay for the Citizen's Pension. The majority of individuals would face unchanged NI rates, but 8.5 million members of contracted-out occupational pension schemes and their employers would see NICs increase.
- Employers running occupational pension schemes would have to decide future contribution levels to schemes. They could continue with existing employer and employee contribution levels or they could reduce scheme contributions to reflect the increase in NICs and accrue benefits in the scheme on, say, a 1/80th basis instead of 1/60th.

Increase the amount paid by the self-employed
A Citizen's Pension would represent an increase in state pension coverage for the self-employed, as they are currently not covered by the State Second Pension.

- Increasing the amount collected from the self-employed reflects a higher state pension entitlement, and may allow for a reduction or smaller increase in the amount collected from employees and employers.
- But fully aligning with the employees' rate of NICs would mean the self-employed see a large increase in payments.

'Rebalance' the NIC system
This represents a compromise between realising all of the money spent on contracted-out rebates, protecting employees and employers from large increases in NICs, and increasing the coverage of the self-employed. As an example of how this could work:

- The NI rates for employees and employers can be set so that enough money is raised to fund the initial transition costs of a Citizen's Pension, but no more[33].
- This could be achieved by all employees and self-employed with the same earnings paying the same contribution rate, irrespective of previous contracting-out status. The contribution rate would be set between the current contracted-in and contracted-out rate.
- The self-employed would pay higher NICs. Individuals currently contracted-in or contracted-out into a personal pension would pay lower NICs. Individuals currently contracted-out into an occupational pension scheme (and employers running contracted-out occupational pension schemes) pay higher NICs, but these could be neutralised by no longer having to make a contribution to the occupational pension scheme to provide contracted-out benefits (Chart 8).

[33] To raise enough revenue (£7bn) to fund the first year cost of a Citizen's Pension of £105 a week, as shown in Chapter 5

- Age-related rebates, which previously were paid from the NI fund to pension funds, are no longer paid. This has no impact on what individuals see as cash flow, but it will mean a smaller pension fund.
- Individuals contracted-out into a personal pension would find their pension fund no longer receives a rebate. If they did nothing, their total state plus private benefit should be accruing at the same level, but they may prefer to contribute more to the personal pension.
- Employers running occupational pension schemes may decide to reduce contributions, and many are likely to take the opportunity to integrate schemes more closely with a Citizen's Pension[34]. This would mean running a smaller scheme. The employer's exposure to risk and the size of <u>future</u> pension liabilities would reduce. As state benefits have been improved, the employees would not be worse off overall.

Chart 8[35]

Possible reshaping of weekly NI and pension contributions
Earning £400 a week

	NI contributions		Employer / employee contribution to pension fund (assumed)	Overall change in NI and assumed pension contributions	Age-related rebate no longer paid	Pension benefit being accrued in state system
	Employee	Employer				
Not making NI contributions	None	None	None	**None**	N/A	Higher, earnings-linked CP replaces partial entitlement to BSP and S2P
Contracted-in to S2P	Reduced by £2	Reduced by £2	None	**Reduced by £4**	N/A	Higher earnings-linked CP instead of BSP and S2P
In a contracted-out Defined Benefit scheme	Increased by £3	Increased by £9	Reduced by £16	**Reduced by £4**	N/A	Higher earnings-linked CP instead of price-linked BSP
In a contracted-out Defined Contribution scheme	Increased by £3	Increased by £1	Reduced by £8	**Reduced by £4**	£10 to £40	Higher earnings-linked CP instead of price-linked BSP
In a contracted-out Personal Pension	Reduced by £2	Reduced by £2	None	**Reduced by £4**	£16 to £40	Higher earnings-linked CP instead of price-linked BSP
Self-employed	Increased by £5	None	None	**Increased by £5**	N/A	Higher earnings-linked CP instead of price-linked BSP

[34] Based on PPI interviews, see also Chapter 3
[35] PPI calculations. Around half of full-time employees earn less than £400 a week.

3. The impact of a Citizen's Pension on saving

In this chapter the effect of a Citizen's Pension on pension saving is considered first, and then the specific issues on the ending of contracting-out.

Key points

3.1 Despite concerns, especially about the ending of contracting-out, on balance this report suggests that the impact on occupational and personal saving with a Citizen's Pension should be positive.

3.2 A Citizen's Pension will allow the state to give a simple, reliable and consistent message on what it will provide as an underpin: *The state will provide £105 per week, and the saving you do on top of that is yours.* Individuals can then make better informed choices on what saving to do for their own retirement aspirations.

3.3 A Citizen's Pension at the level of £105 a week will not be generous enough to make private saving redundant. Some (lower income) people may need to save slightly less; some (higher income) slightly more.

3.4 By removing means-testing for basic income through Pension Credit for the majority over pension age, the Citizen's Pension ensures that it does pay to save. This should remove the 'regulatory reticence' of advisers to sell pensions, and schemes to enrol members, especially at low-middle income levels.

3.5 Accruals of contracted-out benefits would end on C-Day. Contracting-out is declining anyway and the pensions industry sees advantages and disadvantages in this feature of transition.

3.6 Although occupational and personal pensions would no longer receive revenue from contracting-out rebates, the funds would no longer have to provide the equivalent future benefit. This could be a better balance of risk between state and private provision.

3.7 Views differ on whether ending contracting-out would hasten the decline in private sector Defined Benefit schemes, but some believe that it could be positive for such schemes.

3.8 There is a view that contracting-out is not currently working as rebates are not generous enough. However, increasing them to the level that would make a difference would be an extra cost to the public purse to be borne by all taxpayers.

3.9 Moving to a Citizen's Pension without contracting-out would have significant simplification advantages in administration and regulation for occupational and personal pension schemes.

How a Citizen's Pension removes the barriers to saving

A Citizen's Pension should help to encourage healthy occupational and personal pensions, because it would:

1. Allow the state to give a simple, reliable and consistent message on what it will provide as an underpin to private saving.
2. Not be over-generous, so occupational and personal saving is still needed at similar levels.
3. Remove the Pension Credit means-testing trap and ensure £ for £ value from saving.

The changes to a Citizen's Pension may not provide ***sufficient*** conditions for a healthy private sector, because it may be that further savings incentives are needed. But it does seem that the Citizen's Pension could provide the ***necessary*** conditions to make the savings system work effectively, compared to the current system.

1. Allow the state to give a simple, reliable and consistent message on what it will provide. Compared to the current system, under a Citizen's Pension, government policy on 'Informed Choice'[36] - to make sure everyone has the information they need to plan ahead for their own retirement aspirations with confidence - is more likely to work, because of:

- **Simplicity**: A Citizen's Pension means the state system can be described in one phrase with two parameters: level of benefit and state pension age.
- **Reliability**: Notwithstanding the political risk of change with any state pension[37], the Citizen's Pension model allows the state promise to be more certain than the current model:
  - The calculation of an individual Citizen's Pension benefit depends on fewer parameters, so the variability from individual circumstances is reduced.
  - Under the current system, the state pension benefit received in future depends on what happens to the individual's employment, earnings, contracted-out status, savings amount and return, work after SPA, marital status (and which spouse), and residence.
  - Only residence may alter a future Citizen's Pension entitlement and marital status may do depending on the benefit definition chosen.
- **Consistency**: There is a mixed message inherent in current policy that a Citizen's Pension resolves.
  - Government wants people of working age to save, yet also sends out a message that Pension Credit is available to support older people.
  - The Savings Credit element of Pensions Credit is complicated, and there is no evidence that it is working as intended as a reward for saving[38].
  - With a Citizen's Pension, government can give a consistent message to all age groups: *The state will provide £105 a week, and the saving you do on top of that is yours.*

[36] DWP (2004 IC)
[37] But see Chapter 6 for mechanisms to reduce the political risk under a Citizen's Pension
[38] PPI (2004 SWPC)

C-Day brings the opportunity to boost the government's Informed Choice programme:

- It is clearly important that people have the opportunity to make informed choices about future pension saving at C-day as the mix of their state and private benefit changes. There is in particular a risk that individuals saving in personal pensions would, through inertia, not increase their contributions to replace the lost rebate[39].
- By C-Day, or one year either side, a state pension forecast and private pension forecasts should be sent to each person of working age, to encourage appropriate future savings choices.
- This should be feasible, as the government has already started such a policy on state pensions and interviews confirmed providers could do this.

2. A Citizen's Pension is not over-generous, so saving still needed

A Citizen's Pension at the level of £105-£115 a week will not be generous enough to make occupational and personal pensions redundant. It should mean that some (generally lower income) people need to save slightly less; some (generally higher income) slightly more.

- Other countries with a Citizen's Pension do have healthy private savings:
  - Private pension funds in the UK have assets worth 66% of GDP.
  - In New Zealand, Denmark and the Netherlands, respectively, similar measures are 15%, 24% and 105% of GDP[40].
- In comparing the effect on saving of a Citizen's Pension, we need to look at the future pension prospects of working age people under the continuation of the current system and under a Citizen's Pension system. ***Note that this is not a sudden change in the value of accrued rights, but a change in future expectations.***
- Under current policy, higher income people expect higher state pension benefits than lower income people would (as shown in Charts 1 & 2).
- A change to a Citizen's Pension will mean that in principle, and ignoring the transition of accrued rights, everyone expects the same state benefit.
  - For the typical woman of any income group (who does not have full BSP/S2P because of work history) a Citizen's Pension at £115 a week is just as good as the maximum available state pension if she claims Pension Credit at age 65. A Citizen's Pension at £105 would be better than the minimum (if she does not claim).
  - The Citizen's Pension at £105-115 would be above the minimum current state pension expectation for the poorest men (and couple) but below the maximum at age 65. The highest income men (and couple) would expect less from a Citizen's Pension than from the current state system.

[39] Note that such individuals would not be losing out financially (as the 'lost' rebate is staying with the state to provide a better state pension), but the individual may prefer more private saving

[40] Figures for Denmark, the Netherlands and the UK from OECD (2004). Figures for New Zealand based on data from PRG (2003) and Statistics New Zealand. Note that the measures may not be consistent; and they do not take account of non-pension saving.

  - As individuals age, the Citizen's Pension becomes more important as it is indexed to earnings not prices. This means that higher income people will tend to get an income advantage from a Citizen's Pension (compared to the current system) later in life (Chart 5). Aspirations for retirement income before then will most likely be met by occupational and personal saving.
- The amount of state pension income that anyone in a low-middle income range would receive under the current system in future is uncertain, as it depends on:
  - The amount of Pension Credit entitlement, which depends in part on the amount of other income the individual has at a point in future.
  - The parameters in the Pension Credit calculation at that time, which may be more or less generous in the future as now.
  - Whether the individual takes up the Pension Credit to which he or she is entitled.
- Comparing the amounts needed to save under the current system to reach a certain replacement rate and the amounts needed to reach the same target under a Citizen's Pension is therefore not straightforward (Charts 9 and 10).
- The simplest approach is to compare on the basis that Pension Credit awards are zero, because that reflects someone not taking up the benefit, and the risk that changes to the parameters over time make Pension Credit less generous (which seems more likely than it becomes more generous).

Charts 9 and 10 show that there should still be private saving after a Citizen's Pension, and it tilts the need for saving more to people able to save:
- After a change to a Citizen's Pension people will have a new expectation of their future income from the state. The amount of savings needed to maintain a specific replacement rate of income in retirement changes, but only slightly. Private saving is still needed.
- To achieve the same proportion of final salary across the income spectrum, higher income people still need to save more than lower income people do.
- With a Citizen's Pension, only the highest earning 30% of men may need to save slightly more as a % of salary, which could be a fairly substantial £ amount.
- Some lower-middle income people <u>may</u> need to save more with a Citizen's Pension at £105 as compared to the current system of Pension Credit continuing in the future on as generous terms as now. This is a risky assumption, given the state of pension policy, and it also assumes the individual claims the Pension Credit then available.
- Under current policy, a woman needs to save a higher portion of income in a private pension to reach the same retirement target as a man. This is because a woman tends to have a lower state pension, as she misses out on accruing full contributions. A man is more likely to have a full state pension. Under a Citizen's Pension, both the man and woman receive the same amount, so their saving requirements come closer together.

Chart 9[41]

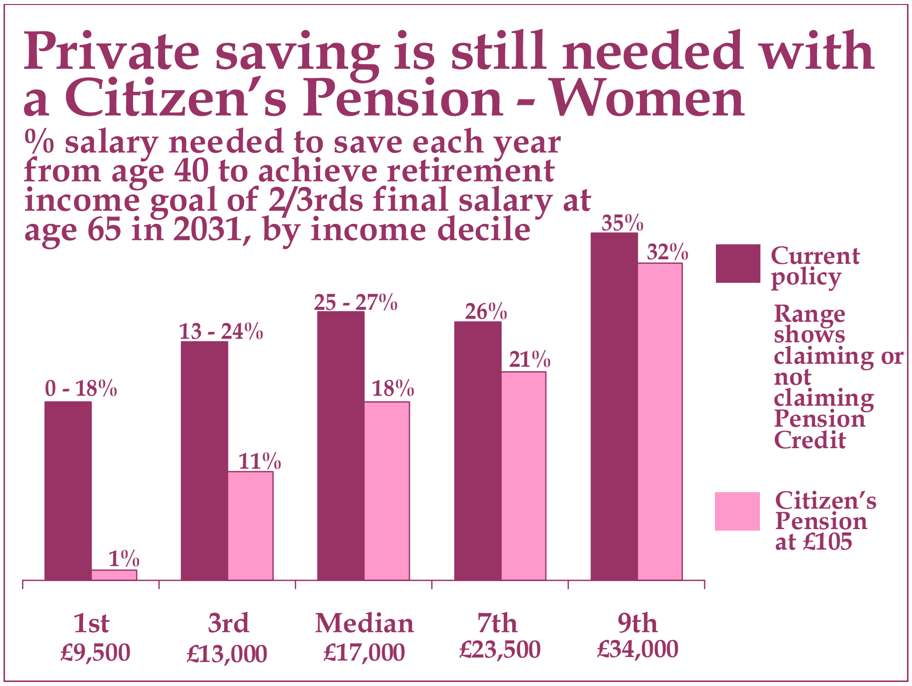
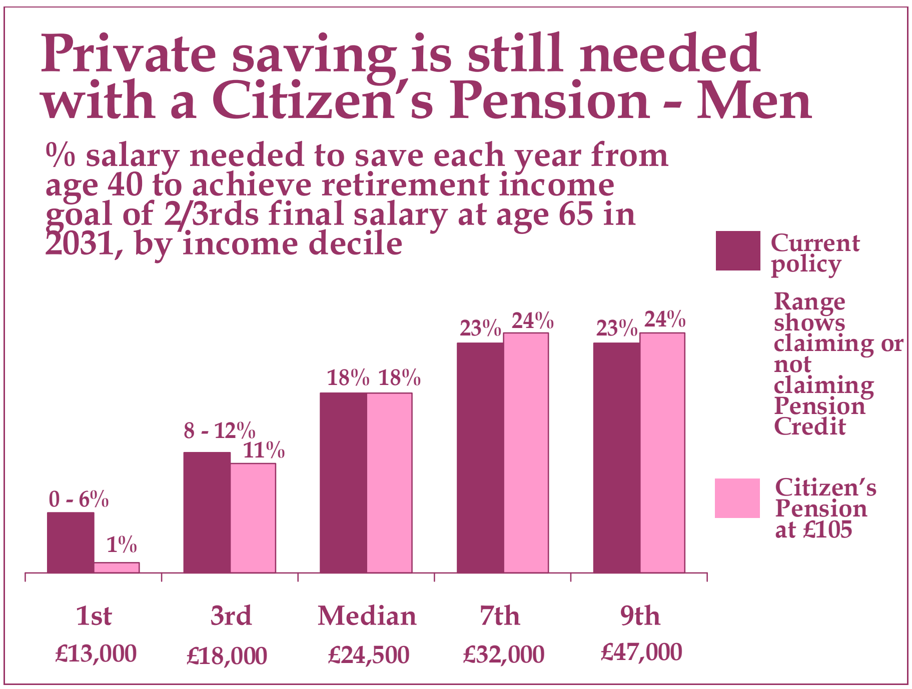


Chart 10



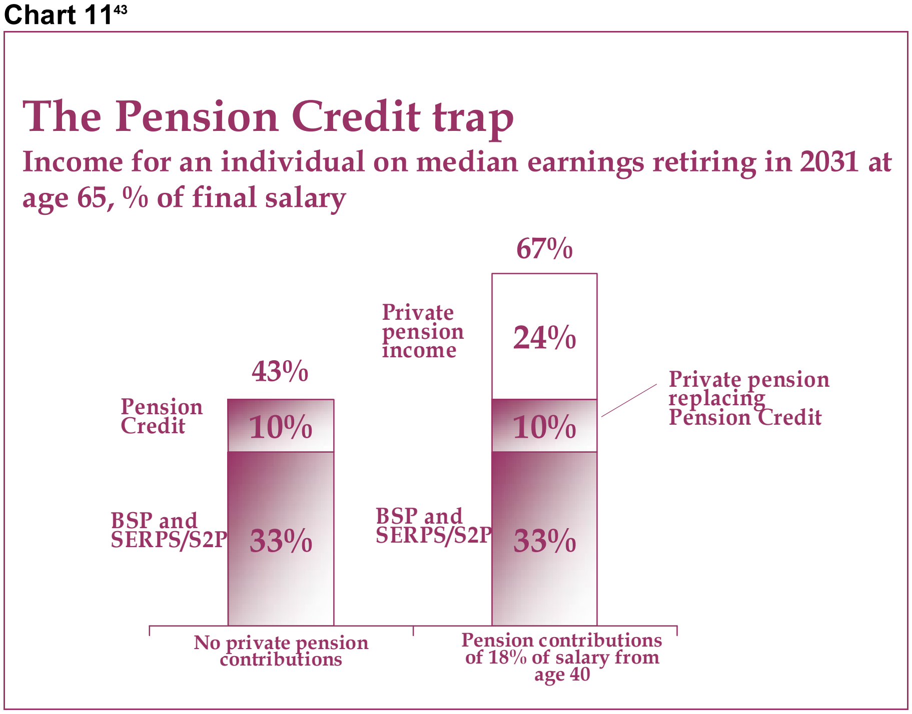
[41] PPI analysis using the Individual Model. Individuals as in Charts 1 and 2. Saving is that on top of either a Citizen's Pension or, under the current system, Basic State Pension and State Second Pension (or contracted-out equivalent). For details and sensitivities see Appendix 3.

3. Remove the Pension Credit means-testing trap
By removing means-testing for basic income through Pension Credit for the vast majority over pension age, the Citizen's Pension ensures that it really does pay to save. This should remove the 'regulatory reticence' of advisers to sell pensions, and schemes to enrol members, especially at low-middle income levels.

The Pension Credit means-testing trap is illustrated by the percentage of saving that turns out to be only replacing what Pension Credit would have provided with no saving (Chart 11).

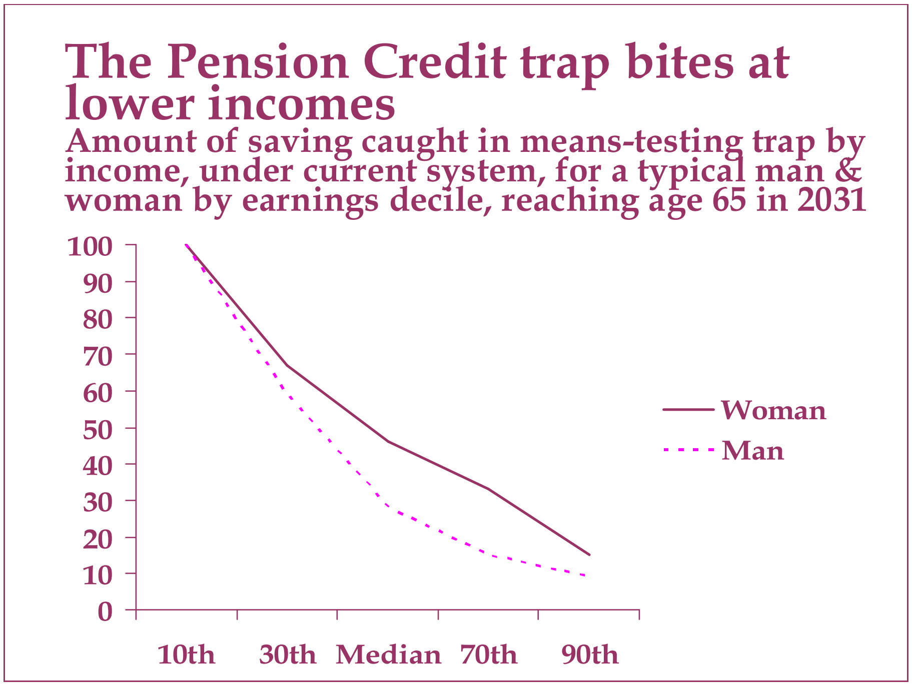
- For example, a man on middle earnings throughout his life might save 18% of salary a year from age 40, and end up with a total income on retirement of 67% of his final salary.
- Suppose his neighbour, on exactly the same earnings, saves nothing, so he has a lower total income in retirement (43% of final salary). But all of his income is provided by the state, whereas the saver has less from the state (33% of his final salary).
- The saver finds that one-third of his saving just replaced additional state pension that his non-saving neighbour receives.
- The means-testing trap bites hardest at lower income levels, and for women who tend to have lower incomes and lower contributory state pension entitlements and are more likely to be on Pension Credit (Chart 12).
- This analysis, at age 65, understates the problem. At older ages, more people are eligible for Pension Credit, as the real value of their income (at best price-linked) falls relative to the earnings-linked Pension Credit[42].

Chart 11[43]



[42] See PPI Briefing Notes Numbers 6, 9 and 11 and PPI (2004 MT)
[43] PPI Briefing Note 9, see Appendix 3

Chart 12[44]



Pension Credit makes it difficult to sell a pension at middle income levels:

- The means-testing trap means an adviser cannot clearly say a client will get full value from saving in a pension, especially given the uncertainty about the future of Pension Credit.
- This means an adviser cannot recommend saving in the secure knowledge that he is following regulatory requirements to give best advice.
- This 'regulatory reticence' is reported to be slowing sales of individual pensions, and employer-based group personal pensions, in the lower to middle-income bands.
- The highest income two deciles for men, and top decile for women are much less affected by the means-testing trap. It is therefore not surprising that advisers concentrate on higher earners.

Under a Citizen's Pension, all saving is paid directly on top of a clearly defined state pension. So it should encourage saving by:

- Improving the value of all saving, with no doubt that any of it will fall into the Pension Credit means-testing trap in later life.
- Removing the regulatory reticence of advisers to sell private pensions.

A Citizen's Pension at £105 a week would still mean some people are eligible to claim Housing Benefit and Council Tax Benefit. There will be fewer than now; and still fewer with a higher Citizen's Pension. But a Citizen's Pension would drastically reduce the spread of means-testing up the income scale, and it would stop means-testing for basic income rather than for specific purposes.

[44] PPI analysis using Individual Model. 'Saving' is that above BSP and S2P or contracted-out equivalent. The illustrative man and woman are as in Charts 9 and 10 on median age/gender specific earnings and start saving at age 40 the amount needed for a two-thirds replacement rate. Examples assume a level annuity is bought.

Ending of contracting-out

As the Citizen's Pension replaces future accruals of both the Basic State Pension (BSP) and the State Second Pension (S2P), accruals of contracted-out benefits would end on C-Day[45]. Contracting-out is declining anyway, and is expected to continue to do so:

- Of people with some second pension, 61% are contracted-out compared to 69% in 1990.
- The decline is almost entirely due to the switch of occupational schemes in the private sector from contracted-out Defined Benefit to contracted-in Defined Contribution. 14% of people with some second pension are now in a Defined Benefit private sector scheme compared to 21% in 1990[46].
- There is general agreement that this trend will continue. There has been for a few years now, and there is expected to be in future, minimal new contracted-out individual or occupational pensions.
- Insurers are now recommending individuals reconsider their contracting-out status and some have been recommending contracting back in since 2003[47].

The pensions industry sees advantages and disadvantages in the ending of contracting-out[48]:

1. The balance of risk for occupational and personal pensions may improve.
2. Views differ on the impact on private sector Defined Benefit schemes.
3. Improving contracting-out rebates would be preferred, but it has a cost.
4. Simplification of administration and regulation would be of significant benefit.

1. Balance of risk for occupational and personal pensions may improve

Although occupational and personal pensions would no longer receive revenue from contracting-out rebates, the funds would no longer have to provide the equivalent future benefit, which would be shifted back to the state. This could be a better balance of risk between state and private provision.

Contracting-out appears to fit with the current government's policy of switching around the proportion of total pension income that comes from state pay-as-you-go provision (60%) and funded private provision (40%)[49]. However:

- *This aspiration is extremely unlikely to be met*[50] as public expenditure is growing anyway (as well as the private sector declining).
- The state will remain the dominant source of pension provision as although everyone receives some state pension, many fewer have significant private retirement income[51].
- Contracted-out saving appears as income from the 'private' pension sector in the 60:40 calculation, but it comes from the 'state' as it is funded by diverting National Insurance contributions that would otherwise be paid to the state and/or by rebates from the state.

[45] Appendix 2 explores this issue in more detail
[46] DWP (2004 STPP), PPI Briefing Note Number 12
[47] ABI (2004 CO); PPI interviews
[48] This section has been informed by interviews with a number of pension providers and pension fund managers, with thanks
[49] DSS (1998 GP), DWP (2004 DR). Note non-pension benefits to pensioners such as Council Tax Benefit and Housing Benefit also appear to be included in the 'state' part of this calculation.
[50] Pensions Commission (2004) p.146
[51] PPI Briefing Note Number 10

The ending of contracting-out would make a difference to the revenue going into the occupational and personal pensions sector (referred to as private pensions):

- 15% of the total contributions into occupational schemes, and 22% of those going into personal pensions are contracting-out rebates[52].
- For providers of personal pensions, this is often profitable business as the rebates are a steady regular income with minimal administration required.

The 'lost' revenue would not be retrospective. It would be matched by the occupational or private pension no longer having to provide the equivalent of the contracted-in S2P benefit for future accruals. This means **the funds are in an 'actuarially neutral' position, but their *future* risk profile has changed**.

It may be beneficial for Defined Benefit (DB) schemes that their future risk would be reduced:

- On the transition to a Citizen's Pension, the DB scheme would no longer receive rebates, and would no longer have to accrue liabilities for the S2P-equivalent contracted-out benefits (see Chapter 2).
- This would reduce the future size of the scheme, as compared to a continuation of the status quo, but would also reduce the future risks of providing pensions that employers have to bear through a DB scheme.
- This may be something that employers prefer, and so would help to keep some schemes going that would otherwise close.
- The employees' total benefit would not be adversely affected compared to people not previously in a contracted-out DB scheme, as future benefits for all are on the same new system.

Future risk would also be reduced for an employee in a contracted-out scheme (who has not had choice about being contracting-out) or an individual who has chosen to be contracted-out through a personal pension.

- The risks for individuals that are inherent in contracting-out, and would reduce if a transition to a Citizen's Pension ended contracting-out are:
    - **Investment risk** where the benefit is on a Defined Contribution (DC) basis;
    - **Provider risk** of loss of contracted-out benefit from a failed provider such as Equitable Life or employer such as ASW;
    - **Rebate risk**, where the rebates turn out to be lower than they should be to provide the equivalent S2P benefit; and,
    - **Political risk** of the contracting-out rules being changed to the detriment of the individual contracted-out.
- Contracting-out can turn out to be a worse deal than remaining contracted-in because of these risks. So ending contracting-out may actually be better for individuals.
- Some individuals choose contracting-out because they have a preference for taking these risks: because they seek a higher investment return on that part of their pension, or because they prefer the non-financial benefits of contracting-out[53].

[52] PPI estimates

[53] Including: availability of benefit before state pension age; the potential for a tax-free lump sum; choice of level or increasing annuity and reduction of the political risk inherent in state pensions (this may be a philosophical preference for market risk)

- However, the financial benefits of contracting-out are not clear cut. The range of possibilities for investment performance is wide enough that loss from contracting-out is possible. As an example: one year's rebate for a forty-five year old person needs to be invested at a net 6.5% pa (after charges) to yield a pension benefit better than the S2P equivalent. The nominal investment return on pension funds over the last 5 years has averaged 5.6% pa before charges, and over the past 20 years has been 10.5% pa[54]. There is no guarantee of obtaining a long-run net 6.5% return.
- This risk of loss from contracting-out of S2P is particularly critical as the Basic State Pension is low. This means that private pension risk is being borne by contracted-out individuals for a potentially large part of their pension income. Under the Citizen's Pension, the state first tier would be larger than the current BSP[55], so the private pension risk borne above that by individuals who then choose to save in the private market could be a more appropriate portion of their total income.

Private pensions would still have a major role with a Citizen's Pension regime. The choice of whether to participate in private pensions would still exist, and the private sector could, as indicated earlier, be able to grow without the current barriers to saving.

[54] Calculated from a model produced for the ABI, with thanks. Other examples show the same point – details available on request. Source for past investment returns: Watson Wyatt.
[55] Maintained at least at 22% of national average earnings as compared to the current BSP of 16% NAE, reducing to 10% NAE by 2040

2. Views differ on the impact on private sector DB schemes

There are different opinions on whether a Citizen's Pension would hasten the decline in private sector Defined Benefit schemes, but a body of opinion among pension funds believes that it could be positive for such schemes.

- There is no disagreement that private sector DB schemes are declining as employers re-evaluate their approach to the increasing cost and risks of providing pensions (stemming mainly from increased longevity, lower investment returns and increased regulation).
- There is a body of opinion that the 'worst is over' in terms of DB scheme closures[56].
- It has been suggested that private sector employers with open DB schemes might react to the ending of contracting-out by taking that as the 'last straw' and deciding to close the scheme, probably changing to a DC scheme.
- But there is a difference of opinion as to whether a Citizen's Pension would hasten the decline further:
    - A change to a Citizen's Pension would mean scheme redesign, so employers might be prompted to move away from DB when they would not otherwise have done so.
    - A scheme redesign might well involve some hybrid arrangement of DB and DC.
    - Any scheme design would be more straightforward with a Citizen's Pension than with the current system. The Citizen's Pension defines a simple and more certain underpin of state income, from which it is easier to design top-up DB benefits.
    - If the ending of contracting-out resulted in smaller, lower risk DB schemes, then the schemes would actually be more likely to survive. This view was prevalent among scheme managers and employers; insurers tended to be more pessimistic about DB scheme survival.
- Public sector DB schemes (in which there are more members than private sector DB schemes), are not affected by the ending of contracting-out except in terms of the structure of benefits. The source of funds (or cash in the case of unfunded schemes) is still the taxpayer. Therefore the ending of contracting-out should not be a reason for change in benefits of public sector schemes; although again it might provide an opportunity for scheme redesign.

[56] Pointing to large employers retaining or returning to DB schemes such as Woolworths, Barclays

3. Improving contracting-out rebates would be preferred, but it has a cost
There is a view that contracting-out is not currently being given a chance to succeed as rebates are not generous enough. However, increasing them to the level that would make a difference would be an extra cost to the public purse to be borne by all taxpayers

- The decline in contracting-out is attributed in part to the level of the contracted-out rebates. These are set every five years with the aim of contracting-out providing equivalent benefits[57], but they may or may not turn out to be generous relative to the S2P benefits given up. For example, all other things being equal:
  - If pension providers charge costs which are lower than those assumed in the rebate calculation then the contracted-out individual will have gained.
  - If the investment performance of the pension product is lower than that assumed in the rebate calculation then the contracted-out individual would have been better off contracted-in to S2P.
- Currently the rebates are seen to be set at a level more likely to favour contracting-in, but this is by no means certain. It is also very complicated to calculate the potential benefit for any individual as the rebates are multi-parameter; varying by age, gender, earnings, and type of product.
- There is, therefore, not an obvious 'sell' for contracting-out – it cannot be clearly shown that it is better for an individual to be contracted-out on financial grounds. Advisers are wary of promoting a product that is not of clear benefit because of the risk of later being found guilty of regulatory negligence or mis-selling.
- One argument against the ending of contracting-out is therefore that, it is currently not being given a chance to succeed, but could do if the rebates – or the benefits the rebates 'bought' - were more generous. There would then be a clearly 'sellable' benefit to contracting-out, and the risk of financial loss would be significantly reduced. Contracting-out would succeed with its original intention and advisers would be able to recommend contracting-out.
- However, for contracting-out to be clearly incentivised in this way, with minimal financial risk, the rebates would have to be more generous than currently is the case (£12bn pa; 20% of the cost of paying all state pension benefits)[58].
- Set at the level to replace the equivalent state benefits, rebates are not costing the taxpayer. Set any higher and the increase has to come from the public purse, in other words, be financed by the taxpayer. Enhancing contracting-out rebates to provide additional incentives for private saving therefore has a cost.
- Given that there is already a high level of public spend on tax relief and incentives for pension saving (£19bn pa[59]); it would be controversial to build in more incentives by improving rebates. It therefore seems unlikely that high enough rebates for contracting-out to succeed can ever be sustained.

[57] GAD (2000 RCN)
[58] PPI analysis of Inland Revenue statistics
[59] Curry and O'Connell (2004)

4. Simplification of administration and regulation would be of significant benefit

There is a natural reluctance to disturb current arrangements. But although change itself adds work, changing to a Citizen's Pension without contracting-out would have significant simplification advantages in administration and regulation for occupational and personal pension schemes.

The transition at C-Day brings the opportunity to simplify the 'legacy management' of Defined Benefit schemes.

- Each individual's accrued state pension rights at C-Day would be crystallised into two numbers: contracted-out and –in. The contracted-out amount may be split to different schemes or providers if an individual has been contracted-out with different employers. The amount of accrued right(s) can then be handed from the government to either to the individual or the employer(s).
- Contracted-out Defined Benefit schemes would find this especially helpful to their legacy management. It would mean they can in future provide transfer values and benefit statements to members without having to access the data held by the Inland Revenue; a process often subject to long delays.
- It would also mean that the government systems handling the contracting-out administration can be 'turned off', potentially making large cost savings.
    - Around 5,000 Inland Revenue staff safeguard and maintain National Insurance records[60]. One-third of these provide support to contracted-out pension schemes[61].
    - Inland Revenue receive 2 million paper forms each year, containing information about terminations of contracted-out periods or transfers of contracted-out rights. In recent years, the proportion of forms submitted incorrectly has ranged from one-third to one-half[62].
    - The complexity and high error rate are caused by contracting-out requiring two independent sets of full records to be kept, then matched using three or four different numbers as identifiers.

A Citizen's Pension without contracting-out would also mean the state need impose less on the private sector, freeing up the industry from the cost of regulation that would no longer be necessary. For example, the state need intervene less in the detailed design of private sector benefits allowing freer choice to the employer and/or individual:

- Contracted-out personal plans and occupational schemes have to follow detailed benefit design rules, e.g. on indexation, and survivor benefits. This restricts an employer's choice, complicates the scheme design above the contracted-out part and may not be best for individual employees.
- Because a Citizen's Pension removes means-testing for basic income, there is a less powerful case for having to buy an annuity with pension proceeds at 75.

[60] Employed in the National Insurance Contribution Office (NICO), www.inlandrevenue.co.uk/nico/aboutus.htm
[61] Employed in the National Insurance Service to Pensions Industry (NISPI). IR (2004).
[62] Information from NISPI

Removing this type of regulation need not reduce any safeguards; it would simply not be needed. But it should mean that the costs of private pensions can be reduced. The private sector could then offer better value products, improving the opportunity for financial inclusion.

- Contracting-out doubles the time needed for the pension selling process as advice on contracting-in or –out is needed in addition to the advice on buying a pension. The ending of contracting-out should therefore halve the time needed to explain a pension purchase and the simplicity of a Citizen's Pension should help reduce the time still further. The cost of selling should reduce commensurately.
- This reduction in cost made possible by a Citizen's Pension should make a big difference to the consumer. Pension products are much more costly than simpler savings products, because of the increased complexity and regulation. The initial costs of handling a new pension policy are at least 50% higher for a pension contract than for a savings contract[63].

[63] Deloitte (2003). Costs here include the processing of the application, post sale disclosure and compliance activity, collection and investment of the first contribution and the issue of contract and other documentation.

4. Eligibility criterion for a Citizen's Pension

This chapter suggests how a residency-based criterion could work for a Citizen's Pension in the UK[64].

Key points

4.1 A fair Citizen's Pension could work in the UK, based on residence.

4.2 The eligibility criterion could be similar to the current UK Category D retirement pension, which would simplify state pension administration for the significant majority of standard cases.

4.3 Social Security Agreements with other countries would cover non-standard cases, as they do now, with little additional 'unfair' liability for the UK.

4.4 Guarantee Credit could remain as the safety-net for residents over state pension age not eligible for the Citizen's Pension but with no other income.

Proposed eligibility criteria for a UK Citizen's Pension

1. **Minimum residency criterion to acquire a Citizen's Pension**
   The full Citizen's Pension will be paid to those UK residents over State Pension Age (SPA) who have had at least 10 years residency in the UK during a continuous 20-year period before or after SPA.
2. **The amount paid to eligible people over SPA who reside outside the UK**
   Social Security Agreements (SSAs) should work with the new Citizen's Pension. Non-standard agreements with some countries could be rationalised if desired.
3. **The amount paid to people living in the UK aged over SPA who do not qualify for the full Citizen's Pension**
   SSAs should cover the cases of people moving to the UK at or after SPA without meeting the UK's Citizen's Pension full eligibility criterion. Foreign state pension payments from outside the EU could trigger a £ for £ reduction from the full Citizen's Pension.

[64] See Appendix 4 for background information on criteria used for other benefits in the UK; Social Security Agreements with other countries; and the criteria used in other countries with a Citizen's Pension

The eligibility criterion has been considered so that the new system:

- Should be as easy to understand and administer as possible.
- Should seek to minimise the potential for people to evade paying contributions but still collect benefits.
- Should fairly allow for people to move countries, before and after state pension age.
- Aims to be as compatible as possible with existing arrangements for mobile workers and retirees.

1. Minimum residency criterion to acquire a Citizen's Pension

The full Citizen's Pension will be paid to those UK residents over State Pension Age (SPA) who have had at least 10 years residency in the UK during a continuous 20-year period before or after SPA.

- A similar criterion already exists in the UK[65] for Category D pensions payable to people over 80 years of age who receive no basic state pension.
- It is a simple test, easy for people to understand.
- History of residency will have to be proved for only 10 years, which is practical, particularly in the transition period.
- 10 years is short enough so many UK residents would receive it by right even if they have worked abroad for some part of their working life.
- By setting the 20 year 'window' of residency close to SPA, eligibility is focused on older people, and rewards continuous residence rather than moving in and out of the country.
- There could be exemptions in specific cases such as being in prison or an asylum-seeker, as in the current rules for Pension Credit.
- In the longer term, the Home Office has proposed a National Identity Register which could provide residency data usable for the Citizen's Pension[66]. But even without the National Identity Register, sufficient information should be available from existing administrative sources including:
    - Tax
    - National Insurance
    - Social security benefits
    - The electoral register
    - NHS/GP registration
    - Council tax records
    - Passport records
- The Citizen's Pension would be available on the same basis to UK nationals and non-nationals. There is no precedent in current UK benefits for different criteria by nationality (as there is with the Danish Citizen's Pension).

[65] A definition of the UK would need to be set. Separate legislation may be required for N. Ireland.
[66] House of Commons Select Committee on Home Affairs Fourth Report (2004)

Using residency rather than contributions as the basis for state pensions may require some changes to non-standard Social Security Agreements (SSAs) but would be covered by the EU SSA[67]. SSAs are used to determine payments to:

- People not resident in the UK after pension age who previously had some time resident in the UK, and
- People resident in the UK after pension age who do not satisfy the 10 year criterion.

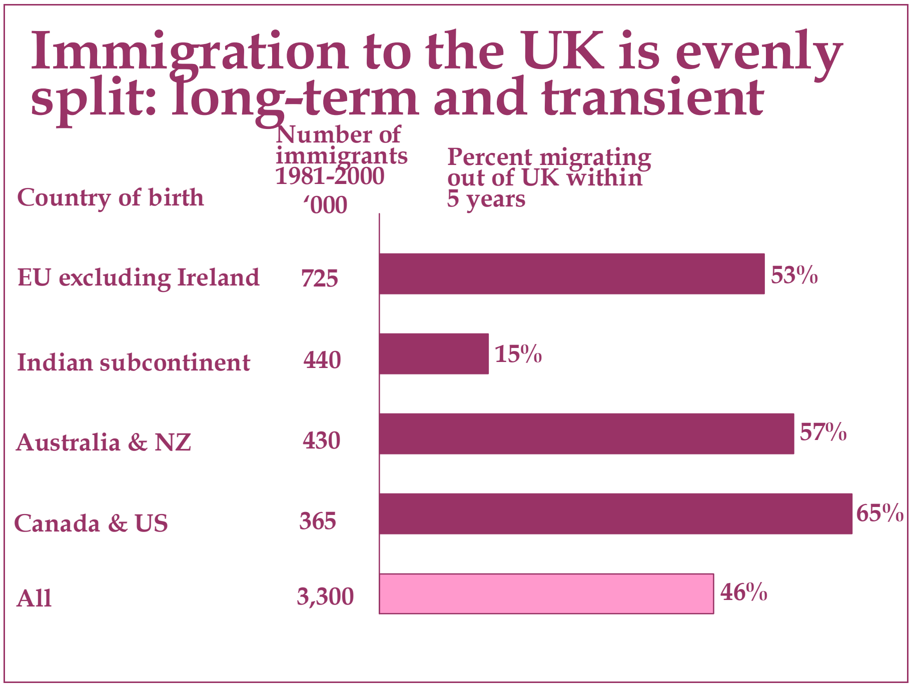
2. The amount paid to eligible people over SPA who reside outside the UK
Social Security Agreements (SSAs) should work with the new Citizen's Pension. Non-standard agreements with some countries could be rationalised if desired.

- This section would apply for people over state pension age (SPA) who may be eligible for the UK's Citizen's Pension but who are not residing in the UK.
  - The test for residing in the UK exists: living in the UK and passing the Habitual Residency Test.
  - A period of absence longer than which triggers these arrangements would need to be set e.g., 16 weeks (as Housing and Council Tax Benefits; Pension Credit stops after 4 weeks abroad).
  - Nearly half (46%) of immigrants to the UK migrate out of the UK after a stay of five years or less (Chart 13). Many stays are therefore short-term, at young ages[68], so may not figure in the individual's pension arrangements in later life.
- People who were resident in the UK at some point during the qualifying period (from 20 years before state pension age) but live outside the UK in later life, could apply for a portion of the Citizen's Pension benefit only if they go through a Social Security Agreement (SSA).
  - SSAs today mean that the total pension entitlement is the total of that which has been 'earned' in each country, and that paid by the UK is the pro rata amount 'earned' in the UK, with a theoretical maximum total of 44 years 'earning' the pension.
  - With a Citizen's Pension, the UK entitlement would be calculated by the proportion of the actual years of residence in the UK during the 20 years before SPA with a theoretical maximum of 10 years.
- The coverage of SSAs (compared to the current system) would be better for some and worse for others:
  - People who have lived in the UK early in their working life (before age 45) would not qualify for any Citizen's Pension.
  - People who have lived in the UK in the 20 years before SPA will receive a higher pension for each year.
  - The net additional cost is likely to be small. 93% of people migrating into the UK do so before age 45; 84% of people migrating out do so before that age[69].

[67] A Citizen's Pension would fall under EU regulation 1408/71, which covers the payment of social security benefits to people who have lived or worked in more than one member state. This covers contributory and residency-based benefits. Regulation 1408 also covers EEA countries and Switzerland. Non-standard SSAs may need to be updated because the scope of the agreements will be broader (covering residents rather than workers), and because the amount of benefit paid by other countries may change.
[68] For example 2-year young person's working visas available to citizens of Australia and New Zealand
[69] International Passenger Survey 2002

- Denmark, the Netherlands as well as New Zealand operate residency-based SSAs with other countries in a similar way.
- For people who are eligible for the Citizen's Pension but have retired to a country with which the UK does not have a standard SSA (e.g., Australia, S. Africa), existing agreements with each country should still apply as above. They are usually less generous than standard SSAs, e.g., pension payments are frozen at the date of emigration. The introduction of a Citizen's Pension could provide an opportunity to rationalise some of these agreements.

Chart 13[70]



[70] Rendall and Ball (2004)

3. The amount paid to people living in the UK aged over SPA who do not qualify for the full Citizen's Pension

SSAs should cover the cases of people moving to the UK at or after SPA without meeting the UK's Citizen's Pension full eligibility criterion. Foreign state pension payments from outside the EU could trigger a £ for £ reduction from the full Citizen's Pension.

- Under SSAs, people living in the UK at and over SPA who spent some or all of their working-age life outside the UK receive their pension entitlement from each country in which they 'earned' an entitlement.
- There are very few people who move to the UK after state pension age.
    - Only 2% of all immigrants arriving in the UK in the period 1975-99 were already of state pension age[71] that is, around 9,000 people a year. Almost three-quarters of these older migrants were returning British citizens[72].
    - Non-UK citizens over SPA with no family reason to come to the UK can only have the right to reside in the UK if they would not be an 'unreasonable burden on the state'[73].
    - The current overseas-born older population (those aged 65 or over) resident in the UK first arrived many decades earlier. Almost 90% arrived before 1971 and therefore would qualify for a Citizen's Pension irrespective of the application of the SSA[74].
- People over SPA who had lived for 10 years in the UK in the last 20, whether that was before or after SPA, receive a full Citizen's Pension as well as any state pension earned from other countries.
- Any state pension received from countries not covered by standard SSAs could be deducted from the Citizen's Pension amount £ for £. This would cap the UK liability at a full Citizen's Pension, and prevent these people from having more than the equivalent of one working life's pension.
- The standard SSA, including that for the EEA, prevents £ for £ deduction of state pensions from those countries. This means that a small number of people could have a full UK Citizen's Pension and some pension from say, an EU country. This could increase the costs of a Citizen's Pension, as under the existing system individuals would only be entitled to less than a full UK pension[75].
- Special rules could be introduced for people who work outside the UK for the UK government or for UK government-supported 'good causes' such as for aid agencies. They could simply be able to count years of such work towards entitlement to the Citizen's Pension, regardless of the country in which the work was carried out[76].
- The Guarantee Credit element of Pension Credit could remain on the current basis as the means-tested safety-net income for residents over state pension age who are not eligible for the Citizen's Pension who have no other income and would otherwise live below the poverty level.

[71] 60 for women, 65 for men
[72] Rendall and Ball (2004)
[73] Right to Reside Test
[74] Rendall and Ball (2004)
[75] There will also be people who would receive no Citizen's Pension because they left the UK before aged 45, who would get some UK pension under the current system. See page 41.
[76] As in, for example, New Zealand Superannuation Act (2001)

Options for length of residency criterion
Instead of a 10 year residency criteria, a Citizen's Pension could be based on a longer qualification period, up to 44 years, with the amount received linked to the total number of years spent resident in the UK. The 44 year option could be achieved by introducing a residency credit in the existing National Insurance system. Overall, there would still be a simplification of the NI system as detailed earnings information and other credits would no longer be necessary.

A 44 year residency criterion would make the levels of Citizen's Pension paid to people of standard SSA countries more like the levels received under the current system:

- Younger people resident in the UK for a short period of time (for example, overseas students) would receive some Citizen's Pension (whereas with the 10 year rule they would not receive any).
- Older people (within 20 years of SPA) in the UK for a short period of time would only receive 1/44 of a Citizen's Pension for each year, rather than 1/10, and would be less likely to receive a full Citizen's Pension.

A 10 year rule is preferred to a longer residency period because:

- 10 years would simplify the administration for the majority of those eligible, who would qualify even on a lifetime residence requirement. There appears to be no data available on the number of these clear cut cases, but it is estimated at 80-90% of all people over state pension age[77].
- Denmark and the Netherlands have longer qualifying periods for their Citizen's Pensions (40 and 50 years respectively), but both countries have population registers. In the UK, past residence is more difficult to prove as there is no population register, so a shorter 10 year period is more practical.
- New Zealand's Citizen's Pension has a short qualifying period of 10 years, weighted towards residency at older ages. The New Zealand model is most like the UK model envisaged as it is the only state pension available.

[77] Based on 19,000 current SSA claims in process (compared to 620,000 new pensioners a year) and fewer than 1m people receiving UK pension overseas out of 11m

Examples for how the different proposed UK Citizen's Pension criteria would work
NOTE: These examples illustrate how the UK Citizen's Pension would work once the Citizen Pension is fully operational. Rights accrued under the current system would continue to be available on the current basis during the transition as described in Chapter 2.

Andy works all his life in the UK and lives throughout his retirement in the UK. Andy represents the majority of people in the UK.

Andy passes the eligibility criterion and is resident in the UK, so receives a Citizen's Pension.

Betty works all her life in the UK and moves to Spain on her 67th birthday, returning on her 75th birthday. There are estimated to be around 7,000 British people over pension age migrating out of the UK each year[78].

Betty becomes eligible for a Citizen's Pension at state pension age (60 due to rise to 65).

- When she is in Spain, the SSA with the European Economic Area (EEA) comes into force.
- However, as Betty has made no payment into Spain's social security system, she is liable for nothing from Spain. The SSA calculation would come down to seeing that Betty qualifies for a full Citizen's Pension, so the UK would be liable to pay her 100% of the UK Citizen's Pension.
- Ex-pats in Betty's situation with less than £105 in state pension income cannot claim Pension Credit as they could in the UK. They would be better off under a Citizen's Pension system.

Carol works for 22 years of her career in Germany, and the last 22 years in the UK. Her brother Connor does the opposite. They both spend their retirement in the UK. This is a somewhat unusual example to illustrate extreme cases.

Under the 10 year qualification rules:

- Carol would qualify for a full Citizen's Pension as of right, as she has lived in the UK for 10 years within the 20 year qualifying period.
- Carol would also receive a pension from Germany based on her qualifications in that system.
- Connor would not be entitled to any Citizen's Pension, as he has spent no time in the UK in the 20 years before SPA.
- He would only receive his pension from Germany, but could qualify for a Citizen's Pension after spending a further 10 years in the UK.

Under a 44 year qualifying period both Carol and Connor would receive a pension from both the UK and Germany, based on 22 years qualification in each country. For the UK, this would be 50% of the full Citizen's Pension.

[78] International Passenger Survey, 2002

Dan comes from another country in the EU and wants to 'game' the UK system. He lives most of his life in his home country, but between ages 55 and 65 he lives in the UK. Then he retires to his home country. Around 1,500 non-British people are estimated to migrate each year from the UK aged over SPA.

As Dan is not resident in the UK over age 65, he will have to apply through the EEA SSA to get any UK Citizen's Pension.

Under the 10 year qualification rule:

- Dan is entitled to a full Citizen's Pension, as he has fulfilled the residency criteria.
- However, Dan can only stay in the UK if he is a worker, self-employed, a work-seeker, or not an 'unreasonable burden on the state'. It seems unlikely someone would change their life for 10 years to 'game' the system in this way.

Under the 44 year rule:

- The maximum Dan can receive under the SSA is 10/44ths of the UK Citizen's Pension.
- This is no different than under the current system, assuming Dan is working in the UK.

Ed moves to the UK for the first time aged 65. There are around 2,250 people a year estimated to be in this situation.

Ed would get no Citizen's Pension at age 65.

- As in the current system, he might be eligible for Guarantee Credit, depending on what other income he had.
- He would receive whatever pension he is entitled to from the country he lived or worked in during his earlier life, depending on that country's residency rules.
- At 75, he could qualify for a UK Citizen's Pension, but it might not lead to any gain for him to do so if he has a large state pension from a non-SSA country, as that would then be deducted £ for £.

5. Affording a Citizen's Pension

A Citizen's Pension can be afforded in the UK. This chapter covers the likely short-term and long-term costs of a Citizen's Pension, the limitations of current estimates and the options for affording a Citizen's Pension. These estimates are preliminary, and will be updated during the next phase of this project.

Key points

5.1 A Citizen's Pension at £105 a week could be afforded today and through transition, within current net expenditure on state pensions.

5.2 A Citizen's Pension would be easier and cheaper to administer than the current system of National Insurance contributions and means-tested benefits.

5.3 Future expenditure on the current pension system could be higher than expected. The increasing cost of a Citizen's Pension is within this 'funnel of doubt' of long-term state pension costs.

5.4 To afford the increasing long-term cost of a Citizen's Pension - or any other plausible pension system including the current one - change to one or more of the following is likely: the current level of state spend on pensions; tax or National Insurance contribution rates; state pension age; or, amount spent on tax relief.

A Citizen's Pension can be afforded now

The available data supports the conclusion that the UK could afford an immediate transition to a Citizen's Pension of £105 a week for each individual:

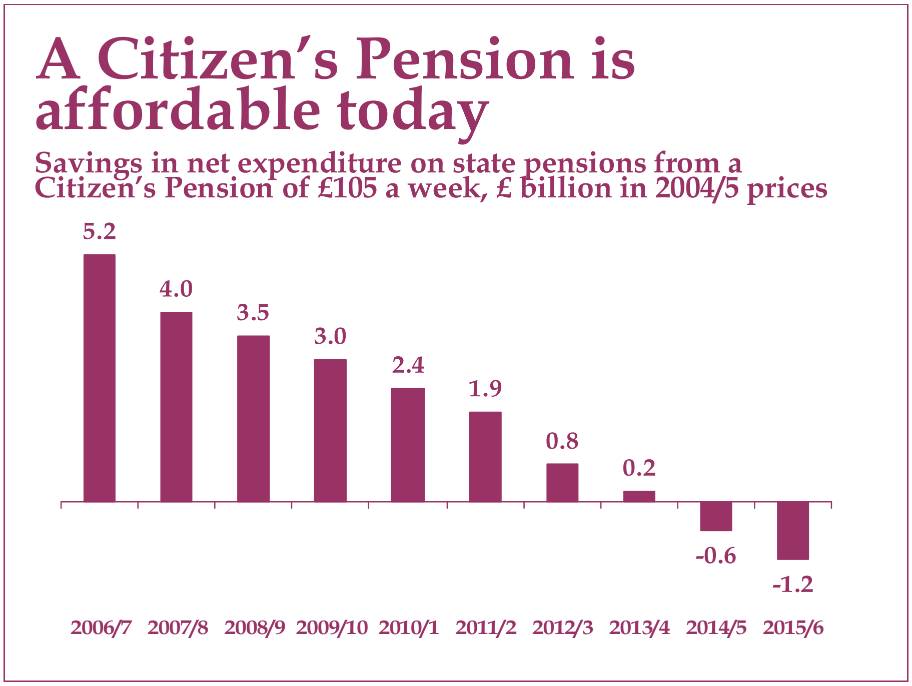
- Recent Parliamentary Questions (PQs)[79] using detailed government data which is not available externally suggest that the immediate gross annual cost of a Citizen's Pension at £105 a week is around £14bn.
- However, the PQs assume that a Citizen's Pension is paid in addition to accrued state rights, so have overestimated the cost of the Citizen's Pension envisaged in this project where accrued state rights are offset.
- The offset of accrued rights against the Citizen's Pension payment significantly reduces the cost of transition to a Citizen's Pension.
    - Any accrued rights below the Citizen's Pension level reduces the amount of Citizen's Pension that is paid. Around half of SERPS/S2P expenditure is currently above a Citizen's Pension level of £105 a week[80].
    - Pension rights accrued from contracted-out rebates also reduce the amount of Citizen's Pension in payment. Almost half of gross SERPS/S2P rights currently in payment have been contracted-out.
    - It has not been possible to model this offset in detail, but it is estimated that the offset reduces the gross cost of introducing a Citizen's Pension at £105 a week by around £5bn[81].

[79] Parliamentary Question Steve Webb 29 April 2004, House of Commons *Hansard* Column 1243W
[80] DWP (2004 SPSS)
[81] See Appendix 5 for details of how the offset is costed and long-term estimates

- After also allowing for savings from Housing Benefit, Council Tax Benefit and increased income tax receipts, the current best estimate of the net annual cost of introducing a Citizen's Pension at £105 a week in April 2006, allowing for the offset against accrued state pension rights, is £7bn[82].
- In 2006/7 it is projected that £12bn will be spent on contracted-out rebates[83] so that there is £5bn more than enough to pay for year 1 transition to a Citizen's Pension.

These PQs suggest that the net cost of introducing a Citizen's Pension could be covered by current net expenditure on state pensions through an immediate transition (Chart 14).

Chart 14[84]



The earlier a Citizen's Pension is introduced, the more affordable is transition. For data reasons Chart 14 assumes that a Citizen's Pension is introduced in 2006. A later transition is still likely to be affordable within current spend.

- Allowing for consultation and legislation, the earliest that a Citizen's Pension could be introduced is 2010.
- The cost of introducing a Citizen's Pension is 2010 is unlikely to be significantly different from the costs in 2010 if the Citizen's Pension had been introduced in 2006[85].

[82] PPI analysis, see Appendix 5
[83] PQ David Willetts 26 May 2004 House of Commons *Hansard* Column W1718
[84] PPI estimates, assuming that the Savings Credit is abolished. Savings from other means-tested benefits and additional income tax are based on PQ Steve Webb 29 April 2004 House of Commons *Hansard* Column W1243, adjusted to take account of the lower gross cost of offsetting a Citizen's Pension against accrued state rights (including contracted-out equivalents). Estimated cost of contracted-out rebates are based on PQ David Willetts 26 May 2004 as above and long-term estimates from GAD (2003 QR).
[85] See Appendix 5 for further information

The net saving from a Citizen's Pension could be used, for a short period of time, to:

- Rebalance National Insurance contributions, as illustrated in Chapter 2.
- Pay some accrued state rights in full rather than offsetting against the new Citizen's Pension, as also discussed in Chapter 2.
- Smooth the loss of contracted-out rebates for occupational and personal pension schemes; for example enhance tax or other types of incentives.
- Compensate individuals who lost out from choosing contracting-out, if the value of their resulting pension is lower than it would have been if they had stayed contracted-in.
- Protect existing Savings Credit payments. Initially this would cost £1 billion, but would reduce quickly[86]. A Citizen's Pension at £115 a week would remove the need for this protection.

A Citizen's Pension would cost less to administer

A Citizen's Pension would be easier and cheaper to administer than the current system of NI contributions and means-tested benefits.

- With a simple Citizen's Pension, contracting-out would be abolished and there would be a big reduction in the role of the Pension Credit. There are likely to be savings on the administration of pension payments.
- The Department for Work and Pensions administration costs of paying benefits to pensioners is expected to be £455 million a year in 2005/6. This is £200 million a year more than the costs in 1998/9, before the introduction of the Minimum Income Guarantee and then the Pension Credit[87].
- Calculating eligibility to, and paying, means-tested benefits is expensive. The annual cost of administering a means-tested benefit for 1 year (£54) is 10 times more expensive than paying a basic state pension (£5.40)[88].
- Although administering contributory benefits in payment is inexpensive, the detailed system of record-keeping and monitoring contributions for each individual over a full working-life, and calculating entitlement at the point of retirement is complex and subject to error.
- Contracting-out increases complexity, and requirements for record-keeping. Around 1,500 Inland Revenue staff are needed to maintain records of contracting-out[89].

Given the paucity of data to quantify the administration cost savings possible with a Citizen's Pension, none have been taken into account in the following conservative cost estimates.

[86] PPI analysis, see Appendix 5
[87] DWP (2004 DR)
[88] As reported in evidence by the Department for Work and Pensions reproduced in the House of Commons Committee of Public Accounts (2003)
[89] See Chapter 3

A Citizen's Pension is affordable in the long term
Future expenditure on the current pension system could be higher than expected. The increasing cost of a Citizen's Pension is within this 'funnel of doubt' of long-term state pension costs.

- The most recent government estimates of future state spending on pensions (including contracting-out rebates) project a slight increase over the next 50 years, from 5.9% of GDP to 6.3% of GDP. However, government projections change frequently, and the expected long-term cost has been increasing with subsequent revisions[90].
  - Expectations of the number of people over state pension age change, and the projections for the size of the UK's GDP are revised.
  - The cost projections also reflect changing policy such as introducing new cash benefits for winter fuel payments.
  - They will also change if assumptions on the eligibility for and take-up of Pension Credit change.
  - The future cost of Pension Credit is very sensitive to the amount of other income older people have from savings and earnings[91].
- There is more uncertainty surrounding Pension Credit projections than other long-term estimates. The actual cost is likely to fall somewhere between the current government projections and an upper bound, based on higher eligibility to Pension Credit and a higher take-up (Chart 15).
- The estimated long-term future cost of the Citizen's Pension is more certain, as it depends only on the number of pensioners and the level of benefit as a percentage of average earnings (Chart 16 and Table 1). These uncertainties are also inherent in the current system.
- Although the longer-term cost of a Citizen's Pension rises above the official government estimates of the cost of the current system, it is still within the funnel of doubt. The uncertainties that cause this funnel of doubt (eligibility and take-up of Pension Credit) do not affect the costs of a Citizen's Pension.

The long-term estimates of the cost of a Citizen's Pension (2023 and beyond) overestimate the likely actual cost[92], so that the actual long-term cost may be longer than shown.

- No allowance has been made for savings on Housing Benefit and Council Tax Benefit, or increased income tax receipts. This might be expected to reduce the cost in 2050 by around 0.5% of GDP.
- There should be some administration cost savings from switching from the resource-intensive checking on National Insurance contribution history to a residency test, and from no longer needing so much Pension Credit administration.

[90] See PPI Briefing Note Number 13
[91] For example, making the assumption that other income grows in line with prices instead of earnings, increases the amount claimed under Pension Credit so that the total state cost of pensions is higher by 2 percentage points of GDP over the next 50 years. See PPI Briefing Note Number 3 and Number 13.
[92] See Appendix 5

Chart 15[93]

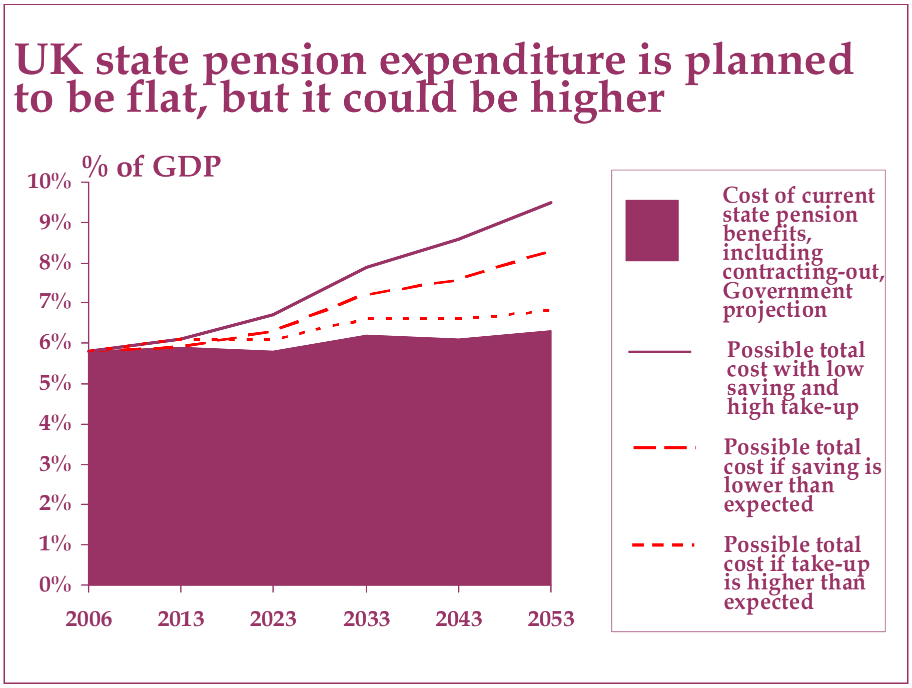
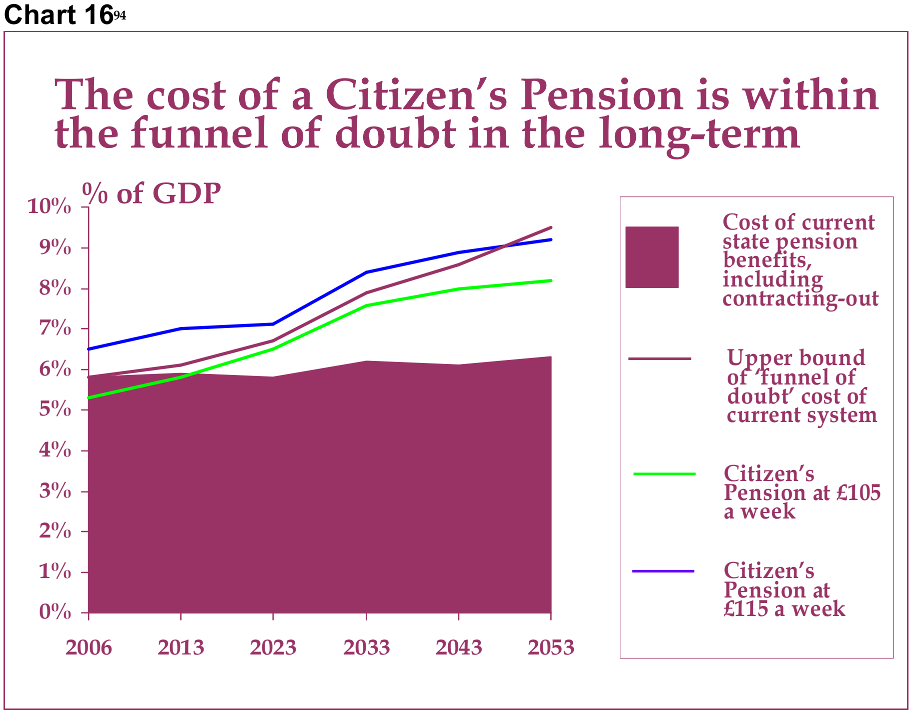


Chart 16[94]



[93] PPI estimates based on data from DWP and GAD. The upper estimates are based on take-up increasing from 75% to 100%, and income taken into account for Pension Credit increasing in line with prices rather than earnings. The upper bound illustrates the maximum possible cost, rather than the likely possible cost. It is theoretically possible for the cost to be lower than the minimum shown e.g. if take-up is lower than 75% or there is faster than historic growth in private income, but this is unlikely.

Table 1: The cost of a Citizen's Pension in the UK[95]

	2006	2013	2023	2033	2043	2053
Estimate of state spend on pensions as % GDP						
Benefits	4.8%	5.1%	5.1%	5.7%	5.7%	5.9%
Contracting-out rebates	1.0%	0.8%	0.7%	0.5%	0.4%	0.4%
Sum – Baseline	5.8%	5.9%	5.8%	6.2%	6.1%	6.3%
Sum – Upper bound	5.8%	6.1%	6.7%	7.9%	8.6%	9.5%
Cost of Citizen's Pension, offsetting accrued state rights						
£105 a week	5.3%	5.8%	6.5%	7.6%	8.0%	8.2%
£115 a week	6.5%	7.0%	7.1%	8.4%	8.9%	9.2%
Additional cost of a Citizen's Pension above Baseline						
£105 a week	-0.4%	-0.0%	0.7%	1.4%	1.9%	1.9%
£115 a week	0.7%	1.2%	1.3%	2.2%	2.8%	2.9%

	2006	2013	2023	2033	2043	2053
Estimate of state spend on pensions, £ billion 2004/5 prices						
Benefits	£60	£73	£89	£115	£137	£164
Contracting-out rebates	£12	£11	£12	£10	£10	£11
Sum – Baseline	£72	£84	£102	£125	£146	£175
Sum – Upper bound	£72	£87	£118	£159	£205	£263
Cost of a Citizen's Pension, offsetting accrued state rights						
£105 a week	£66	£84	£113	£153	£191	£228
£115 a week	£80	£101	£125	£168	£212	£256
Additional cost of a Citizen's Pension above Baseline						
£105 a week	-£6	£0	£12	£28	£45	£53
£115 a week	£9	£17	£23	£43	£66	£80

[94] PPI estimates. Note that the short-term cost of a Citizen's Pension at £115 is overestimated as savings from all means-tested benefits have not been calculated.

[95] All estimates of the costs of a Citizen's Pension are PPI analysis. Figures for 2006 and 2013 for a Citizen's Pension at £105 allow for savings from means-tested benefits and income tax. Later estimates are less detailed, and do not allow for these savings. See Appendix 5 for more details. Current system estimates are taken from GAD (2003 QR) Table 5.6 and www.dwp.gov.uk/asd/asd4/Table3_Long_Term_Projections.xls. Cost of accrued state rights (SERPS/S2P and COD) estimated from GAD (2003 QR) Table 15.9 and DWP (2004 SPSS).

There are options for affording a Citizen's Pension in the future
A Citizen's Pension at the Guarantee Credit level of £105 a week is affordable in the UK, now. Further, the future long-term cost could be within the future cost of the current system. This means that ways to pay for the increasing cost of a Citizen's Pension in future will need to be found. But this will need to happen under any plausible pension system, including the current one, as the population ages.

The (over-)estimate of the long-term cost of a Citizen's Pension at £105 a week is that at the peak in 2041 the additional spend is up to 2 percentage points of GDP (Table 1). This could be afforded by one of the following, or a combination of partial implementation of each:

1. **Switch some state spending from other areas to pensions.** Finding all of the extra cost would be difficult. To illustrate the order of magnitude, 2% of GDP is 40% of the annual spend on education or 20% of that on health.
2. **Raise taxes (or National Insurance contributions).** If this were the only lever used, the total tax take would have to increase by less than 5% by 2041 (with all the increase allocated to pensions).
3. **Raise the state pension age.** If this were the only lever used, SPA would have to rise to 70 by 2031[96].
4. **Restructure tax relief for private pension saving.** A change to the system of individual tax relief may be desirable to rebalance the current bias towards higher rate tax payers. Such a restructuring may also reduce the overall cost of tax relief (around £20bn a year)[97]. Even if restructuring raised the current full cost (which is unlikely), a small additional amount would still need to be found from other levers for the years after 2041.

There could be ways of designing the Citizen's Pension so that the long-term cost is less than 2% of GDP. This would mean that the measures to be taken to pay for it will not need to be as strong as described above.

For example, if individuals in a couple each received a lower Citizen's Pension than a single individual, the cost could be significantly reduced. If a Citizen's Pension were paid to each member of a couple at 80% of the full rate (so a couple received 160% of the single rate) gross costs could be 0.5% lower initially, and up to 1% of GDP lower in the long-term.

The next phase of this project will examine the impacts of using the different levers in different ways.

[96] See Appendix 5 and O'Connell (2004 CPNZ)
[97] Curry and O'Connell (2004)

6. A timetable for change

This chapter sets out a timetable for change and describes possible mechanisms to build consensus around the specifics of reform.

Key points

6.1 The timetable for change to a Citizen's Pension should reflect the need to get state pensions right for the long-term and the sense that reform would be better sooner rather than later, especially for current pensioners.

6.2 **C-Day**, the date of an overnight transition to a Citizen's Pension, could be on **6 April 2010**.

6.3 A simple Citizen's Pension could be more stable than the current UK pension system but consensus is important for the long-term stability of any pension system. Three mechanisms are suggested to develop and maintain consensus.

6.4 A State Pension Review Board with cross-party, pensions expert and pensioner interest group membership should be set up to review and advise on the work done within a government working group on state pension reform.

6.5 An 'Accord' on the structure and principles of state pension policy, to which political parties can sign up their agreement, should be drafted.

6.6 The setting up under statute of a regular independent state pension policy review process should be considered.

The **principles** in developing this timetable for reform are:

- **Right for the long-term:** State pensions affect everyone in the country over a lifetime. For a twenty-five year old, a further 70 years of life would not be unusual. Reform has to last for the long-term, so it is better to take time to get it right.
- **Reasonable pace**: While there is no immediate demographic crisis, there are pensioners in poverty and people not saving enough now. Reform is more easily done sooner rather than later[98], so the timetable should be tight, and actions taken in anticipation where possible.
- **No need to start afresh**: There is or will be work available to build on, including from this project. The Pensions Commission's Second Report is likely to include analysis on the changes to the state pensions essential for the long-term savings market to work. But there will need to be more detailed work within government where the full data resides, and where the decisions will be taken, to fine-tune the specific parameters of transition.
- **Consensus**: Despite the Citizen's Pension being potentially more stable than the current system, consensus for the long-term stability of any pensions system would be preferred. Therefore, actions to develop and sustain a consensus on state pension policy have been suggested and built into the timetable.

The **timetable** suggested is in Table 2. **C-Day**, the date of an overnight transition to a Citizen's Pension could be on **6 April 2010**, assuming:

- Government sets up an internal Working Group to assess future state pension policy by the end of 2005. This is after the Pensions Commission report, and the next report from this project, both expected in Autumn 2005. But the timetable could be brought forward six months if the new Government set up the Working Group soon after a General Election in Spring 2005, and the Group initially worked in parallel with the other studies.
- The Working Group works to a pace that produces a Green Paper on state pension reform plans by Spring 2007.
- A decision is made in principle to move to a Citizen's Pension at that time, so that early preparation (such as planning the calculation and communication of accrued rights) can begin in parallel with the legislative process.
- Recognising the pace of the timetable, the Working Group cannot, and does not need to, consider all of the possible reform options. The remit suggests the starting point is the critical question of how the citizenship and contributory approaches compare. Specifically, this could initially focus on comparing the Citizen's Pension model as described in this paper, with the option to increase the Basic State Pension to a similar level.

[98] PPI (2004 MT) and Chapter 5

Table 2: Timetable for reform to a Citizen's Pension

Date	**Milestone**
Early 2005	• Feedback gathered on this NAPF interim report.
Spring 2005	• General Election?
Autumn 2005	• Pensions Commission report on recommendations for the long-term savings • Next NAPF report on a Citizen's Pension
End 2005	• Government sets up a cross-departmental State Pension Working Group (SPWG) to ***assess the contributory and citizenship options for state pension reform, recommend how state pensions should best be reformed to be appropriate for the long-term (next 50 years) and plan for implementation by April 2010*****.** • Government sets up a State Pension Review Board of pension spokespeople from major political parties, pension experts and pensioner interest groups, chaired by the Secretary of State for Work and Pensions, with remit to ***review and advise on the work of the SPWG and to consider mechanisms for long-term stability in the state pension system.***
Spring 2007	• Green Paper on state pension reform plans
Summer 2007	• Consultation period on Green Paper ends
Spring 2008	• White Paper
Spring 2009	• Legislation through Parliament, Royal Assent • Accord signed
APRIL 2010	**Possible C-Day for transition to a Citizen's Pension**
During 2008/9	• Prepare accrued rights and GMP data
By April 2010	• State pension forecasts sent to all over 50s
By April 2011	• State pension forecasts sent to all under 50s
April 2015	• First Periodic Review of the new state pension system

A simple Citizen's Pension could be more stable than the current UK pension system, even though the Citizen's Pension is not based on the contributory principle:

- The current UK system is based on accruing rights to state pension, but significant cuts in future benefit have been made with little notice taken. For example, reductions in the accrual rate for SERPS legislated for in 1986 and 1995 reduced the level of the final benefit receivable by an individual with a full employment record by 15-20%.
- With means-tested benefits now affecting half the pensioner population, and growing, the contributory link to work history is anyway being diluted.
- Other countries with a Citizen's Pension have sustained them for a long time. New Zealand has had a form of Citizen's Pension since 1938, and it has been in its current form for 25 years[99]. The Dutch system was introduced in 1957[100].
- The Citizen's Pension is very simple and defined by very few parameters. Any change would be more obvious to the electorate. This is not a guarantee against change, but it does mean that changes can be more actively campaigned against. Pensioners have campaigned for the restoration of the earnings link (an obvious parameter) but not the restoration of the SERPS accruals rates (hidden from view).

Consensus is important for the long-term stability of any pension system, and particular mechanisms to develop and keep consensus should be introduced.

- State pensions affect everyone in the country (both paying for and receiving) over a lifetime. For a twenty-five year old, a further 70 years of life would not be unusual[101].
- Stability in the system over a lifetime helps people do their own individual retirement planning.
- Whether or not a Citizen's Pension is introduced, more stability in pensions would be welcomed by all pension experts[102].
- Stability is not guaranteed by a political consensus, but it must help in that it would be more difficult for any politician to make a negative change if that involves being obviously different from the agreed starting point. Mechanisms to make this obvious should, therefore be helpful.

Three mechanisms should be considered to develop and maintain consensus in taking Citizen's Pension reform further:

[99] O'Connell (2004 CPNZ)
[100] PPI (2003 SPM)
[101] A female aged 25 has a 27% probability of living to age 95 according to GAD's 2002-based cohort projections
[102] O'Connell (2004 SPR:CR)

1. A Review Board of politicians, pensions experts and pensioner interest groups in the reform process.

- The UK reform that seems to have won most plaudits recently – tax simplification – involved industry practitioners directly in the development of the proposals, rather than keeping them out of the process until asking for responses in a structured consultation process.
- The Swedish pension reform of 2001 *was based on the shared perception that reform was necessary…five political parties, representing 80 per cent of the current parliament and bridging the traditional divide…have been able to agree on far-reaching reforms*[103].
- Coincident with the start of the State Pensions Working Group (SPWG), the government should set up a **State Pension Review Board**:
  - Chaired by the Secretary of State for Work and Pensions
  - With members drawn from the pensions spokespeople of the main political parties, pensions expert organisations and pensioner interest groups
  - With a remit to (1) *review and advise on the work of the SPWG and (2) to advise on mechanisms to achieve long-term stability of the state pension system in the UK, including consideration of an Accord on the structure and principles of the state pension policy for the long-term.*

The benefits of such a cross-interest Review Board would be:

- Expert, practical advice to improve the process of planning, and speed the process compared to sequential consultations.
- Momentum for the change to happen, as the pensions people who would necessarily be involved in making it happen would be part of the development.
- Even if they did not agree on everything, the process of joint working on the issue would help build commitment to the outcome.
- Political commitment, by the Review Board being chaired by a senior politician with a strong hand in implementing the policy outcome.
- In addition, a specific output in terms of a draft Accord, recommended by the Review Board as being the minimum all political parties should sign up to in order to get a measure of consensus on the shape of pension policy for the long-term.

[103] Hörngren (2001)

2. An Accord on the framework for the state pension system signed by political parties. This seems to be a way of reducing the risk of sudden, hidden policy change on the basic structure while still enabling wide political debate on policy.

- An Accord on the New Zealand pension system was signed in 1993, by the three major political parties in New Zealand (and subsequently by another)[104].
- The government has to consult formally with those parties if contemplating any change to the eligibility age and level of the Citizen's Pension. Any change to the key parameters would therefore be highly transparent.
- The purpose of the Accord was *to achieve consensus on the retirement income policies to be implemented in New Zealand*[105]. Although the Accord later broke down, a victim in part of political fighting under a new electoral system, it is striking compared to the disagreements in UK pensions today, that[106]:
    - Consensus still remains on the structure - and residency-basis - for the New Zealand state pension.
    - There is agreement on the parameters for today's pensioners. Out of 7 political parties, 6 would keep the eligibility age at 65; 1 would increase it to 66. All would keep the benefit level as it is, except 2 smaller parties would increase it.
    - There is debate about how the parameters might need to change for future pensioners: 3 parties would consider raising the pension age; 2 would increase the level of benefit and one would reduce it.
    - There is more political division on the role of private provision, for example, compulsory private saving and tax incentives.
- Under this suggested process, it would be for the Review Board to draft an Accord for the UK, but it would be for politicians from the different parties to decide whether to sign it.

3. Legislation for a regular independent pension policy review to provide better discipline in the pension policy process.

- The current UK system of ad hoc government reviews tends to react to short-term political pressures.
- As an example, New Zealand has had since 1993 a Periodic Report Group every 6 years to report on the retirement income policies of the New Zealand government[107]. This is now changing to a 3 yearly review.
- A similar approach could be considered by the UK State Pension Review Board.

[104] New Zealand Retirement Income Act 1993
[105] New Zealand Retirement Income Act 1993
[106] ASFONZ Press Release 2 September 2004
[107] New Zealand Retirement Income Act 1993

List of Appendices

Available on: www.napf.co.uk
www.pensionspolicyinstitute.org.uk

Appendix 1: Assumptions and alternative scenarios for Charts 1 and 2 in Chapter 1

Appendix 2: How contracting-out works, and more detail on how National Insurance contributions could change, as described in Chapter 2

Appendix 3: Assumptions and alternative scenarios for savings analysis in Chapter 3

Appendix 4: Background information on the eligibility criteria in Chapter 4

Appendix 5: Assumptions and further detail on the costing calculations in Chapter 5

Acknowledgements and Contact Details

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Feedback on this interim report is welcomed. Please send written comments to Christine Farnish by the end of February 2005.

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