**Submission to the House of Commons Work and Pensions Committee's inquiry into pension reform**
**March 2006**

PENSIONS POLICY INSTITUTE

# PPI

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**Summary (starting paragraph of each section noted)**

I. There is widespread agreement among experts involved in pensions across a range of disciplines that the pension system needs reform and that reform should start with the state pension (Paragraph 2).

II. The broad construct of the Pensions Commission's proposals were in line with the ideas suggested by many pension experts, and so should command consensus support (Paragraph 8).

III. However, many pension experts would urge a bolder solution than the Pensions Commission proposal to meet the Government's tests for reform more effectively (Paragraph 18). Specific aims would include:
   a. Reducing means-testing from its current levels, rather than trying just to stop the future spread of means-testing.
   b. Moving quickly to a simple, flat-rate state pension, probably a single tier, rather than keeping an element of earnings-related benefit in the second state pension for decades.

IV. A faster transition to a simpler state system along these alternative lines is both possible and affordable, could have a better distributional outcome, and could reduce reliance on means-testing still further (Paragraph 35).

V. Moving forward is difficult in the absence of any transparent, engaged debate on how much we should be spending on state pensions, and on how to afford the consensus solution. Creative solutions are possible (Paragraph 55).

VI. The National Pension Savings Scheme (NPSS) will be very difficult to justify unless means-testing is reduced from current levels. And even then, there are significant risks and uncertainties with the 'new build' nature of the NPSS proposal (Paragraph 63).

VII. A less radical NPSS for discretionary savings rather than purely pension purposes, working from existing provision and learning lessons from the only other example of a national auto-enrolment scheme (the KiwiSaver planned for New Zealand) could achieve much of the benefit NPSS is proposed to deliver with less risk (Paragraph 73).

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**The role of the Pensions Policy Institute**

1. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI does not make policy recommendations, or support any one reform solution, but exists to contribute facts and analysis to help all commentators and policy decision-makers.

**Consensus on reform**

2. There is widespread agreement among experts involved in pensions across a range of disciplines that the pension system needs reform and that reform should start with the state pension.

3. The PPI has been keeping a 'stocktake' of pension reform proposals made by different organisations with an interest in pensions[1]. By the time the Pensions Commission published its Second Report in November 2005, the stocktake analysis covered over 30 proposals.

4. All of the proposals in the PPI stocktake suggested reform of the state pension system. The problems with the current state pension system have been summarised by the PPI as follows[2]:
   - **Unequal outcomes** arise because higher earners get disproportionately more than lower earners from Basic State Pension (BSP), State Second Pension and tax relief on private pension saving. In particular, women are disadvantaged compared to men as they do not have working lives that fit easily with National Insurance contribution rules that need to be met to qualify for the state pensions.
   - **Individuals cannot be sure what they will get from the state in future or understand how their entitlement is derived,** because of the complexity of over 100 parameters defining state pension income, and uncertainty in what those parameters will be in future. Confidence in future state provision is low.

[1] See PPI Briefing Note 18 *Pension Reform*, updated October 2005
[2] See PPI (2006) *PPI initial analysis of the Pensions Commission's Second Report*

- **Too high expectations are placed on the private pensions sector**, which seems unlikely to grow significantly. Private pensions contributions have been, at best, flat and employer provision is changing. Property investment cannot make up for declining pensions, as the people with property tend to be those who have pensions as well. The state is likely to remain the majority provider of retirement income.
- **Policy on state pensions seems unsustainable.** Current policy is widely seen as politically difficult as it implies over three-quarters of people over 65 eligible for the means-tested Pension Credit in future. To avoid this, Pension Credit could be made less generous, but this would then reverse the improvements made in pensioner poverty. A new policy based on greater entitlement to state pension is widely seen as the better alternative. This will require addressing the long-term cost of state pensions, but this is inevitable anyway, as even the recently increased estimate of long-term state spending on pensions appears low against comparisons with other countries.

5. Nearly all the calls for reform suggest that the Basic State Pension needs strengthening in all of the following three 3 ways:
   - The level should be increased from £84 a week to, preferably, £114 (the minimum level for Pension Credit).
   - It should be indexed at something faster than prices, preferably earnings.
   - Coverage should be widened to be fairer between women and men.

6. The consensus on reform was further underlined by the results of a PPI project run throughout 2005 (funded by the Nuffield Foundation). This project involved around 80 pension experts from over 40 organisations, debating detailed papers on critical aspects of the interaction of state and private pensions. The final report[3] stressed the majority view of the pensions experts involved - that the currently muddled role of the state in pension provision should be clearly delineated into two:
   - Deliver better on the one role that only the state can do - poverty prevention, and,
   - Enable and incentivise the private sector to do what it does best – provide earnings-related pensions on a voluntary basis.

[3] PPI (2006) *Shaping a Stable Pensions Solution: How pension experts would reform UK pensions*

7. The reasons for this view include:
    - There is a widespread concern that means-testing makes it uncertain what people will receive from the state in future. Experts believe that central to promoting personal responsibility to save for a higher-than-adequate retirement income is that Government should communicate with certainty what the state pension will give[4]. This implies a clearly delineated state pension with certain outcomes, and less reliance on Pension Credit.
    - It is well accepted that the state has a duty to redistribute tax revenues to provide a state pension to take people to an adequate level of retirement income, so that poverty is prevented in old age. But in an ageing society, the cost to the state of doing a lot more than that will probably mean too high a tax rate. The appropriate level of adequacy for the state pension would always be debated. For the UK, provided it has wide individual coverage, the state pension would need to be at least 21%-25% of NAE (because Pension Credit is of this order), but higher would of course be welcomed[5]. Having settled on an affordable level of state pension the question becomes how best to organise it simply so that adequacy is guaranteed without the uncertainties, inequalities, gaps in coverage and unintended consequences inherent in the current system.
    - Government intervention in the private sector necessarily means regulation (so cost to consumers), and can mean confusion where state and private pensions overlap. Preferences from industry participants have generally been to aim for simplification, to minimise regulation and to lobby for Government to increase incentives to influence savings behaviour.

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[4] There will always be political risk of change in any system, but the certainty important here is that with no policy change, an individual can be sure what his or her state pension will be

[5] The history of SERPS plans and subsequent cutbacks has meant that the long-run history of UK state pensions has generally provided in this range. If left to evolve without reform, the current system will flatten out at providing around 20% of NAE. See PPI (2005) *Should earnings-related pensions be compulsory or voluntary?*

**Consensus on broad construct**

8. The broad construct of the Commission's approach is very much in line with the consensus among pensions experts that has emerged in the last year or so. The basic theme of the Commission's proposal for state pension reform is a higher, simpler flat state pension with less means-testing and wider coverage for those with interrupted work histories. However, there are concerns with the particular model for state pension reform the Commission has chosen, explored later in this submission (paragraphs 18 et seq.).

9. The fact that this will cost more than the current system in the long-term is only to be expected as it is unrealistic to keep spending level while the number of people over state pension age is increasing so rapidly. This submission considers alternative ways of affording state pension reform (paragraphs 60 et seq.).

10. The way of mitigating the cost in the long-term suggested by the Commission – raising state pension age – has been promoted by many pensions experts for some time as the most logical approach. This is because of the life expectancy improvements already made, let alone the further improvements expected in future (Table 1).

**Table 1: Average life expectancy from age 65 for men and women aged 65 in the year shown (Government Actuary's 2004-based projections)**

| | Men | Women |
|---|---|---|
| **1981** | 14 years | 18 years |
| **2005** | 19 years | 22 years |
| **2025** | 21 years | 24 years |

11. There are concerns about the proposal to increase state pension age, but the Commission's specific proposal suitably takes these concerns into account:
    - The proposal is for a small increase in the state pension age compared to the life expectancy improvements already locked in. Even since the 1980s (let alone since 1928 when the state pension age was first set at 65 for men and women), many more people are reaching age 65, and then living 4 or 5 years longer on average (Table 1). In comparison, the Commission's central proposal for one year increments to age 66 by 2030, 67 by 2040 and 68 by 2050 looks modest.

- A suitable notice period is suggested compared with the 15-20 year notice period given for the 5 year step for women's state pension age from 60 to 65 in the Pensions Act 1995.
- Some concerns have been expressed that raising state pension age disadvantages poorer people who are more likely to die younger than richer people. There is a socio-economic gap in life expectancy, but it is exaggerated by poor historic data, and by looking at the ends of the distribution (fewer than 5% of men are now in the unskilled manual Class V group, and declining). Life expectancy has improved for all socio-economic groups, in similar orders of magnitude[6]. As a way of softening the impact of any raise in state pension age for people unable to continue working, the PPI suggested keeping Guarantee Credit (GC) available a few years below state pension age[7]. GC is available now at age 60, but the age of availability is expected to increase to 65 between 2010 and 2020 coincident with the increase in female state pension age. The Pensions Commission also proposed this[8].

12. Some commentators have cautioned against future rises in state pension age because the impact that observable increasing rates of diseases such diabetes and obesity will have on future life expectancy is not understood. This is because life expectancy projections are carried out by extrapolating probabilities of dying in aggregate (that is, from all causes of death). A more detailed epidemiological model, working 'bottom up' from each cause of death would be required to increase our understanding of future likely trends.

13. Further research on the 'bottom up' approach should be supported. Such a model would help to predict whether it is likely that future life expectancy improvements would be slower than those seen to date, or whether life expectancy would actually start to decline on average or for some groups (although a decline in life expectancy has hardly been seen in the developed world).

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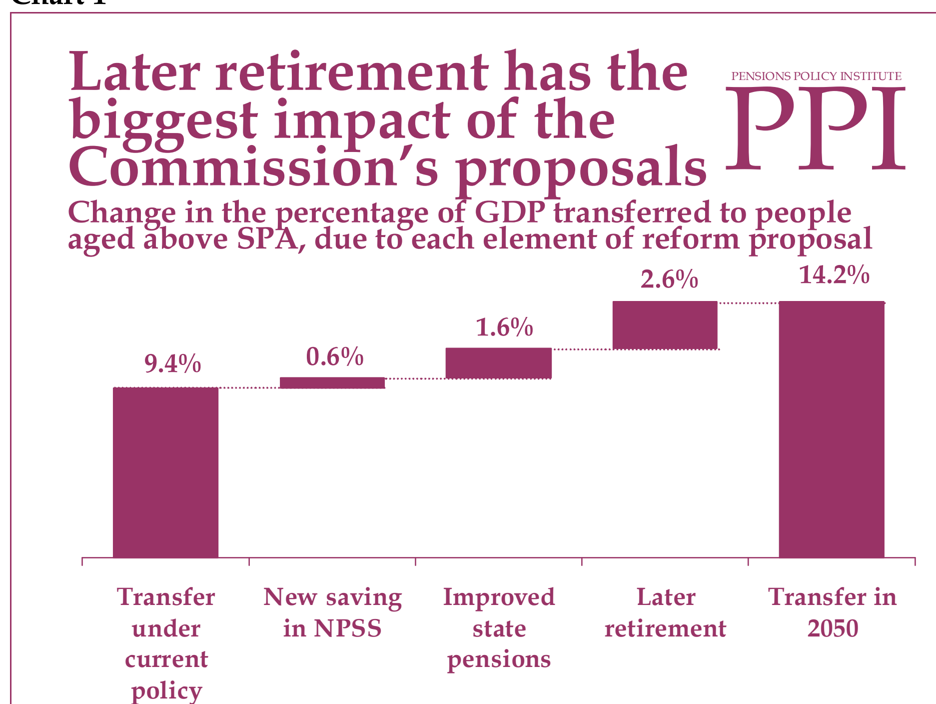
[6] PPI Briefing Note 17 *How big is the life expectancy gap by social class?*
[7] PPI *Submission to the Work and Pensions Committee of the House of Commons on the Future of UK Pensions* October 2002; PPI Submission following the Pensions Commission's First Report January 2005, paragraph 89
[8] Pensions Commission Second Report (2005) p. 24

14. Even while such research is taking place, it would be better to signal future increases in state pension age so that people can plan against that expectation. The proposed increases can be cancelled or scaled back should life expectancy unexpectedly worsen. The alternative, of waiting to confirm further improvements before acting, risks either higher than expected costs or having to push through increases in state pension age at short notice.

15. The Commission highlights that working at older ages will be a large part of the solution. In fact, looking at the sources of economic value from the Commission's proposals, later working contributes more than either state pension reform or the NPSS (Chart 1).

**Chart 1**[9]




16. The policies to make extended working lives a reality operate in the labour market rather than in pensions. It is important that this does not get forgotten in the pension policy debate. The proposals made by the Commission to encourage longer working lives are therefore very important.

[9] Simplified from Pensions Commission Second Report (2005) p. 289 and p. 299

17. The Commission's proposals for a new National Pensions Savings Scheme have been welcomed largely because auto-enrolment is seen as a good 'halfway house' between compulsion and laissez faire. However, there are some concerns about the particular model proposed by the Commission for the NPSS which are considered later in this submission (paragraphs 63 et seq.).

**Bolder solution preferred**

18. Many pension experts would urge a bolder solution than the Pensions Commission proposal to meet the Government's tests for reform more effectively. Consistent with the PPI analyses referred to earlier, many pension experts would advocate:
    a. Reducing means-testing from its current levels, rather than trying just to stop the future spread of means-testing.
    b. Moving quickly to a simple, flat-rate state pension, probably a single tier, rather than keeping an element of earnings-related benefit in the second state pension for decades.

**a) Reducing means-testing from current levels**

19. There is serious concern among pension experts about continuing the current level of means-testing for basic income, through Pension Credit. It is recognised that Pension Credit has done much to lift up the income of the poorest pensioners, and was a useful short-term measure to target additional spending on the poorest pensioners at a time of high levels of spending on higher income pensioners because of past accruals of earnings-related state pensions. It is also recognised that there will always be a need for the safety-net of Guarantee Credit, and that means-tested benefits for specific purposes such as Housing Benefit will always exist.

20. But the scope of Pension Credit, both now and in future if current policy continues, is seen to cause problems[10]:
    - Pension Credit, comprising Guarantee Credit and Savings Credit, is complicated and adds significantly to the number of parameters on which an individual's income depends.
    - Pension Credit is not certain, as its parameters can be set at short notice in a Budget rather than being set in legislation. Small changes in these parameters from expected can make a big difference to being eligible in future or not. So continued reliance on Pension Credit means that people will continue to be uncertain about the income they can expect from the state.
    - Pension Credit also causes further uncertainty about the value from saving, because it is impossible to predict whether savings made now or later will fall inside or outside the ambit of Savings Credit in future. This concern will matter even more with auto-enrolment for pension savings.
    - Means-testing can be seen as 'something for nothing'. And although Savings Credit was intended as a reward for saving, whether it is received or not is disconnected from the savings decision. Savings Credit has reduced withdrawal rates on savings from 100% to 40%, this still depresses returns from savings (and withdrawal rates can be higher if the individual is on other means-tested benefits too).
    - The process of having to claim means-tested benefits, while improved, is still disliked by many. Pension Credit take-up rates are remaining well below 100% (Table 2).

[10] PPI *Submission to the Work and Pensions Committee of the House of Commons inquiry into the introduction of Pension Credit* October 2004

**Table 2[11]: Take-up of Pension Credit, 2003/4**

| Type of benefit | Eligible households (thousands) | Receiving households (thousands) | Implied take-up |
|---|---|---|---|
| **Guarantee Credit only** | 880 – 1,030 | 710 | 69 - 81% |
| **Guarantee Credit and Savings Credit** | 1,690 – 1,960 | 1,230 | 63 – 73% |
| **Savings Credit only** | 1,170 – 1,500 | 540 | 36 – 46% |
| **All Pension Credit** | 3,750 – 4,330 | 2,490 | 58 – 66% |

21. There is a clear link from these problems to the Government tests for state pension reform of promoting personal responsibility to save, simplicity and sustainability. High levels of Pension Credit will make these tests difficult to meet.

22. Because of the consensus, agreed by the Pensions Commission, that means-testing through Pension Credit causes problems, a critical measure of success for the Commission's proposals is the level of means-testing expected through Pension Credit after the proposals have worked through.

23. The appropriate measure for this is the proportion eligible for Pension Credit, rather than the proportion receiving or the amount left unclaimed. This is because it is the uncertainty caused by being near to eligible that is the problem. So although the proportions eligible for different types of Pension Credit might change (for example, more people may be eligible for smaller amounts of Savings Credit than larger amounts of Guarantee Credit), that does not make the problem better (in fact, could make it worse as Savings Credit has the lowest take-up).

[11] DWP (2006) *Income related benefits: Estimates of take-up 2003/4*, p. 35

24. However, following detailed conversations with the Secretariat of the Pensions Commission, we understand that there are errors in the way the Commission refers to Pension Credit in the Second Report. Numbers shown in the Second Report (and in the detailed spreadsheets on the Commission's website) are actually the Commission's estimates of the proportion eligible for Pension Credit, even though they are labelled as the proportion 'on' and referred to as the proportion 'receiving' Pension Credit (pages 10, 11 and 240).

25. Furthermore, the Pensions Commission's estimates for the proportion eligible for Pension Credit seem low. DWP estimates of the number of pensioner benefit units entitled to Pension Credit are between 3.8 million and 4.3 million[12]. These figures imply that somewhere between 44% and 51% of pensioner benefit units are entitled to Pension Credit. The Pensions Commission's estimate of 39% is below the lower end of this range.

26. The PPI's own modelling of current entitlement to Pension Credit is more in line with DWP estimates. The PPI estimates that the proportion of pensioner benefit units eligible for Pension Credit is around 50% in 2005. Our projections suggest that even after the Pensions Commission proposals (for state pension reform and the NPSS) have almost worked through, in 2050, the proportion would remain in the order of 45%. The Pensions Commission's own estimate for this 2050 figure is 33% (Chart 2).

27. All the estimates suggest eligibility for Pension Credit will still be high after the Commission's proposals compared to historic levels. PPI analysis of DWP data suggests that the highest level of eligibility for means-testing for basic income for pensioners was 35% in 1994/5, and for most of the 1990s was less than 30%.

[12] See Table 2

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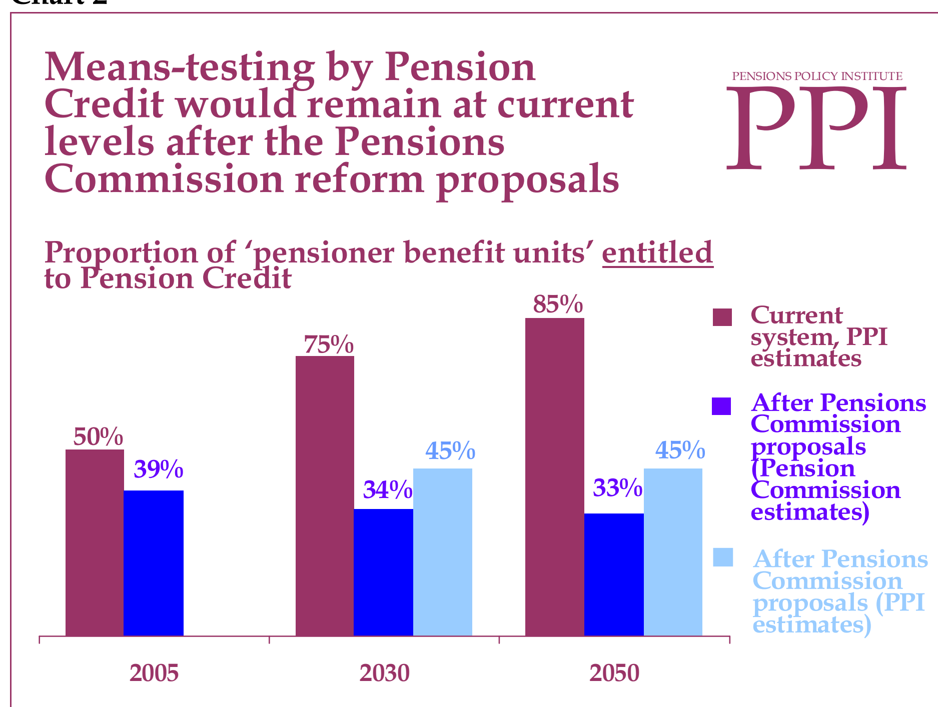
Chart 2[13]




28. PPI discussions with pension experts suggest an 'acceptable' level of remaining means-testing through Pension Credit would be lower than 30%. So both the Pensions Commission's eligibility for Pension Credit at 39%-33% and the PPI estimate at 50%-45% are still at the level to cause concern.

29. Means-testing could be drastically reduced by implementing a faster transition to a more universal flat-rate pension. See paragraphs 31 et seq.

30. One other way to reduce the extent of means-testing for basic income is to scrap Savings Credit altogether. If there were a better state pension that takes, say, 95% of people over the Guarantee Credit level, then the remaining 5% are not likely to be savers. Therefore, the problem of cliff-edge 100% withdrawal rates on any saving would be less acute. The role for Savings Credit would become unnecessary. Scrapping it (with suitable transition protection) would be a big simplification.

[13] PPI analysis and information from Pensions Commission

**b) Moving quickly to a simple, flat-rate state pension**

31. The other way in which the consensus of pension experts would suggest a bolder state pension reform than suggested by the Commission is to move more quickly to a simple, flat-rate state pension, probably a single tier. The Commission's proposal is to make changes to the accruals of both Basic State Pension (BSP) and State Second Pension (S2P), which means a very slow transition, keeping an element of earnings-related benefit for decades, until arriving at a fully flat-rate pension (albeit in two tiers) by around 2060.

32. The gradual transition approach for state pension reform preferred by the Commission has three significant problems: complexity, risk of constant fiddling and distributional inefficiency:
    - The Commission's preferred approach of making incremental improvements to the current system adds more parameters to an already complicated picture. Each of these parameters evolves over time in different ways. The pension entitlement of any one individual can be computed, but not in a way that the individual can do him or herself or understand the calculation.
    - Because of the complexity, the transition intention can easily be changed by successive governments, as happened with SERPS. Pensions stakeholders feel very strongly that simplicity is desired both to help people understand what they will get from the system, and because simplicity would make it harder for governments to change the system over time.
    - The Commission's proposal delivers gains to higher income pensioners first. Indexing the BSP to earnings gives more to people who have more BSP. The improvements for less well off pensioners – for example the change to a universal BSP, and the flattening of State Second Pension – are brought in only for future accruals, so filter through very slowly over decades.

33. Below we consider three possible alternatives to the Commission's proposals which fit with the broad construct, but address the problems. All of these alternatives are:
    - Single-tier, and so simplify the pensions system. Accruals to S2P stop and the level of the first tier is increased.
    - Set at the Guarantee Credit level (£114 a week for single pensioners in 2006/7), and so reduce means-testing.

- Fully indexed to average earnings, so state pension does not decline in retirement and people falling onto means-testing at older ages is less likely.
- Gender-neutral by setting eligibility for each individual. The pension is set at 80% of the single rate for each individual in a couple.
- With wider coverage than the current BSP. For ease of modelling, we have assumed that the single-tier pension would be universal, so that coverage for the state pension is improved to the extent that most people qualify for it. In practice, this could be achieved either through an improved contributory or a residency approach.

34. The three options differ by how long they take to reach the new system. They have a short, medium or long transition, which are all shorter than the Commission's 'very long' approach.
    - **Short:** The flat-rate pension is introduced immediately by increasing the BSP to the new level. The most affordable and progressive transition mechanism uses the 'offset' method, discussed below. Other mechanisms are possible, but at higher cost.
    - **Medium:** The level of the BSP is increased faster than earnings until it reaches £114 a week in 2030. After 2030, it increases with earnings. Offset is not used.
    - **Long:** Accruals to BSP and S2P stop in 2010 and are replaced by accruals to a new, higher pension. Existing accruals to BSP would increase with prices but accruals to the new pension would increase with earnings. Offset is not used.

**Bolder solution possible**

35. A faster transition to a simpler state system along these alternative lines is both possible and affordable, could have a better distributional outcome, and could reduce reliance on means-testing still further. It is likely to better meet the Government's tests of affordability, fairness, promoting personal responsibility, simplicity and sustainability.

36. The options are all **affordable** in that they lie within the Pensions Commission cost envelope (Table 3).

**Table 3[14]: Estimated state expenditure on state pensions (BSP, SERPS/S2P, contracted-out rebates, Pension Credit and other pension benefit such as Winter Fuel Allowances), state pension age increases gradually to 68 by 2050, as a percentage of GDP and in £ billion, 2005/6 prices**

| | | | Alternative single tier options (costs are on the basis that contracted-out rebates are spent on current pensions) | | |
|---|---|---|---|---|---|
| | Current system | Pensions Commission preferred approach | A: Short Transition (using offset) | B: Medium transition | C: Long transition |
| **2010** | 5.6% | 5.8% | 5.6% | 5.1% | 4.9% |
| **2020** | 5.2% | 5.8% | 5.5% | 5.3% | 4.6% |
| **2030** | 6.0% | 6.7% | 6.4% | 6.7% | 5.4% |
| **2040** | 6.5% | 7.4% | 6.9% | 7.1% | 5.8% |
| **2050** | 6.6% | 7.2% | 6.6% | 6.6% | 5.9% |
| **2010** | 80 | 83 | 81 | 73 | 70 |
| **2020** | 95 | 105 | 100 | 95 | 85 |
| **2030** | 130 | 150 | 140 | 150 | 120 |
| **2040** | 170 | 195 | 185 | 190 | 155 |
| **2050** | 210 | 235 | 215 | 215 | 195 |

37. Affordability is most likely to be constrained in the short term (2010 to 2020) than in the long term. In general, the slower the transition, the lower the cost, but all three options could be afforded by a mixture of:
    - Using the offset method for the short transition (see paragraphs 38 and 39).
    - Spending some of the savings from abolishing contracted-out rebates on current pensions (see paragraph 40).
    - Modest increases in National Insurance contributions (NICs).
    - Diverting state spending from elsewhere.

[14] PPI estimates using the Aggregate and Distributional Models. See PPI (2006) *Transition tradeoffs* (forthcoming) for more analysis of these options and PPI (2005) *What will pensions cost in future?* for a technical description of the models. Figures in £ billion are rounded to the nearest £1 billion for 2010 and to the nearest £5 billion for the later years.

38. The offset method could be used in the short transition option, but is not applicable in the medium and long transitions. It targets gains on those with a state pension income of less than the new pension level of £114 a week:
    - Those with state pension income (BSP+S2P or contracted-out equivalent) of less than £114 a week are brought up to that level.
    - Those with more state pension income than the new level do not gain immediately, but lose nothing.
    - All accrued rights are honoured.
    - The offset therefore avoids the perennial problem of higher income pensioners gaining more than lower income pensioners from incremental improvements to the current system.

39. The offset is administratively feasible. Interviews with NISPI led the PPI to conclude that it would simplify state and private pension administration[15]. The Pensions Commission interviewed officials in the Pensions Service, and came to the conclusion that the offset would be possible, but complex[16].

40. There has been no clear statement by Government on whether the extra revenue raised from abolishing contracted-out rebates (£11 billion in 2010 in 2006/7 prices) should be available to spend on current pensions. The Pensions Commission have asserted that ideally the rebates should be devoted to national savings rather than current pensions but not all commentators agree this is the most appropriate use. If rebates did help pay for better state pensions, both current and future pensioners would benefit. Future pensioners would have a more understandable and certain foundation for saving, and this could be an alternative way to encourage higher levels of national savings.

41. If both the offset method and contracted-out rebates were used, then the short transition is possible with only an extra £1 billion to find on introduction in 2010 and an extra £3 billion by 2020. This could be achieved by small increases in NICs or diverting spending from elsewhere. As a rough indication of the size of the cuts needed, Winter Fuel Allowances, other age-related payments, Over 75s TV licences and Christmas Bonus together cost around £2 billion a year[17].

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[15] NAPF (2004) *Towards a Citizen's Pension: Interim Report* p.37
[16] Pensions Commission (2005) Second Report p.248
[17] DWP expenditure projections for the 2005 Pre-Budget Report

42. In 2010, the offset saves £12 billion and abolishing contracted-out rebates saves £11 billion. If neither could be used, then the total of £23 billion to be found could be raised by a combination of increasing NICs and cuts to other areas of state spending. The increases may mean that a slower transition is preferred.
    - If the total was to be found only by NICs, then NICs would have to be increased by around 2% for each of workers and employers on earnings above the Primary Threshold (£97 a week in 2006/7). This is twice the recent increase for NHS reforms.
    - If the total were to be found by only cutting spending, then, as an indication, the health budget would be reduced by around 20% or the education budget by around 25%[18].

43. The medium and long transitions do not need to use the offset method. The medium transition would require some use of contracted-out rebates or higher NICs, while the long transition would require very little on top of current government expenditure plans before 2020.

44. The medium transition would require only around £4 billion out of the £11 billion saving in contracted-out rebates in 2010. By 2020, as benefit improvements become larger, either all of the contracted-out rebates would be needed (then totalling around £12 billion in 2006/7 prices), or money would have to be found elsewhere, from higher NICs or diverting other state spending. If NICs were the only method used, then they would have to increase by around 1% for both workers and employers.

45. The long transition would cost only a little more than the state pension system before 2020. The accruals to the new BSP take time to work through before a significant amount is in payment. A small amount of money from contracted-out rebates might be needed, but the Government would have the choice about how to spend most of it.

46. The three single-tier options all target a lower level of state benefit than the Pensions Commission's preferred option (although are more evenly distributed). In the long term, this means that the state could spend less on pensions than envisaged by the Commission, the pension could be set at a higher level than the Guarantee Credit, or state pension age could increase to less than age 68.

[18] HMT (2005) *Long-term public finance report: an analysis of fiscal sustainability* p.45

47. A faster transition would be **fair** in that it would target resources on those who need it most. Pension Credit has been a useful short-term measure to target additional pensions on the poorest pensioners but suffers from complexity, uncertainty and low take-up (as described earlier).

48. PPI analysis shows that the extra spending under the Pensions Commission preferred option is likely to go to the most well-off pensioners rather than the least well-off, at least in transition. The most well-off 10% of pensioners could be around £25 a week better off in 2030, compared to only around £5 a week for the least well-off 10% of pensioners (Table 4). The most wealthy pensioners benefit more than the least under the Pensions Commission proposals because they are not caught in Pension Credit, are less affected by reducing the scope of Savings Credit and because they are more likely to have a full BSP, so benefit more from uprating the BSP with earnings.

49. In comparison, the short transition considered above is progressive. The least well-off 10% stand to gain around £15 a week, while stopping S2P accruals mean that most well-off would have around £10 a week less than they would under the current system. The slower transitions to a single-tier pension are less progressive, because they build up benefits slowly and do not use the offset method.

**Table 4:**[19] **Illustrative weekly after tax income of people over SPA in 2030 by decile of the income distribution, £ per week in 2006/7 earnings terms**

| | Current system | Pensions Commission preferred approach | Alternative single-tier options | | |
|---|---|---|---|---|---|
| | | | A: Short Transition | B: Medium transition | C: Long transition |
| **1st** | 105 | 110 | 120 | 120 | 105 |
| **3rd** | 135 | 140 | 135 | 155 | 130 |
| **Median** | 165 | 180 | 170 | 190 | 170 |
| **7th** | 215 | 230 | 210 | 240 | 215 |
| **9th** | 340 | 365 | 330 | 375 | 345 |

[19] PPI estimates using the Aggregate and Distributional Models. All figures have been rounded to the nearest £5.

50. To **promote personal responsibility** successfully, good incentives to save are required and therefore a limited extent of means-testing. Pension Credit reduces returns on saving.

51. The Pensions Commission's preferred option would maintain rather than reduce means-testing, at historically high levels (Table 5 and paragraph 27). But the bolder reforms within the same cost envelope as the Pensions Commission proposals considered earlier in this submission could drastically reduce it. All of the single-tier options would reduce Pension Credit to around 10% of pensioner benefit units eventually.

**Table 5:[20] Illustrative estimates of the percentage of pensioner benefit units eligible for Pension Credit**

| | Current system | Pensions Commission preferred approach | Alternative single-tier options | | |
|---|---|---|---|---|---|
| | | | A: Short Transition | B: Medium transition | C: Long transition |
| **2005** | 50% | 50% | 50% | 50% | 50% |
| **2030** | 75% | 45% | ~ 10% | ~ 10% | 50% |
| **2050** | 85% | 45% | ~ 10% | ~ 10% | 25% |

52. A bolder reform is likely to score higher on the other government tests of **simplicity** and **sustainability**, because it results in a single-tier pension. With a single-tier state pension system that pays the same amount to almost everyone, uprated in line with earnings, it will be much easier to tell what the state pension will deliver.

53. A faster transition to a single-tier state pension system may be more difficult for the state to administer in the short term but would mean more people could be given a clear message, and would ease ongoing administrative burdens by removing complexities like contracting-out.

54. With a simpler system there is less room for future Governments to change part of the state pension system without public debate. Having only one tier of state pension rather than two means that it is not possible to trade one pension off against the other – for example, to allow for a more generous second tier by reducing the value of the first.

[20] PPI estimates using the Aggregate and Distributional Models. See PPI (2006) *Transition tradeoffs* (forthcoming) for more analysis of these options and PPI (2005) *What will pensions cost in future?* for a technical description of the models. Figures have been rounded to the nearest 5%.

**Need to debate affordability**

55. Moving forward is difficult in the absence of any transparent, engaged debate on how much we should be spending on state pensions, and on how to afford the consensus solution. Creative solutions are possible.

56. There has been little debate, and no consensus, on the balance of spending between current and future pensioners, or on the politically acceptable or affordable level of long-term spending[21].

57. A more generous state pension system would mean higher spending on pensioners both in the first few years of implementation and the longer term.

58. In the long term the additional cost of a more generous system can be reduced by increasing state pension age. But realistically, state pension age cannot be increased before 2020.

59. The Pensions Commission suggest that most of the additional cost of reform could be covered by using the savings projected to arise from the increase in female state pension age between 2010 and 2020. Assuming that this expected fall in spending on pensioners has already been factored into medium-term spending plans, additional resources would have to be found.

60. Resources could be found by:
    - 'Offsetting' new pensions against existing entitlements to Basic State Pension and State Second Pension (as described in paragraph 38).
    - Using the increased revenue from removing contracting-out (as described in paragraph 40).
    - Increasing National Insurance contribution rates (paragraphs 42-44).
    - Re-allocating spending from other areas of Government spending.
    - Redesigning tax incentives for private pensions.

[21] See PPI Briefing Note Number 27 (2006) *How much should the state spend on pensions?*

61. Just under £18 billion a year is currently awarded as tax relief on private pension contributions[22]. If National Insurance relief on employer contributions is also added, but income tax received on private pensions currently in payment is netted off, the total fiscal cost of tax relief currently stands at £21 billion a year. This cost is expected to remain significant in future[23]. The current system of awarding tax relief at the marginal rate of income tax is regressive and poorly understood.

62. Despite the underlying complexity of tax relief, it may be possible to design a system to make tax incentives more effectively targeted and reduce the cost to the government in the short-term. As the difficulty in reform lies with Defined Benefit schemes, a working group of DB scheme practitioners could be asked to investigate feasibility if Government wanted to consider alternatives to the status quo.

**Risks with NPSS[24]**

63. This section considers why the National Pension Savings Scheme (NPSS) will be very difficult to justify unless means-testing is reduced from current levels. It also describes some significant risks and uncertainties with the 'new build' nature of the NPSS proposal.

64. In the only other country where auto-enrolment into a savings scheme is being considered (New Zealand) the state pension is relatively generous. It provides 33% of National Average Earnings (for each eligible individual in a couple; eligible individuals living alone receive 42% of NAE). Because of the wide coverage of the New Zealand state pension, 93% of people receive the full amount and so means-testing for basic income is limited to around 5% of people over state pension age.

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[22] PPI Pension Facts Table 25
[23] Steventon (2005) *What will pensions cost in future?* PPI
[24] More detail on the issues considered in this section and the next can be found in O'Connell (2006) *NPSS policy design and choices* PPI

65. Even after the Pensions Commission's proposals for reform, the UK state pension will be lower relative to NAE than in New Zealand. Further, it will vary over time and for different people. Adequacy (in the sense of poverty prevention) will not be assured:
    - Someone with a lifetime of median earnings would receive a Basic State Pension and State Second Pension of 31% of median earnings, by 2053, after the full impact of the Commission's proposals. This is equivalent to 27% of NAE, less than the state pension in New Zealand.
    - But for many people, the state pension will be less than this, because of gaps in eligibility for State Second Pension (S2P), and/or because lower earnings mean a lower accrual to S2P, and/or because of the delay until the proposed improvements have worked through fully.
    - Also, as S2P is indexed to prices rather than earnings, pensioners will receive less relative to NAE as they grow older.
    - A floor should be provided by Pension Credit, of around 21% of NAE for a single person or 32% NAE for a couple. But this is compromised by low take-up (Table 2). Half of pensioner households are currently eligible for Pension Credit. The Pension Commission proposals would keep this proportion broadly level in future, instead of the rapid increase expected under current policy (Chart 2).

66. This means that the NPSS is proposed to be built on a foundation where adequacy is not guaranteed, and first has to compensate for that before it can take retirement income to higher levels.

67. In order to help overcome the means-testing trap, it is proposed that employer contributions are compulsory where the individual does not opt-out[25]. The level of this contingent compulsory contribution has been set at 3% of band earnings, just under 40% of the total 8% of band earnings contribution. This means it roughly compensates for the 40% withdrawal rate on Pension Credit.

[25] Pensions Commission Second Report (2005) p. 134

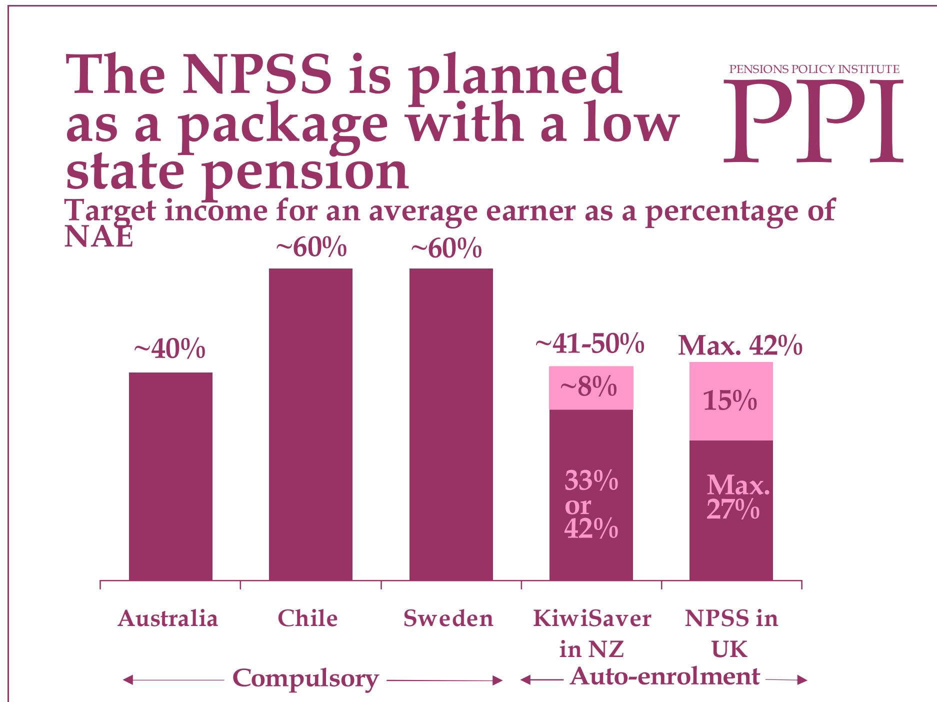
68. But the proportion of 'pensioner benefit units' expected to be eligible for means-testing through Pension Credit even after the full impact of NPSS has worked through (as well as the impact of the state pension reforms) is still around 45% (Chart 2). This means that saving in the NPSS will be of uncertain value for many people: despite the contingent compulsory employer contribution and the tax incentive. This threatens to undermine the success of the NPSS.

69. Further, the Commission believes that *it is a reasonable aim of public policy to seek to ensure that the median earner achieves an income replacement rate of at least 45%*[26]. This defines a target and asserts that the target should be reached by a specific combination of state pension and state-sponsored saving. This sets a very high standard for the NPSS.

70. The Commission's approach also means that the nature of Government intervention in retirement income policy is different from that in other countries which have introduced either auto-enrolment or fully compulsory savings schemes (Chart 3).
    - In theory at least, in the countries which have introduced compulsory private savings, everyone should be taken above and beyond adequacy: to around 40% of National Average Earnings (NAE) in Australia or around 60% in Sweden or Chile.
    - An alternative policy is to guarantee adequacy through the state pension. New Zealand is a fairly generous example of this approach, with a state pension at a minimum of 33% of NAE. Auto-enrolment for additional saving allows opt-out, but choosing to do so will not threaten adequacy for individuals. No target for retirement incomes above adequacy is set.
    - The Pensions Commission proposes auto-enrolment through the NPSS on top of a state system with remaining uncertainties and inadequacies. Even with the NPSS many will still be eligible for means-tested benefits and not take them up. A fairly high target for retirement income is set, but seems unlikely to be met not only as the state foundation low, but also because there will not be full enrolment to the NPSS.

[26] Pensions Commission Second Report (2005) p. 274

**Chart 3**[27]




71. Therefore, the evidence from other countries suggests that the design of NPSS should be carefully considered in respect of the adequacy of the state pension. The chances of success seem more likely if the NPSS is sitting on top of a state pension that better guarantees adequacy. This is not to say that the UK has to go all the way to the generous state pension of New Zealand. The crucial test is that eligibility for means-testing by Pension Credit can be reduced from the 45% or so which is expected to be the result of the Pensions Commission reforms to something more like the 10% or so possible by reforms along the lines considered earlier in this submission (Table 5).

[27] O'Connell (2006) *NPSS policy design and choices* PPI p. 20

72. In addition, there are a number of risks and uncertainties in the proposed design of the NPSS:
    - **Employer compulsion**: Contingent compulsion on employers is controversial and not as straightforward as it often seems at first sight. It means that additional policing of employer contribution payments and behaviour is required (for example, whether undue pressure is being put on employees to accept a higher level of salary if they opt-out). Further, measures would have to be taken to absolve employers of liability from participation or investment choices made by them on behalf of, or by, their employees.
    - **Liability risk to Government**: Because the NPSS is presented as an inherent element of achieving a Government-endorsed level of saving, and the NPSS looks very like a state body, expectations are raised. 'Political moral hazard' (the risk of increased lobbying for pension increases when expectations are not met) is increased. In theory the risk to Government is limited because individuals retain the choice of opt-out, and they can choose their investment profile. But this may not prove an effective get-out clause; after all, the basis for the NPSS is that people are not making such decisions sensibly. As the majority of members are expected to be in one default fund, the governance of that fund through the NPSS will be questioned if there is any issue over its investment performance, and it will be hard for the Government not to be involved in such issues.
    - **Risk to existing provision**: The NPSS is unusually being proposed into an environment with an already high level of existing private pension provision (despite its recent decline). So there are few clues as to the impact NPSS might have on existing personal or occupational pensions. Existing pension arrangements will become more regulated. They would have to prove they are at least as good as NPSS or convert to an NPSS scheme. Employers may react by 'levelling down' contribution rates to the default 8% of NPSS band earnings. This means NPSS has to work even harder for new saving to make a net increase in the aggregate saved, or, there has to be acceptance that the policy might lead to some people having new saving, but others having less.
    - **Low cost and new systems**: The low cost of the NPSS is emphasised so will be a high-profile measure of its success. This drives radical design features such as centralised collection and one default fund, which are untested, and need new systems.

- **Promoting personal responsibility**: Although personal funding may increase, personal responsibility (in the sense of individuals making informed, active decisions on whether to save, with which provider and in what investments) is rather heavily directed with the NPSS. If 90% of people stay in the default fund, would confidence in saving have improved, or saving responsibly increased?

**Learn from KiwiSaver**

73. A less radical NPSS for discretionary savings rather than purely pension purposes, working from existing provision and learning lessons from the only other example of a national auto-enrolment scheme (the KiwiSaver planned for New Zealand) could achieve much of the benefit NPSS is proposed to deliver with less risk.

74. The experience of planning for KiwiSaver in New Zealand suggests some lessons for the implementation risks of the NPSS. New Zealand is a much easier environment in which to introduce an auto-enrolment scheme:
    - It has a population of 4m people, not the UK's 60m. The New Zealand Government is planning for 25% of eligible people to stay opted in to the new arrangements, compared to the Pensions Commission's roughly 75%. The expectation in New Zealand is that there will be around 680,000 new savers in KiwiSaver or approved alternative after 5 years, compared with the roughly 7 million people expected by the Pensions Commission to join NPSS or approved alternative.
    - Only around 15% of employees have existing pension provision in New Zealand. In the UK, existing provision is 3 times larger than in New Zealand with 53% of employees with some pension provision.
    - New Zealand has a PAYE system that does work as a monthly contribution collection system. In the UK, the PAYE system does not attribute contributions at the individual level monthly, only annually, so a new system would need to be built to work for a monthly savings scheme.

75. But still, there were concerns about the implementation of KiwiSaver in New Zealand, so the Government there took four key decisions to make implementation easier than it might otherwise have been. All of these could work in the same way in the UK, and could mean the risks of new systems not working, or of IT overspends or delays, are less than those in the more radical new-build approach of the Pensions Commission's NPSS proposals:
    - Instead of everyone being auto-enrolled into KiwiSaver immediately, auto-enrolment only occurs when people change jobs. This means the new system is phased in gradually, rather than everyone eligible joining on the first day.
    - Any existing provider – insurance company, investment company, bank, pension fund - can become a KiwiSaver provider if it can administer the product and pass existing 'approved provider' tests. This means the implementation runs off existing systems, and is the responsibility of the providers. Set-up can therefore be quicker and more flexible, reducing the implementation risks and set-up cost compared to developing a new vehicle like the NPSS. Under this approach, liability risk for investment performance also seems more removed from Government than in the NPSS, where most saving is expected to be concentrated into one central fund.
    - The Government decided to minimise compliance costs for employers, so there is no compulsion and the extra administration is simply additional information flow to and from employers and the Inland Revenue.
    - Auto-enrolment should lower costs by improving economies of scale and proliferation costs are kept low by only allowing any individual to have one KiwiSaver account at any one time. Beyond this, there is no plan or felt need to change industry structure in order to reach a radically lower cost base (as in the NPSS proposals). However, the New Zealand Government is planning to make a contribution to members' account fees which will reduce the cost of having a KiwiSaver for the consumer still further from other savings products.

76. There are also some KiwiSaver design features that could be attractive in the UK and so should be considered for an NPSS-style product:
    - **Promoting personal responsibility**: KiwiSaver is based around KiwiSaver scheme providers rather than funds, so individuals engage with providers about their fund choices and, potentially, other product needs. This should mean more personal responsibility is encouraged, compared with the NPSS model which assumes most people make no choices but stick with the default.
    - **Guide would-be savers with financial information**: In New Zealand, the Retirement Commission and *Sorted* website are well-established sources of information and guidance on making financial decisions. This is now to be enhanced with financial education 'champions' in the workplace widening the reach of such guidance where it is needed because of the workplace-based context of KiwiSaver. The UK has no such unique source of unbiased help. Introducing a similar body offering information, education and tools to help make decisions on financial matters – not just connected with the NPSS, but also covering issues such as debt management and all forms of saving - seems not only essential if an NPSS-style product is introduced, but if done well is also likely to be popular.
    - **Use more encouraging language about helping would-be savers**: The rationale for the NPSS is in the context of the pension debate in the UK which is spoken and written about in terms of people needing to save more. This is in marked contrast to the language used in New Zealand which assumes that people want to save, and KiwiSaver is promoted by the Government as helping them to do so.
    - **Reconsider incentives**: The financial incentives for the NPSS and KiwiSaver are structured very differently. KiwiSaver has a lump sum at outset of NZ$1,000 (about £365), a further lump sum of up to NZ$5,000 for withdrawal to buy a first home, and subsidised fees. The NPSS tax incentive is an ongoing percentage of band earnings, which is expressed differently than the tax incentives for existing pension provision, complicating any comparisons. Given the widespread agreement that the current pension tax incentives are regressive, it would be preferable to review them before introducing any new incentives in the NPSS.

77. If the NPSS were being introduced into the UK pension environment where state pension better guaranteed adequacy then the NPSS could be, like KiwiSaver, for discretionary savings and have a less prescriptive product design. In this case, some design features of the NPSS need be less constrained and could follow some of the potentially more appealing design features of the KiwiSaver:
    - **Purpose of saving**: If the state pension guarantees adequacy then any saving on top is discretionary and has no impact on the amount of state pension received. Success in greater saving would be welcomed, but is not critical to achieving a specific Government-endorsed retirement income target. There is no danger of a means-testing trap and annuitisation is not necessary. The flexibility to withdraw savings before state pension age can be included, for example, to help purchase of a first home.
    - **Employer compulsion**: There need be no compulsory employer contribution if the NPSS is for discretionary savings. This would reduce the regulation and potential liability on employers. The product could be introduced without any requirement on employers to contribute, and the experience of take-up, amount saved examined before deciding that there is a stronger case for employer compulsion.

78. Different models for the state pension to guarantee adequacy were explored in earlier sections of this submission. If it were decided to take such an approach, then it could also be decided to raise National Insurance rates to help pay for it. Say, an increase of 1% in National Insurance employee and employer contributions is made. Then commensurately less contribution could be expected into the NPSS – only 6% in total, say, rather than 8%.

79. A small additional NI contribution – even if compulsory – may be preferred by employers and employees to assure a good foundation state pension. Full value from the NPSS saving would be achieved with no means-testing trap. Total pension – state and NPSS – would be at least as good as otherwise expected, with less exposure for the individual to investment and annuitisation risk.

80. A higher amount in the NPSS means less in pay-as-you-go pension and more in funded savings. Another way to increase the level of funding in the system, under any structure of state pensions, is to use a 'Buffer' or 'Reserve Fund'. This invests part of the pay-as-you-go revenues to help smooth cash flow for later payouts. In other countries, including Ireland, New Zealand and Norway such a fund can be controversial but it can also help to support long-term stability of the state pension system.