PENSIONS POLICY INSTITUTE

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Submission from the Pensions Policy Institute in response to the SNP proposals for a Citizen's Pension and Pension Saving Report *A Secure Retirement for All*

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Summary

1. There is a growing consensus for a better foundation pension for the UK. The thrust of the reforms outlined in *A Secure Retirement for All* are in line with the majority of other proposals for the introduction of a foundation pension at or above the level of the Guarantee Credit.

2. More detail is required to analyse fully the costs and impact of the policy proposals. In particular, a number of questions remain concerning proposals for compulsion, and the role of the State Pension Fund. It is therefore not possible to comment further on these issues.

3. Recent research carried out by the PPI for the National Association of Pension Funds shows that a Citizen's Pension is feasible and affordable for the UK.

4. The Citizen's Pension in this proposal differs from the NAPF proposals in two important respects:
   - It would be paid *in addition to* existing SERPS and S2P rights, rather than *offset* against them. This would increase the costs of the proposal.
   - It would pay a lower rate to couples. This would reduce the costs of the proposal.

   As well as the impact of the above two points, the overall affordability of the SNP proposal depends how much of the money saved by not paying contracted-out rebates is re-directed to pay for credits in the State Pension Fund.

5. Increasing state pension age should be considered as part of a complete package of state pension reform rather than considered in isolation. Existing estimates of life expectancy by social class are out of date, and do not take account of improvements in life expectancy for people born in specific years. Other policies could be put in place to protect those worst affected.

6. State-Matched Funding may not increase saving significantly among low earners. Many low earners will still not be able to afford to save, irrespective of the increase in the incentive.

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, but exists to contribute facts and analysis to help all commentators and policy decision-makers.

2. This submission is written by Chris Curry, Research Director, who has worked in pensions for the Government and the private sector for 10 years.

There is a growing consensus for a better foundation pension for the UK

3. Pension reform looks inevitable in the UK. When the Government produced a Green Paper in 2002, despite their intended focus on private pensions, most major organisations said reform of the state pension system was needed, and many have since put forward proposals for reform of the state pension system.

4. The thrust of the reforms outlined in *A Secure Retirement for All* are in line with the majority of these proposals. 14 out of 17 recent reports studied by the PPI call for a foundation pension at or above the current level of the Guarantee Credit. Half of those calling for a higher foundation pension suggest the foundation should be a Universal, or Citizen's, Pension[1].

More detail is required to fully analyse the costs and impact of the policy proposals

5. *A Secure Retirement for All* outlines a comprehensive reform package for the UK pension system[2]. However, there is at this stage little detail of how the proposals would work in practice. In particular, there is little concrete information on compulsion, and the role of the State Pension Fund. A number of questions remain unanswered, including:
   - Would compulsory contributions be paid by employers or individuals?
   - How large would compulsory contributions have to be?
   - Would existing contributions to private pensions (including defined benefit arrangements) be sufficient?
   - How would the arrangements be policed?
   - Would the self-employed and temporary workers be compelled to save?
   - How low would income have to be to qualify for a credit?
   - How big would the credit be?

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[1] See PPI Briefing Note Number 16 *Pension reform: who is proposing what?*

[2] Throughout this response it has been assumed that the proposed changes would apply throughout the UK

- How much would credits cost each year?
- Who would run the State Pension Fund?
- Who would determine the investment strategy?
- How would the regulatory regime be strengthened?
- Would the State Pension Fund guarantee a level of return on contributions, or could an individual get back less than the level of his or her contributions?

6. Without answers to these questions it is not possible to comment further on the feasibility of these particular aspects of the proposals.

7. Further details are also required to allow a full analysis of the other aspects of the proposals, including the residency requirements for the proposed Citizen's Pension, and the levels of State-Matched Funding available for private pension saving. Some general comments can be made about these aspects of the proposal.

A Citizen's Pension is feasible and affordable

8. In December 2004 the National Association of Pensions Funds (NAPF) published *Towards a Citizens Pension*[3]. This research, undertaken by the PPI for the NAPF, contains detailed analysis of how a Citizen's Pension could be introduced in the UK. The report concluded that it would be feasible to transition to a Citizen's Pension in the UK, and affordable. A second report, looking in more detail at transition, costings and the implication of different levels of Citizen's Pension will be published in Autumn 2005.

9. A Citizen's Pension would have a number of advantages relative to the existing UK state pension system, including:
   - Adequacy: a Citizen's Pension would ensure a minimum income level in retirement, without needing to claim means-tested benefits.
   - Simplicity: one system, with one set of rules and one benefit level, rather than the current combination.
   - Inclusion: nearly all residents, and some former residents are included.
   - Certainty: the level of future benefits is well-defined and easy to see.

[3] NAPF (2004) *Towards a Citizen's Pension* www.napf.co.uk

This proposal differs from the NAPF proposal

10. The structure of the Citizen's Pension examined in *Towards a Citizen's Pension* (the NAPF report) is different from that proposed by the SNP in a number of respects.

11. In the NAPF proposals, the Citizen's Pension would replace future accruals of the Basic State Pension and the State Second Pension[4] (S2P). The amount of extra state pension an individual would receive through the Citizen's Pension would depend on his or her *accrued state pension rights*. These include accrued rights in the Basic State Pension, SERPS/S2P. Any individual with accrued state pension rights worth less than the Citizen's Pension level would have his or her income topped-up to the Citizen's Pension level.

12. This means that the Citizen's Pension is *offset* against current payments of the Basic State Pension and SERPS/S2P. This reduces the cost of introducing a Citizen's Pension, and means that people who have high accrued state pension rights (because they have had long careers and/or relatively high earnings) do not receive windfall gains from the Citizen's Pension.

13. In contrast, the Citizen's Pension as outlined in the SNP proposal replaces the Basic State Pension, but does not affect the State Second Pension (which would be replaced by a State Pension Fund (SPF)).

14. This would mean that existing rights to S2P would continue to be paid *in addition to* the new Citizen's Pension. This would significantly increase the cost of introducing a Citizen's Pension, and give higher income pensioners windfall gains[5].

15. Under the NAPF proposals, contracting-out is abolished, meaning that the £12bn currently paid in contracting-out rebates could be used in other parts of the pension system.

16. Under the SNP proposals, the amount currently spent on contracted-out rebates seems likely to be redirected to the new SPF as credits for low paid workers (although it is not clear if this would be more or less than the current level of contracted-out rebates).

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[4] As a Citizen's Pension would replace S2P, it would also replace contracting-out of S2P. Throughout this response, when S2P rights are referred to they include the contracted-out equivalent rights that have been funded by the contracted-out rebate.

[5] PPI (2004) *State Pension Reform: Managing Transition*

17. The SNP proposal would pay a Citizen's Pension on a 'benefit unit' basis – that is, one payment made to a single person, and one (higher) payment made to a couple. The NAPF report is based on a separate Citizen's Pension being paid to all individuals. This would give a couple a higher Citizen's Pension than the SNP proposal. In this aspect, the SNP proposal would therefore cost less than the proposal costed in the NAPF report.

18. The additional cost of paying a Citizen's Pension in addition to existing SERPS and S2P payments under the SNP proposal is likely to be similar to the saving from paying a lower rate to couples[6]. Re-directing at least part of the contracted-out rebates into the SPF will increase the costs of the SNP proposal relative to the NAPF proposal, but without further detail on the size of the SPF it is not possible to say by how much.

Increasing state pension age should be considered as part of a complete package of state pension reform rather than considered in isolation

19. The long-term costs of both the NAPF and SNP proposals are likely to be higher than the amount spent on pensions today. Whether the SNP proposal costs more or less than the NAPF proposal depends on the amount of money paid into the SPF as credits for low earners. If this is more than the cost of paying benefits on an individual rather than benefit unit basis, the costs will be higher under the SNP proposal.

20. For a Citizen's Pension to be affordable, other changes are likely to be required. Similar changes are also likely to have to be made under the current system[7].

21. One potential way in which pensions can be afforded in future is by people working longer[8] – an effective increase in the *retirement* age. One way of encouraging later retirement – and releasing money to improve state pensions at later ages - would be to increase the state *pension* age, the age at which state pensions become payable.

22. This is explicitly ruled out in *A Secure Retirement for All*, on the basis that there are differences in health, quality of life and life expectancy between different income groups.

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[6] Around £5 bn - NAPF (2004)
[7] See PPI Briefing Note Number 14 *State spending on pensions: An update*
[8] Other methods include increasing spending on pensions (effectively an increase in taxation) and increasing the amount saved for retirement

23. While there is undoubtedly a difference in life expectancy and quality of life for different socioeconomic groups, the impact of increasing state pension age can be overstated.

24. Existing estimates of life expectancy by social class are out of date, and do not take account of improvements in life expectancy for people born in specific years. The life expectancy of a man in Social Class V aged 65 today is likely to be more than 15 years[9] (even allowing for some widening of the life expectancy gap between classes). Life expectancy could be significantly higher by the time any increase in state pension age could be implemented[10]. Other policies could be put in place to protect those worst affected, such as retaining the start of Guarantee Credit at 5 years before state pension age[11].

25. Increasing state pension age should be considered as part of an overall package of reform, rather than as a stand alone solution in its own right, and any evaluation of the potential impact of raising state pension age should be based on reliable and relevant data.

State-Matched Funding may not increase saving significantly among low earners

26. *A Secure Retirement for All* proposes replacing the existing system of tax relief with State-Matched Funding. This is designed to redistribute the existing money spent on tax relief so that more is paid to lower earners, and to increase the level of saving at lower earnings levels. Although savings from reforming tax relief are proposed as helping to fund the Citizen's Pension, the proposals for State-Matched Funding are cost-neutral (page 17). Although there is the potential to make savings (by limiting the amount that can be matched), there is not enough detail in the proposal to estimate the overall cost, the impact on saving in private pensions or the potential winners and losers.

27. Introducing a State-Matched Funding scheme would not be simple. In particular, the system may be very difficult to integrate with existing employer pension provision, especially Defined Benefit arrangements. In these schemes, contributions are pooled, and the benefits of the state-match do not feed through into the benefits received by the individual[12].

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[9] PPI estimate. See forthcoming PPI Briefing Note.
[10] Likely to be 2030 at the earliest
[11] Under current plans the entry age to the Guarantee Credit will increase to age 65 by 2020 – see the PPI submission to the Work and Pensions Select Committee inquiry into the introduction of the Pension Credit
[12] See Curry and O'Connell (2004) *Tax Relief and Incentives for Pension Saving* for further details

28. While there is evidence that tax incentives can increase pension saving, by redirecting money that would otherwise have been invested in other savings vehicles, it is not clear that any system of tax incentive or relief significantly increases the amount saved[13]. This is because:
    - Tax incentives are complex, making them difficult to understand.
    - Tax incentives often do not appeal to their target group. Low to middle income groups (who are traditionally low savers) pay lower rates of tax, and so gain less from reduced tax liabilities.
    - The amount that people want to save is determined by a range of factors not linked to tax relief or rates of return, such as income and affordability.

29. A system of State-Matched Funding would address the first two of these problems, but not the third. Many low earners will still not be able to afford to save, irrespective of the increase in the incentive.

[13] Curry and O'Connell (2004)