PENSIONS POLICY INSTITUTE

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Initial analysis of the Pensions Commission's Second Report

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The PPI is independent and does not lobby for a particular solution or campaign on any particular issues. Our concern is that a sustainable pension system is designed with the right facts and analysis.

This note gives the PPI's early thoughts on the Pensions Commission's Second Report based on our large body of work on pension reform, seminar discussions with representatives of various pensions organisations on the implications of the Report, and our own preliminary economic analysis of the Commission's proposals.

What is the problem?

1. The Commission is right to say that there is no immediate 'crisis' in pensions. However, as the Commission has recognised, the structure of the pensions system causes problems that can only get worse in future.

2. The PPI has characterised the problems with the UK's pension system as follows. All of these points are consistent with the Commission's analysis.
   - **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.

- **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.

The direction of travel

3. The broad construct of the Commission's approach is very much in line with the consensus among pensions stakeholders that has emerged in the last year or so. The basic theme is a higher, simpler flat state pension with less means-testing and wider coverage for those with interrupted work histories.

4. 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 low while the number of people over state pension age is increasing so rapidly.

5. The way of mitigating the cost in the long-term suggested by the Commission – raising state pension age in line with life expectancy increases – has been promoted by many pensions stakeholders for some time as the most logical approach.

6. The Commission also proposes a National Pensions Savings Scheme to which individuals will be automatically enrolled. They can opt-out, but if they stay in then their employer has to contribute a percentage of their salary to their NPSS pot.

7. The NPSS meets an agreed need for a low-cost savings vehicle that can be easily accessed, and will be especially valuable to low income people with no employer provision available. Many pension stakeholders will agree with the philosophy of the NPSS: that providing pensions related to salary is the role of private savings rather than the state system. And there is general agreement that automatic enrolment may be a good way of overcoming people's inertia to save while avoiding the problems of compulsory individual saving.

8. 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. The policies to make this a reality operate in the labour market rather than in pensions, so it is important that it does not get forgotten in the pension policy debate.

9. While the implied destination of the Commission's proposals will, we expect, be welcomed by all, there are options for the details of how to get there. The PPI's initial assessment is that reform to state pensions could be more radical, getting to a simpler system quicker; and that the NPSS idea could be improved by making it more flexible and less prescriptive.

State pension reform: simpler and quicker options

10. The gradual transition approach for state pension reform preferred by the Commission has 3 big 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 make much sense of.

    - 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.

11. The Commission recognised that other transition options would make a faster journey to a similar end-point. The PPI has previously looked in detail at alternative models, for example a Citizen's Pension (a flat £109 to each individual who has been resident in the UK for an eligibility period). The transition to a Citizen's Pension could be designed to target gains on the less well off pensioners, using a process known as 'offset'. This simply means that people already entitled to more than £109 in state pensions do not get any more, whereas those with less than that amount get taken up to £109. Although not without issues, we believe that such a transition would be administratively possible, and the prize would be a fast track to a simpler and more sustainable system with a better, flatter distribution.

12. Other transition models, such as the Commission's own version of a Citizen's Pension ("ESP") are worth looking at in more detail to see if we can get to the desired end game quicker than the Commission's proposals would suggest. The PPI will be publishing more work on different options in the spring.

13. There may be some very practical areas of transition technicalities that working parties of practitioners could be tasked with mapping out e.g., how to wind down contracting-out faster than envisaged by the Commission.

14. There will be some short-term costs with any transition, and long-term spending can only be expected to increase. The Pensions Commission suggest long-term pension spending should be in the range of 7.5%-8% of GDP (it is currently around 6% of GDP on this measure). It would be helpful to have a wider debate on whether this is the right range to aim for, and to clear up some technical questions on what is included in the costs. For example, tax relief has a cost that is not appropriately recognised.

More flexible savings scheme?

15. Pensions stakeholders are divided on the NPSS. There are those who think that it is worth doing because it will give access to low cost saving for those who do not currently have it. There are others who, pointing to the risks of employers levelling contributions down to the 8% of salary mandated by the NPSS, of mis-selling issues and the cost to small businesses, are wary of another big government 'silver bullet' solution.

16. The basic idea of the NPSS – lower costs by centralising contribution collection and direct feed-through to fund managers instead of the individualised nature of stakeholder - is radical but generally well accepted. However, there is some disagreement over whether the scheme would be better run by the state or the industry. And the particular proposal seems very prescriptive in the detail. For example:
    - There is a very strong compulsion on employers, triggered by the employee choice of staying in the NPSS, which gives an unusual balance of power in employer/ee relations.
    - The money is locked away until pension age, with no option to take any out before then.
    - The money has to be annuitised, like other pensions.

17. One example referred to by the Commission in developing the NPSS was the KiwiSaver in New Zealand. This was not designed to be a pension; rather a low-cost, flexible savings plan. It provides a kick-start to saving through auto-enrolment, but no compulsion on individual or employer. The money is locked away until age 65, but then can be taken however the individual wishes, and some money can be withdrawn earlier in cases of financial hardship or to put down a deposit on a first home. KiwiSaver is therefore an attractive multi-purpose savings plan. A 'BritSaver' on the same lines might look more like something people would want to join than a very prescriptive vehicle that provides only a pension.

18. Given the risk of over-reliance on a big, new government-sponsored scheme that requires new computer systems for contribution collection, it might be better to consider a phased approach to opting individuals into an NPSS. For example, the KiwiSaver is to be phased in by automatically enrolling individuals as they join the workforce for the first time or as they start a new job.

19. The costs of the NPSS are kept low partly by removing the need for face-to-face advice and selling. This puts the onus on government to provide basic impartial advice. The Informed Choice programme could be redesigned to meet a wider need than originally envisaged, for example, to provide a website giving straightforward, generic advice on all aspects of personal finance through the life course - from Child Trust Funds to debt management to saving for later life.

20. There is disappointment among pensions stakeholders that reform to make tax incentives for occupational and personal pension saving less regressive was deemed too difficult by the Commission. Although the tax incentives for the NPSS are on a better system of matched contributions, the more generous tax incentives for higher-rate tax payers in traditional pensions may lead to a divide between those in and out of the NPSS. If the NPSS is established as proposed, a working party of practitioners to look at ways of putting existing pensions on the same tax relief system as the NPSS may be useful.

21. The NPSS as proposed may establish a norm of 8% of salary as a total contribution to pensions in the private sector. Contribution rates in the public sector are typically around 20% of salary. The NPSS could therefore make the distinction between the sectors more stark. It might be helpful to develop an objective framework to address what the level of pension benefits in the public sector ‘should’ be.