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PPI

Shaping a stable pensions solution

How pension experts would reform UK pensions

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Shaping a Stable Pensions Solution

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Introduction

The aim of the *Shaping a stable pensions solution* project was to build up a picture of the possible shape of a consensus pension solution that could work for the long term. The approach was to use a series of seminars in which pensions experts debated papers written by specialists on the most critical and topical pension policy issues.

There are some limitations to this approach. Like experts in any field, many pension experts are technically highly knowledgeable about only one part of the system, but have a less clear idea of how other parts work. Discussions can sometimes be very technically detailed to the detriment of getting a clear view of the overall themes; sometimes there is a tendency to focus on the lobbying cause rather than the wider view. Many experts have lived through many reforms, and have been part of debates on recurring themes over the years, so there can be a tendency for 'group think'. Myths develop without checking facts.

This project was designed to overcome these potential hazards. It involved around 80 specially invited experts from over 40 organisations in 5 seminar discussions on specific research questions. Each seminar was based on a detailed fact-based paper, with responses from experts chosen to represent knowledgeable different points of view. The audience contributed comments which were synthesised by the PPI, with a focus on answering the specific policy questions posed.

All this material is available on the PPI website. The following chapters summarise the seminar papers and debates. Each chapter covers one of the seminar topics. Points of consensus from the seminar debates are presented at the end of each chapter in a box. Points raised during the seminar discussions are shown in italics, boxed and presented at various stages through the chapters.

The findings from this project are rigorous and very important. Alongside the findings of public interest research and of detailed economic work, the themes of this project should help form the shape of a new pensions solution.

Summary of conclusions

The *Shaping a stable pensions solution* project commenced in Autumn 2004, motivated by a sense in the pensions community that consensus did exist on the need for pension reform. It is now accepted by Government that the pension system should be reformed with a White Paper due to be published in Spring 2006. The Government has also identified that consensus is necessary for a sustainable solution.

Fundamental to getting pension policy on the right track is clarifying the currently confused role of the state in pension provision. The majority view of the experts contributing to this project was that the role of the state in UK pensions 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.

Consistent with this approach, this project identified the general shape of a consensus pensions solution (outlined in the following Box 1):

1. The current state pension system needs to change in order to guarantee against poverty in retirement more effectively.
2. Extensive means-testing forces a number of difficult policy trade-offs and is not sustainable in the long term.
3. Coverage of the state pensions needs to improve, with particular focus on improving gender equality in retirement income.
4. Well encouraged and regulated, voluntary earnings-related provision on top of a reformed state pension could meet the objectives of a compulsory savings scheme.
5. Working longer will play a key part in increasing retirement income.

There is a widespread concern that pension policy, once reformed, should be sustainable and stable over time. To achieve this, many suggestions have been made for some kind of independent permanent pensions commission. While differing in precisely what this might mean, most suggestions aim for some kind of unbiased research and commentary on pension policy trends and choices. But independent review of policy may not guarantee stability if it leads to frequent change of the system. Many experts believe that the best way to ensure stability is to have as simple and transparent a pension system as possible.

Box 1: A consensus view on a pensions solution

1. **The current state pension system needs to change in order to guarantee against poverty in retirement more effectively.** The primary role of the state has to be to prevent poverty in retirement, as only the state can guarantee this. However, poverty prevention is currently not guaranteed as state pensions are low and there is less than full take-up of Pension Credit. Private pensions will continue to be an important source of retirement income, but the appropriate or realistic balance between state and private will vary from person to person. It is unlikely that the Government will achieve its long-term target of switching the proportion of pension income from 60% state and 40% private to 40% state and 60% private. The "40: 60" measure may be an interesting policy indicator, but the state looks set to remain the majority provider of retirement income.
2. **Extensive means-testing forces a number of difficult policy trade-offs and is not sustainable in the long term.** Means-testing is an effective short-term method of targeting limited state resources. However, current policy trends show the extent of means-testing will increase significantly in future. This will exacerbate a number of problems, including the public's dislike of means-testing, uncertainty as to how much individuals will receive from the state, and increasing cost. Alternative methods for targeting resources exist which may be more politically acceptable and sustainable in the long term. For example, affluence testing could be explored further.
3. **Coverage of the state pensions needs to improve, with particular focus on improving gender equality in retirement income.** A residency-based system provides better, gender-neutral coverage, but reforming the current contributory system implies less change and is seen as being less risky. Improvement to women's state pension entitlement is now regarded as central to the pension reform debate. At the very least, improvements need to be made to the design of credits for people not in paid work within the contributory system.
4. **Well encouraged and regulated, voluntary earnings-related provision on top of a reformed state pension could meet the objectives of a compulsory savings scheme.** The state already enables and incentivises private pension provision. Strengthening this role, for example, with the introduction of a national auto-enrolment scheme, may be preferable to compulsion as a means to reinvigorating voluntary saving. Ways to make the tax relief system simpler and more progressive should also be considered. However, the effectiveness of any such method is likely to be reduced if it is designed to sit on top of the very complicated state system, with people remaining uncertain as to what they will receive from the state. A simpler state system that people can understand and trust could encourage more private saving.
5. **Working longer will play a key part in increasing retirement income.** In general, people will want to work longer, and the labour market will need to adjust in order to accommodate this. This should include increasing opportunities for flexible, part-time working.

1. Overview of a consensus solution

This chapter:

- Summarises the context of pension policy in the UK over the period of the project.
- Lays out the general shape of the pensions solution that emerged from this project.
- Suggests some ways in which the general shape of that solution can remain stable over time.

2005: A remarkable year for pensions policy

This project progressed while a remarkable story on pension policy played out. During 2005, the pensions policy scene shifted dramatically:

Up to Autumn 2004, when the PPI starts working with the Nuffield Foundation on this project

This project was first mooted because of a sense that there was a consensus – then not acknowledged by Government - that the UK's state pensions needed reform. For example:

- PPI publications[1] from early 2003 had highlighted concerns with the declining value of state pensions, the degree to which improving longevity had not been addressed, the increasing extent of means-testing, the complexity of the system, and the number of people 'under-pensioned' by anomalies in the system; all of which problems made growth in private pensions more difficult and the prospect of declining incomes for pensioners relative to the rest of society more likely.
- Other organisations from various pension viewpoints[2] had published commentaries on similar themes, for example, in responses to a Green Paper in 2002 and to Select Committees in both Houses of Parliament[3].
- Given views that reform of the state pension system should be the first step to any reform of private pensions, ways to reform the state pension system had begun to be examined by the PPI and others[4].

[1] For example, *Raising State Pension Age: Are We Ready?* (2002), *The Pensions Landscape* (2003), *Guide to State Pension Reform* (2003), *The Under-pensioned* (2003), *State Pension Reform: The Consultation Response* (2004), *Citizen's Pension: Lessons from New Zealand* (2004), *Managing Transition* (2004)
[2] For example, Age Concern, the Association of British Insurers (ABI), the Confederation of Business Industry (CBI), the Equal Opportunities Commission (EOC), Help the Aged, the National Association of Pension Funds (NAPF), and the Trades Union Congress (TUC)
[3] DWP (2002), House of Commons Work and Pensions Select Committee (2003), House of Lords Select Committee on Economic Affairs (2004), House of Commons Work and Pensions Committee (2005)
[4] IPPR (2002), O'Connell (2004 CPNZ), PPI (2004 MT), see also PPI (2004) Briefing Note 16

But Government seemed at the time preoccupied with private pension provision, for example:

- The Pensions Commission, which started work in early 2003, was tasked to look at the future of long-term savings, with state pensions not mentioned in its remit.
- The Pensions Act 2004 was almost entirely about private pensions, including major initiatives to improve regulation of occupational schemes (the new Pension Regulator) and an urgent response to the problem of occupational pensions lost when employers became insolvent (the Pension Protection Fund).

October 2004: Pensions Commission's First Report

The Pensions Commission's First Report[5] highlighted again many of the concerns already identified with UK pension provision. It summarised the overall problem by saying that pensioners will become poorer relative to the rest of society unless taxes or National Insurance contributions devoted to pensions rise, or private saving rises, or average retirement ages rise.

The report crystallised the sense that the state pensions system could not continue on its current path, and responses to the Pensions Commission developed further ideas for reform.

February 2005: Government commits to reform

In early 2005, as the paper for the first seminar in this series was being prepared, Government made the first public statement recognising that state pensions should be reformed.

The Government's short document *Principles for Reform*[6] outlined how pension policy had developed in the last few years and, by announcing that possible reforms would be tested against a set of principles, committed to considering reform options.

[5] Pensions Commission (2004)
[6] DWP (2005 PR)

Mid 2005: An emerging consensus?
There was much debate at this time about 'consensus': could pensions stakeholders across the political spectrum, and representing diverse interests not always in agreement, come together to agree on a pensions solution that by its consensual nature would stand some chance of lasting?

The desire for consensus was and is really about a desire for a stable solution: so pensions will not continually be the subject of reviews that add yet more to an already complicated system. It is of course one of the main questions to be addressed by this project.

Among the many proposals made for reform, it is easy to find areas of disagreement, and headlines such as *Organisations disagree on how to reform state pension system*[7] were made.

But it is just as easy to emphasise the areas of agreement. For example, many pensions stakeholders had been saying for some time that means-testing could not be left to extend to more than two-thirds of the population, as predicted under current policy, as it is just too unpopular[8].

Since the end of 2004, the PPI had been keeping a 'stocktake' of the various proposals for reform of state pensions made by different organisations with an interest in pensions[9]. This showed broad agreement on significant points of principle, and some strong 'camps' emerging, for example:

- Agreement that the first tier state pension should be increased (most commonly to the level at which means-testing for basic income purposes starts) in order to reduce the current level and future spread of means-testing among pensioners.
- Agreement that the eligibility criterion for state pensions should be widened, but different views on whether to do this by changing National Insurance rules or moving to a universal system based on residency.
- Agreement that the State Second Pension and contracting-out should be reformed, but different views on whether they should be scrapped (for simplicity) or contracting-out made more generous (to grow private pensions).
- Splits on whether state pension age should be raised (to reflect improving longevity) or not (because of perceived inequalities in life expectancy).
- Splits on whether private pensions should be made compulsory (for employers and/or employees) or remain voluntary.

As this seminar series progressed, the issues underlying some of these different points of view were debated. It became clear that even though views might differ on the technical design points of the solution, there was a high degree of agreement on what the broad objectives of pension reform should be.

[7] *Financial Times*, 1 February 2005
[8] Brooks and Denham (2005), Hancock et al (2005)
[9] PPI (2004) Briefing Note 16

A mid-project review[10] published in October 2005 summarised those aims so far broadly agreed (to be considered in more detail in the next section):

- ***What should be the balance of state and private pensions?*** The state is likely to remain the major provider of retirement income as only the state can guarantee poverty prevention. The current system needs to change to do so more effectively.
- ***Should state pensions be contributory or universal?*** A residency-based system provides better, and gender-neutral, coverage compared to the current contributory system and is seen by many to be fair and simple to understand. However, there are concerns that it is too radical, so reforming the current contributory system may seem like the less risky option.
- ***Should earnings-related pensions be compulsory or voluntary?*** The role of the state ought not to stop at poverty prevention, but need not extend all the way to providing compulsory earnings-related provision (that is, a pension higher in value for people that earned more compared to those that earned less). Reinvigorated voluntary private saving, enabled and incentivised by the state, may be preferable.
- ***How does the interaction of state and private pensions affect incentives to work and save?*** Working longer will play a part in increasing retirement income. The key is to make possible the type of work that people want. An increased state pension and a simpler state system less reliant on means-testing should help to overcome many of the current disincentives to save more and work longer.

[10] PPI (2005 MPR)

End 2005: Pensions Commission Second Report and Government response
At the end of November 2005, the Pensions Commission confirmed its analysis of the issues in UK pensions, suggested some options for resolution, and proposed its preferred way forward. The proposals were highly consistent with the shape of the emerging consensus identified by this PPI/Nuffield project[11]. Definitive recommendations included:

- The state system should be reformed to make it *less means-tested than it would be if current indexation arrangements continued indefinitely*, requiring an acceptance that this implies *some increase over the long-term in tax/NI devoted to pensions as a percentage of GDP*: in other words that state pensions have to become more important in the state:private mix than current policy expects, and should become better at getting people above the means-testing threshold (which is widely used as a proxy for the poverty level).
- The state system should be reformed to *ameliorate the disadvantages suffered by people with interrupted paid work records and caring responsibilities* (who are largely women). The Commission proposed a mixture of eligibility criteria: residency-based for the Basic State Pension[12] and based on National Insurance contributions made or credited for the State Second Pension.
- Both state pensions should be flat-rate (that is, the same benefit applies to eligible individuals whatever their earnings history). Earnings-related pensions should be provided by private savings, with a quasi-compulsory National Pensions Savings Scheme (NPSS) into which employees are automatically enrolled. They can voluntarily choose to leave the scheme, but if they stay their employer is compelled to contribute.
- State pension age should rise in line with life expectancy increases, and Government should pursue various initiatives to encourage later working.

The Government's response to the Pensions Commission report has been to announce a White Paper on pension reform in Spring 2006. It has confirmed that the principles by which it will assess reform options are, more or less, as previously announced. As will be seen in later chapters, the general shape of the consensus view of experts involved in this project is very much in line with the Government's principles for reform[13]:

- **Promoting personal responsibility**: *An active welfare state must provide a floor below which no-one should be allowed to fall but its primary role must be to enable people to provide for themselves, giving everyone the opportunity to build a decent retirement income that meets their needs and expectations.*
- **Fairness**: *It must be fair to women and carers correcting past inequalities and reflecting their changing role in today's society….. it must be fair to those who have saved – rewarding those who have contributed and incentivising those who can save to do so.*
- **Affordability**: *Clearly any system needs to be affordable to taxpayers and the economy as a whole. As the country ages we will face pressures to spend more on pensions.*

[11] Pensions Commission (2005) p. 300-301
[12] Residency-based for future accruals of the Basic State Pension and universal for residents over 75s
[13] John Hutton, Minister for Work and Pensions, speech to IPPR *Securing our Future: The Pensions Challenge* 24th November 2005

- **Simplicity**: *There needs to be a clear deal between citizens and the state. People need to know what the Government will do for them and they need to be clear about what is expected of themselves.*
- **Sustainability**: *Any package of reform must form the basis of an enduring national consensus – and one on which people can make decisions about their retirement planning with confidence that it won't be pulled apart by successive Governments fiddling with the system.*

So this PPI/Nuffield project has lived through a remarkable year: starting with having to make the case for reform and ending with that case widely accepted, with Government commitment to reform and with even a fair degree of consensus on the shape of the solution. The remainder of Chapter 1 covers the important features of that solution as it emerged from this project, and how the consensus might be maintained.

Experts' views on the shape of UK pensions reform

This project involved around 80 specially invited experts from over 40 organisations in 5 seminar discussions on specific research questions. Each seminar was based on a detailed fact-based paper, and the discussion on each paper was captured in written summaries.

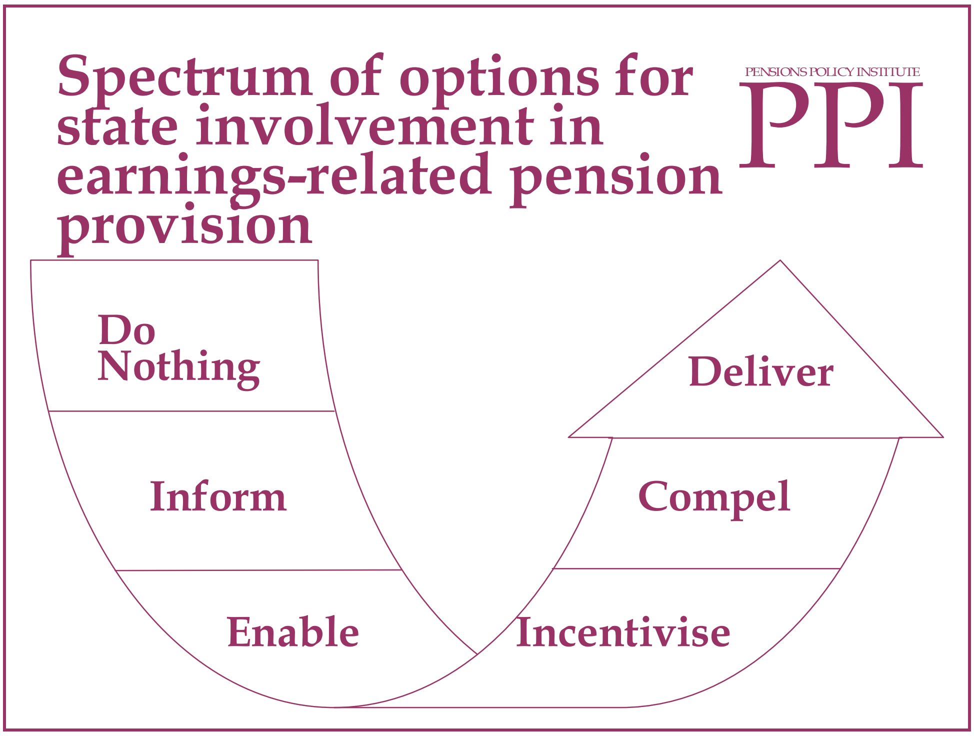
In this section, the general themes emerging from the project are covered. More detail is in each of the following chapters, one for each seminar.

The fundamental question is: **what should be the role of the state in pensions provision?** Should it just provide an absolute minimum safety-net for those with no other provision, or should the state get everyone to the supposed desired target of two-thirds of final salary[14]?

After poverty prevention has been secured, there is a range of possible roles for the state's involvement in earnings-related provision (Chart 1). Instead of the state **delivering** a pension, it could **compel** it to be provided some other way, give financial **incentives** or **enable** it to be provided as an individual chooses (perhaps through advice or regulation), or the state could **do nothing**. Is it helpful for the role of the state to be simply defined, or are multiple roles needed?

[14] Because this is what good Defined Benefit schemes have typically aimed for, this has become an often-used benchmark for what people are thought to want as retirement income. In fact, the average pensioner income from all sources is about two-thirds of pre-retirement income. See NAPF (2004) Appendix 3.

Chart 1



The role of the state in the current system is not clear, but it intervenes heavily in ways that result in more pension income for higher income people:

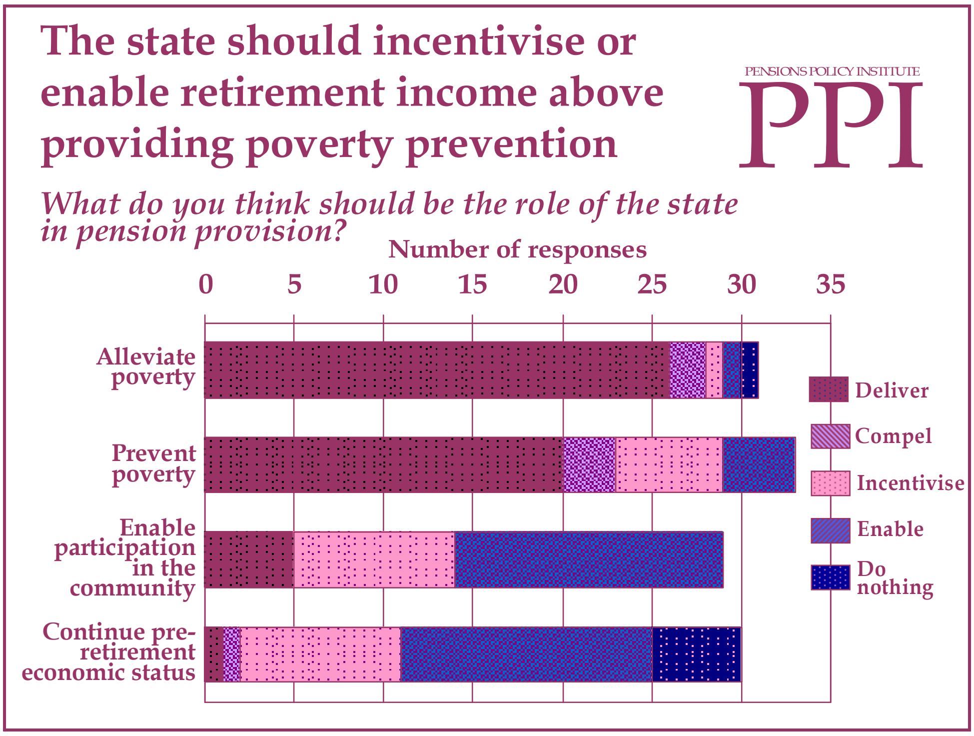
- Delivery of income to prevent poverty in retirement is compromised by inadequacy of the components:
  - Many people (because of breaks from the workforce or spells on low pay) do not get enough from the contributory pensions delivered by the state (Basic State Pension and State Second Pension), so have to claim Pension Credit to get up to a minimum income of £109 a week[15]. In 2004/5, women pensioners received on average £60.85 per week of BSP, and men received £74.01[16]. The average amount of SERPS and S2P[17] received per week in 2004/5 was £12.66 for women and £39.44 for men[18], compared to the maximum rate of £140[19]. As many do not have much further income, it is easy to see that the average man and woman received less than the weekly Pension Credit guarantee of £109.
  - While there is a debate about the definition of the poverty level (is someone on £109 a week out of poverty?), poverty is clearly not prevented because of the less than 100% take-up of Pension Credit[20]. The state does not provide a complete safety-net.

[15] The Guarantee Credit element of Pension Credit tops up income to £109.45 a week for any single person over 60; for a couple it is £167.05 (rates for 2005/6)
[16] PPI (2005 PF)
[17] Including the amount that should be delivered through private pensions to individuals who have contracted-out of SERPS / S2P
[18] DWP (2005 SPSS), table SP9
[19] PPI analysis
[20] For example, only between 65 and 75% of those eligible for the Guarantee Credit actually take-up the benefit (PPI analysis of DWP (2006 IRB))

- Yet for people at the other end of the income scale, the state has been delivering generous earnings-related benefits through SERPS. The maximum amount of SERPS paid in 2001/2 was 30% NAE compared to 19% NAE for someone on average earnings. Even though the replacement for SERPS, State Second Pension, has a flatter benefit across incomes, the change happens too slowly to make much difference[21].
- Voluntary private pensions are enabled through regulation and tax incentivised at the marginal rate of tax[22]. This means that higher income people get proportionately much more from the state for the larger amount of savings they do, compared to lower income people. 55% of total tax relief on individual and employee pension contributions went to higher rate tax payers in 2004/5, even though only around 10% of taxpayers are paying higher rate tax[23].

The majority view of the experts contributing to this project was that the role of the state in UK pensions should be clearly delineated into two (Chart 2):
- 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.

Chart 2[24]



[21] See PPI (2005 SEM 4)
[22] Subject to a minimum of the basic rate of tax
[23] PQ Chris Huhne House of Commons *Hansard* 31 October 2005 Column 731W. HMRC (2005) *Number of individual income taxpayers* www.hmrc.gov.uk/stats/income_tax/2_1dec05.xls
[24] PPI survey of 29 multi-disciplinary pensions stakeholders at a PPI/Nuffield Foundation seminar, May 2005

As well as clarifying the role of the state, and hopefully making it easier for people to understand what they will get from the state, the rationale here is partly about cost. In the decision of how to spend the available state resources on retirement income, there is wide agreement that the priority has to be about effective (not widely means-tested[25]) poverty prevention, rather than replacing pre-retirement earnings[26]. This means more redistribution by flattening the benefits of the contributory pensions across income groups.

The other main rationale in beefing up the role of the state in poverty prevention is that it can then legitimately step back from so much intervention in private pensions - and so make private provision easier, and, hopefully, more likely. Under current policy, because the state wants people to save in a certain way (to keep off means-testing, or to mimic state benefits by contracting-out), so the state has to regulate aspects of private pensions very tightly, in ways that would not be needed if there were a clearer division of responsibilities between state and private[27].

This model therefore says that the state has a responsibility to ensure everyone of pension age has a certain amount – say £109 a week for simplicity – but then the rest is up to the individual with his or her employer, with a certain amount of state help (e.g., tax incentives). This contrasts with the current system where there is a strong expectation that savings will contribute to the £109, <u>and</u>, that higher income people can expect more than the £109 from their compulsory state contributions.

The Pensions Commission's preferred three-fold solution[28] is relatively interventionist, with the state not only taking people up to and beyond £109, but also pushing hard for them to achieve more than that:

- **Delivery** of the Basic State Pension and State Second Pension, enhanced from the current system by widening the eligibility criteria and increasing in value, so that fewer people would need to claim Pension Credit than under the continuation of the current system (that is, most people get to more than £109 with these pensions but some still get less).
- **Strong encouragement** for a 'baseload' of earnings replacement, through the NPSS, tax-incentivised, using inertia to almost compel the individual, and compulsion on employers.
- **Enabling** and **incentivising** of further voluntary pension saving on the current basis in existing vehicles, and in the NPSS.

[25] See Chapter 3
[26] See Chapter 5
[27] See Chapter 2
[28] Pensions Commission (2005) p. 19. The preferred solution is shown split into five separate components, but it is simplified here.

For someone with a lifetime median income[29], the Pensions Commission proposal would give £75 of BSP per week, plus £62 of S2P per week in 2053[30]. This would be supplemented by an expected £66-£80 per week from the NPSS[31].

It is worth noting that both the consensus solution from this project and that from the Pensions Commission suggest the role of the state needs to be strengthened, implying that the share of GDP spent on state pensions should increase. This is largely a response to the perceived inadequacy of the current system's benefit levels. Although the experts' view was that the additional spend should be directed to poverty prevention, the Pensions Commission solution would spend more on benefits above that first level.

Keeping policy stable

As reflected in the Government's *Principles for Reform*, there is a widespread concern that pension policy will continue to be 'fiddled with'; each fiddling adding more complexity, and making it yet more difficult for people to understand or trust what their future retirement income might be.

Achieving consensus to reform is clearly important, but what else can be done to keep the chosen pensions solution stable? Although stability was not addressed directly by any of the seminars[32], it has been an important underlying theme throughout the series. This section briefly considers three mechanisms:

- Some kind of ongoing independent commission.
- Transparent cross-party agreements.
- Long-term system design features.

While regular independent review of policy should improve the understanding of policy issues, it may not guarantee stability if it leads to frequent change of the system. Many experts believe that the best way to ensure stability is to have as simple a pension system as possible.

[29] £23,000 per year (2005/6 terms)
[30] On the basis of a full 44 years of contributions/ credits
[31] Pensions Commission (2005) p. 283
[32] A seminar on the theme of stability was planned for December 2005, but this did not take place due to the publication of the Pensions Commission's Second Report at the end of November

Independent Commission

One mechanism often suggested is a permanent or regularly convened independent pensions commission. Proposals differ over what such a commission's responsibilities would be, its structure, and how, as an independent, unelected body, it would be accountable to the public (Table 1).

The proposals divide into three main types:

- To give general policy advice to Government based on expert, unbiased and publicly available research, which would then be expected to be a basis for building consensus amongst the pensions community.
- To make recommendations to Government based only on pre-agreed parameters, such as state pension age and affordability. For example, the Low Pay Commission's remit extends only as far as recommending the level of the minimum wage.
- To use prescribed policy tools to meet Government imposed targets. For example, the Monetary Policy Committee has the authority to adjust the interest rate in order to meet the Government's pre-set inflation target.

Once the aims and responsibilities of the proposed commission had been mapped out, it would then be necessary to determine the structure. There are two specific ways proposed for how a pensions commission could work:

- A permanent commission, which once established has an ongoing remit.
  - This type of structure could have the necessary length of time to build consensus around issues, and the opportunity to develop a reputation with the public as being an independent, reliable and trusted source of information, such as the New Zealand Retirement Commission. An established permanent commission would lose credibility if it was seen to be swayed by lobby groups, so would work hard to be impartial.
  - But there is a risk of a permanent commission becoming rigid in its policy position and working procedures, sticking to a preferred position despite changing circumstances.
  - If a permanent commission is tasked with making politically difficult decisions, such as raising the state pension age, there is a risk of being used as a scapegoat by politicians and of becoming increasingly unpopular with the public.
- A regular commission could be set up every few years to subject Government's pensions policy to a thorough review. There could be a mix of 'old' and 'new' members each time.
  - In comparison to a permanent commission, the renewal of membership could allow this type of structure to be more flexible and reactive to the general policy environment.
  - But the commission may have insufficient time to foster good working relationships. Members may remain committed to their parent organisation's policy position. This would make consensus building difficult and slow the decision-making process. Changing membership between reviews could lead to policy inconsistencies.

Table 1: Proposals for an independent pensions commission and examples of existing organisations

1. Commissions with a general advisory role			
Commission	**Aims**	**Activities**	**Structure**
Pensions Commission proposal[33] Pensions Advisory Commission	To better focus public debate on policy changes and to build consensus.	*Continually assessing developments and laying before Parliament a report every three to four years … spelling out unavoidable trade offs.*	Permanent, independent.
NAPF proposal[34] – Pensions Standing Commission	*To advise ministers on the way forward for UK pensions…*[to] *provide the independent basis on which to base critical decisions as increasing the state pension age, and on which to build an ongoing consensual approach to pensions*	*To keep under review all matters relating to the UK pensions system and its long-term effectiveness and sustainability, and report every three years to Parliament.*	Permanent, independent. 8 -12 Commissioners appointed by Secretary of State.
Example organisations			
New Zealand Retirement Commission[35] established in 1995 under the Retirement Income Act 1993	Primary aim is to *help New Zealanders get their finances sorted so that they can retire with an income that meets their lifestyle expectations.*	Responsibilities include: *To develop and promote methods of improving the effectiveness of the retirement income policies implemented by Government … To monitor the effects of such policies …. To review such policies and to report to the Minister at 3 yearly intervals.*	Autonomous crown entity. Headed by the Retirement Commissioner whose role is created in statute and is a ministerial appointment. Small team of staff.
Pensions Policy Institute[36] founded by the Pension Provision Group following a recommendation in their 1998 Report *We All Need Pensions - The Prospects for Pension Provision*	*To have responsibility for accumulating, analysing and publishing information about current and future pension provision and its implications for pensions policy.*	*Encourage the right framework for long-term pensions planning. Provide better information on the extent and nature of pension provision. Extend and encourage research at the PPI and with other organisations. Be a 'critical friend' for providers, policy makers and opinion formers. Improve public understanding of pensions issues.*	An educational charity. 80 voluntary governors from a wide range of pension and ageing-related backgrounds, of which 13 sit on the Council responsible for management. Small team of staff.

33 Pensions Commission (2005) p. 406
34 NAPF (2005) Press Release *NAPF calls for new Standing Commission on Pensions* 14 September 2005
35 See www.retirement.org.nz/about_us.html
36 See www.pensionspolicyinstitute.org.uk

2. Commissions making recommendations			
Commission	**Aim**	**Activities**	**Structure**
Fabian Society proposal[37]	To remove aspects of pensions policy from political sphere, introducing a *strong element of independent oversight and management into the pension system.* Also, *to rebuild public confidence.*	To agree consensus on certain aspects of pensions policy. Possibly to administer certain aspects of policy, such as the setting of state pension age.	Members to represent key stakeholders.
Help the Aged proposal[38] Independent Pensions Authority	To ensure that pension reform has *long-term security and resilience to shocks in both the political and wider worlds.* To remove policy from *the 'short termism' of the political environment.*	To monitor the pensions system, to advise government and make recommendations on future pensions policy. To carry out research into an appropriate level of BSP. To provide public information about pensions.	The commission would comprise of *pensioners and representatives from pension companies, employers and government.*
Liberal Democrat Party proposal[39] Independent Pensions Authority	For *politician proofing* and to *report on the sustainability of the pensions system.*	*To advise on the state pension age and pensions affordability. To review the economics of the different public sector schemes…and to make recommendations.*	Permanent, independent.
TUC proposal[40]	*To help ensure a continuing consensus.* To maintain and analyse the adequacy of pension benefits.	Analyse and monitor the pensions system. Report every 4 years to Government, recommending an adequate pension level.	Permanent, independent. Designed along the lines of the Low Pay Commission.
Example organisation			
Low Pay Commission[41] Set up under the National Minimum Wage Act 1998	*To monitor the impact of the national minimum wage* and *review the levels of each minimum wage rates and make recommendations.*	Includes: *extensive research … commission research projects… carry out surveys…consultation … collect written and oral evidence…fact-finding visits throughout the UK.*	Independent, statutory, non-departmental public body. Nine members drawn from a range of employee, employer and academic backgrounds.

[37] Brooks and Denham (2005)
[38] Help the Aged (2002)
[39] Liberal Democrat Party (2005)
[40] TUC (2005)
[41] See www.lowpay.gov.uk

3. Commissions using prescribed policy tools			
Commission	**Aim**	**Activities**	**Structure**
ABI proposal[42] Retirement Income Commission	*To deal with uncertainties about costs and charges,* and to protect *existing saving and good pensions schemes.* To protect consumers and ensure competitiveness.	*Economic regulation …including defining acceptable levels of costs and charges … Monitoring the implementation of the new pensions policy framework ... Keeping the level of employer contributions under review …Promoting saving.*	Standing statutory body with executive powers.
Example organisation			
Monetary Policy Committee[43] Bank of England	*Sets an interest rate it judges will enable the* [Government's] *inflation target to be met.*	Operational independence to use range of prescribed policy tools. To make forecasts and judgements for inflation and output growth.	Nine members – including four external members appointed by the Chancellor. Members meet once a month to set the interest rate. Decision is based on one member, one vote.

Both a regular or permanent commission could have the benefit of adding more pensions research to debates, helping to ensure better knowledge and future thinking about the implications of pension policy and options for change. But it would not guarantee stability. It may even have the opposite effect: a body charged with making recommendations every few years may feel it necessary every time to 'fiddle' with the system.

However a commission is designed, devolving responsibility to an unelected, independent body would need to be balanced with safeguards for political accountability. The importance of this would depend on how much power a commission has to affect pensions policy. A commission that can apply policy tools, such as raising the state pension age, would need to be subject to very high levels of accountability and transparency, as it would have a direct impact on Government spending.

[42] ABI (2006)
[43] See www.bankofengland.co.uk/monetarypolicy/overview.htm

Cross-party agreements

Another way to improve stability is for the basic features of pension system design to be agreed by political parties in such a way that it would be very obvious if they were in danger of being broken.

For example the 'Accord' as used in New Zealand includes general principles for a pension system, as well as the minimum and maximum level of the state pension as a percentage of National Average Earnings. If the government of the day contemplates any change to the state pension, it has to consult formally with any party who signed the Accord first[44]. Any change to the key parameters would therefore be highly transparent.

Such a mechanism could be a way of reducing the risk of sudden, hidden policy change on the basic state pension structure while still enabling political debate on wider pensions policy, such as private pensions. It could help the electorate to feel politicians are committing to new ways of developing trust. However, it could be argued that with sufficiently good political and technical commentary on pensions policy, any change would be put into the public domain quickly, so that a special mechanism like an Accord is not needed.

Long-term system design features

Two design features that may help to keep a pension system stable are examined here: a Reserve Fund and pension system simplicity.

A number of countries have sought to achieve stability by establishing a Reserve Fund in which part of the contributions to state pensions are invested[45]. In essence, part of what would otherwise be a Pay As You Go system is invested, largely in equities, for long-term return. While such funds are often controversial, once they exist then they are likely to be around for a long time. Some may interpret this as helping to support long-term stability of the system, although it would be possible to redesign system features while maintaining the Fund.

Many pension experts believe that the best mechanism for ensuring stability is to make the pensions system, and pensions policy, as simple as possible, so that any changes cannot be done without everyone noticing[46].

The current system, conservatively, is described by around 100 parameters, that is, to work out future entitlement to state pensions (including Pension Credit) you need to know around 100 different things about an individual's circumstances, as they change over the individual's life. These parameters can change by a change in circumstances (e.g., divorce or bereavement) or by annual Budget decisions (e.g., the current rate of Pension Credit benefit) or by a Government policy decision (e.g., State Second Pension replacing SERPS).

[44] New Zealand Superannuation and Retirement Income Amendment Act 2005, Part 3 section 73
[45] Pensions Commission (2005) p. 167 and GOA (2005)
[46] For example, see NAPF (2004) and O'Connell (2004 SPR:CR)

These varying parameters accumulate to a very complicated, ever-changing system, which is why, even when a forecast of what an individual's state pension might be at age 65 is available, it is very difficult to work out why it is so or how it might change as the individual gets closer to 65. There is therefore very little public engagement possible with the pensions system, and changes to parameters are noticed only when very obvious: the classic example is the public campaign to have the value of the Basic State Pension linked to earnings rather than prices (easily understood) compared with the almost un-noticed reduction in accrual rates to SERPS (not understood by pension non-experts).

But absolute simplicity is of course impossible, and flexibility is good when the environment changes unexpectedly. So design features that give some certainty and transparency to individuals, while retaining simple flexibility could be expected to help keep the system stable. For example, instead of setting just one method of indexing the state pension (which tends to polarise into a debate on earnings vs. prices), the level of the state pension could be mandated to be within a band defined by percentages of national average earnings, with mandatory increases each year at least linked to prices.

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This chapter has summarised the context and outcomes of this project. It is clear that there is consensus on the general shape of a pensions solution, and support for ways to keep a consensus as a way of promoting stability in pensions policy for some time.

2. What should be the balance between state and private pensions?

Both state and private pensions are and will be important sources of retirement income. The Government has a long-term target of switching pension provision from 60% state and 40% private to 40% state and 60% private.

However, it looks unlikely that the "40:60" target will be achieved in future. The state is likely to remain the majority provider for many people as only the state can guarantee poverty prevention. The current system needs to improve to do that more effectively.

Why "40:60" and what does it mean?
In December 1998 the Government announced a target of switching the proportion of pension income from 60% state and 40% private to 40% state and 60% private.

This has subsequently been adopted as a Public Service Agreement (PSA) target - the specific targets that must be met in return for the resources provided through the Government's Spending Review[47]. It therefore remains in the objectives of the Department for Work and Pensions (DWP).

The PSA target sets a timescale for the change – 50 years - with an intermediate target of moving to a 50:50 share of provision from state and private sources by 2025[48].

This long-term target of switching from the state to private provision was stated as allowing the Government to *meet the demographic challenge of much higher numbers of pensioners whilst delivering a decent income in retirement for everyone and maintaining public expenditure at prudent levels*[49].

Other than this statement, no analysis was published as to whether a shift from state to private provision would be desirable (in macro-economic, micro-economic or social policy terms), or why private provision is preferable. Full privatisation and full state provision were ruled out in 1998, but there was no examination of the appropriate balance between them[50].

[47] DWP (2005 DR)
[48] DWP (2005 DR)
[49] DSS (1998) p. 32
[50] DSS (1998) p. 30

What counts as state provision and what counts as private provision?
The distinction between 'state' and 'private' refers to the delivery of the pension rather than the how the pension is paid for. For this target, public sector pensions, contracted-out pensions and tax relief on private pension contributions are counted as being 'private', when in fact they are money from state resources.

The definitions used by the DWP in the "60:40" ratio calculation are:
- **Pension income from the state** includes all pension and benefits delivered by the state to older people[51]: retirement pensions, disability benefits and income-related benefits such as Pension Credit.
- **Pension income from private pensions** includes occupational, personal pension and investment income, the latter including income from annuities, property, stocks and shares and savings[52].

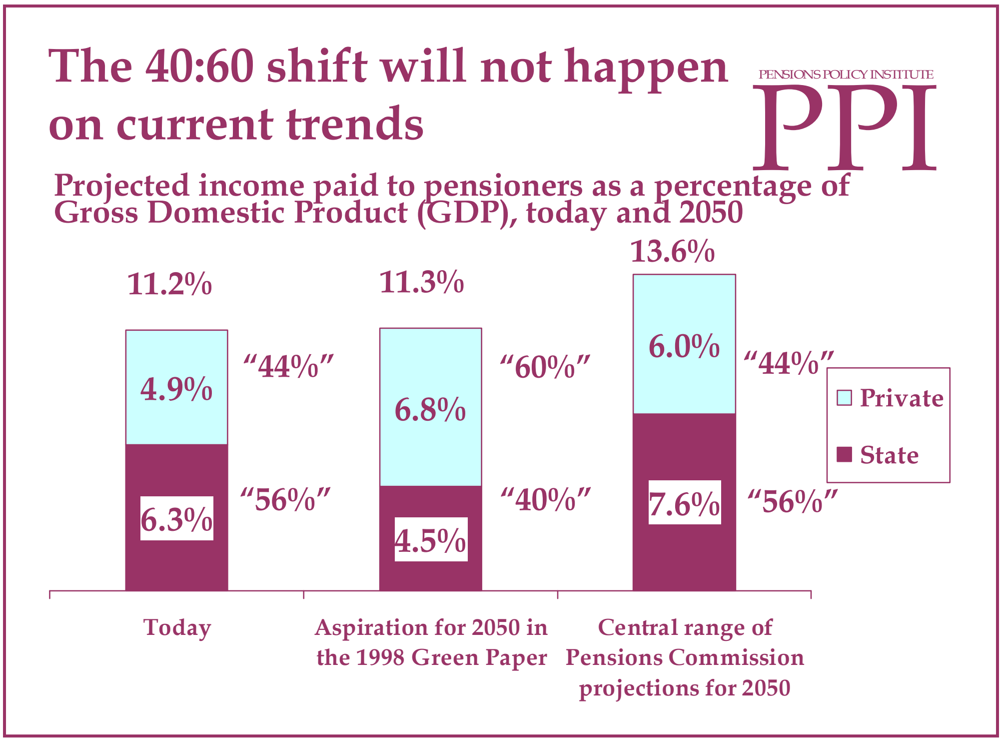
Under this definition, the proportion of pension income derived from the state in 2004/5 was 56%[53]. The balance has not changed significantly in recent years[54].

The shift from "60:40" to "40:60" is not likely to happen
Macro-economic analysis suggests that the "40:60" target is unlikely to be met in future because (Chart 3):
- *Future state spending has increased.* In October 2003, the Pension Credit was introduced, which increased future state spending on pensions. Projections of state spending have also increased as assumptions on life expectancy have been raised upwards, so increasing the projected number of people over state pension age in future.
- *Income from private sources is not expected to increase as significantly as it would need to.* Since 1998, the outlook for private pension provision has changed. New data suggests that contributions to private pensions are not as high as had been previously thought[55]. Projected increases in longevity and reductions in the long-term rate of return have reduced the expected income derived from contributions. Occupational pension provision is declining[56].

There may be other sources of private income that are not included here that help tip the balance more towards private income, such as non-pension saving and people working to older ages than they do currently. But it seems unlikely for non-state income to grow to as much as 60% of the total.

[51] In this context people over state pension age
[52] Although this includes non pension saving, this paper continues to refer to this total private provision as 'private pension income', for brevity
[53] PPI analysis based on DWP (2006 PI)
[54] PPI (2005 PF) Table 4
[55] Forrest et al (2004)
[56] Curry and O'Connell (2004), Pensions Commission (2004)

Chart 3[57]



How much would individuals need to save to meet the "40:60" target?
Moving from macro to micro-economics, by analysing the likely state and private pension outcomes for illustrative individuals, the "40:60" target looks achievable for only a small segment of the population.

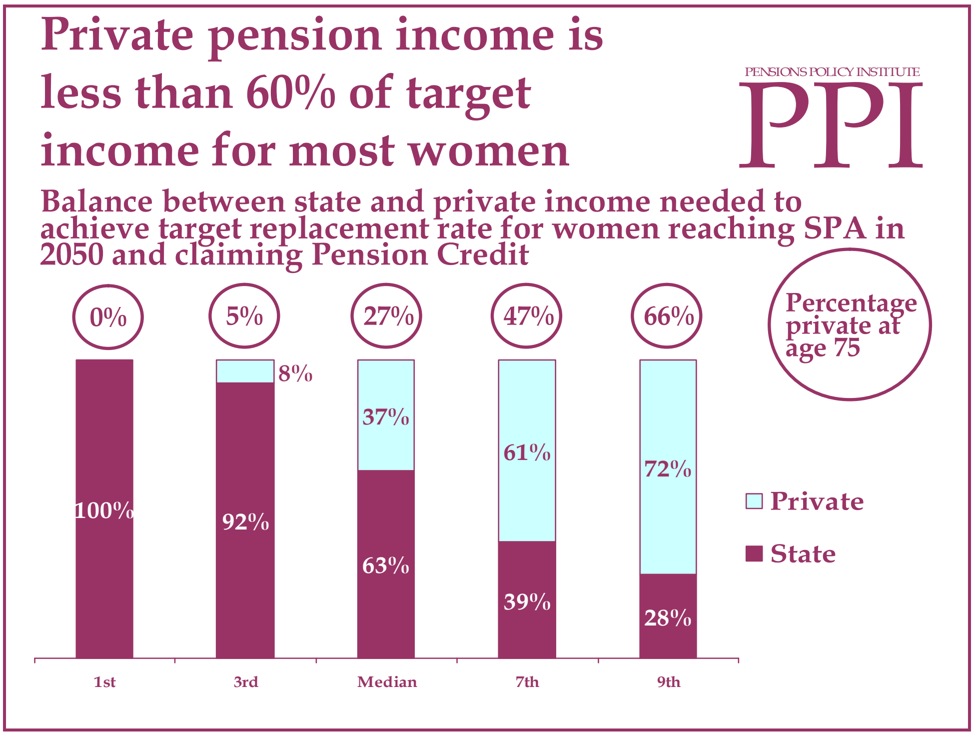
Fewer than half could achieve "40:60"
Given the level of state pension, fewer than half of women (Chart 4) and around half of men could ever achieve "40:60" in favour of private provision, even if they save enough to reach target replacement rates.

Total income desired at state pension age has been taken in this analysis to be the 'benchmark' Target Replacement Rates (TRR) assumed by the Pensions Commission[58].

Contracting-out makes some difference, assuming contracted-out pension is counted as 'private' income. If the individuals in Chart 4 were contracted-out, some of their state pension would instead be counted as 'private income'. However, the amount of contracted-out income is a small proportion of the total (for people at mid-high earnings levels), so the overall picture is not too much changed[59].

[57] PPI calculations based on DSS (1998), HMT (2005) and Pensions Commission (2005) p. 63. Income from private sources based on the central point of the range specified by the Pensions Commission on the basis of current policy continuing.
[58] Pensions Commission (2004) p. 143. These are based on current actual replacement rates, rather than a specific definition of adequacy.
[59] See PPI (2005 SEM 1) p. 16

Chart 4[60]



Actual savings patterns fall short of required for "40:60"

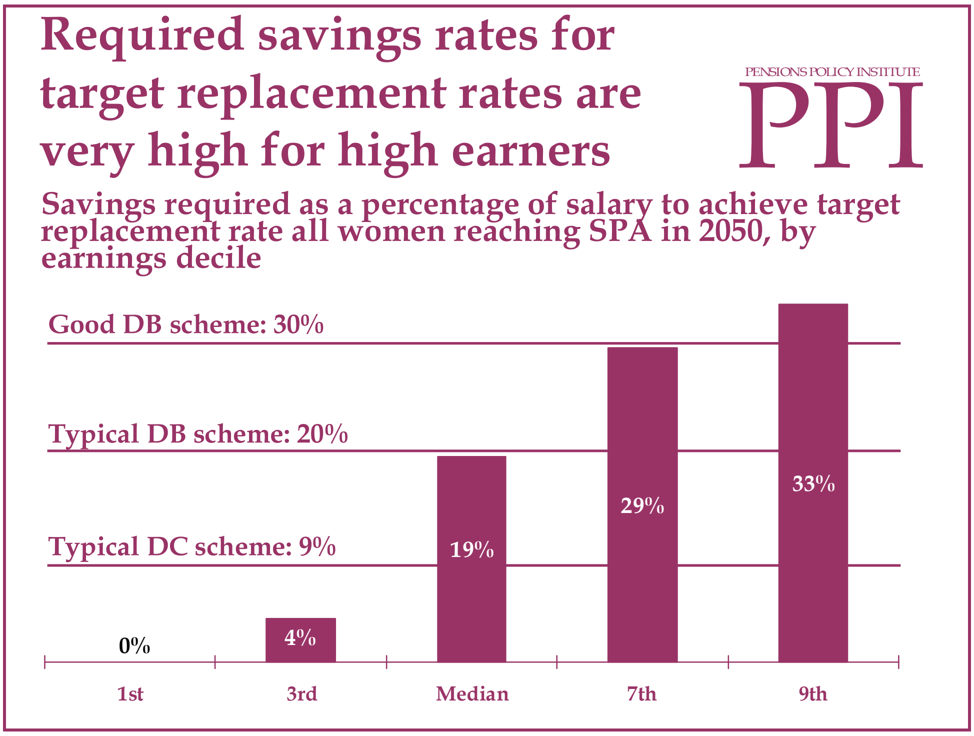
Actual saving patterns suggest that people would save less than required to meet the TRR condition, so that in practice even fewer would reach the "40:60" goal. High earners would need persistent membership of a good occupational pension scheme to achieve the Pensions Commission TRRs. (Chart 5).

- For women, if saving starts at age 40[61] and continues until age 65 the implied required savings rates are close to or above the value of a typical contribution to a standard DB scheme for all of the examples who earn above median earnings. The savings rates at the higher earnings levels (29-33% of salary) would be obtainable only from persistent membership of a generous occupational scheme, or significant non-pension saving on top of a good pension.
- For men, the required savings rates for the top 70% of earners are at the level of a generous occupational scheme.

[60] PPI analysis. Deciles points to divide the earnings distribution into 10 groups each of which contains the same number of workers, so for example, 30% of female employees earn below the third decile of the female earnings distributions and 60% earn below the 6th decile.

[61] This is the central case, based on general patterns of pension saving (see, for example, and O'Connell (2004)).

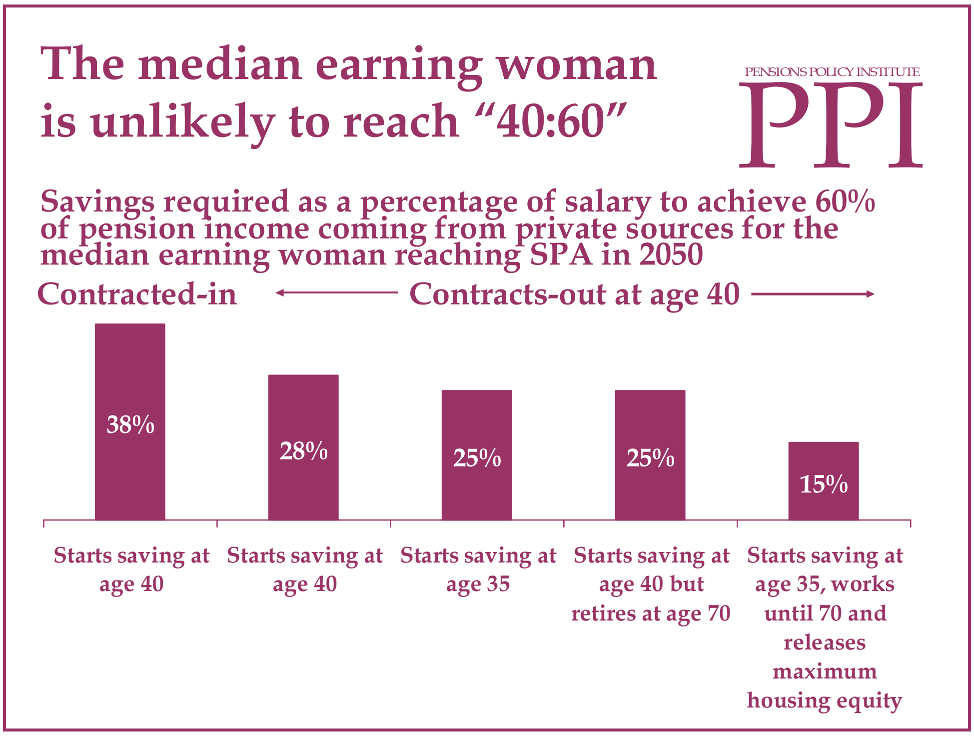
Chart 5[62]



Taking Charts 4 and 5 together suggests that "40:60" might be achieved by higher earning people, especially if contracting-out is counted as private income, but it is hard to see how actual patterns of saving at the individual level can ever combine to achieve "40:60" in aggregate. As an illustration of the size of the task, if a median-earning woman started persistent saving at age 35, contracted-out at age 40, worked until age 70 and released maximum housing equity she would 'only' need to save 15% of income each year to achieve "40:60" (Chart 6).

[62] PPI analysis. DC contribution rates are from GAD (2005 OPS). DB contribution rates are derived from O'Connell and Silver (2005). They all include both employer and employee contributions and contracted-out rebates to contracted-in schemes. The "typical DB scheme" is a 60ths scheme with a normal retirement age of 65. The "good DB scheme" is illustrative of the most generous DB schemes available: it is a 45ths scheme with a normal retirement age of 60.

Chart 6[63]



Is private provision preferable to state provision?

The presumed rationale behind the switch is that an increase in the amount of private saving towards pension provision is desirable. This means that to achieve the "40:60 switch", some change to the current pension system would be required. But is this a desirable outcome?

Setting the appropriate balance of state and private pension provision requires a consensus view on the merits of private as compared to state pension provision. However, opinion is based on a wide range of perceived strengths of each type of provision (Box 2).

[63] PPI analysis. Equity release assumes a median house value of £150,000, house prices grow in line with average earnings and a maximum amount released of 20% of the house value.

Box 2: Perceived strengths of state and private pensions[64]

Perceived strengths of state pensions:

1. State pensions can be redistributive towards those on low incomes and people out of the workforce in a way that private pensions cannot.

2. State pensions have lower expenses than private pensions. The expenses of private pensions can be very significant, particularly for those on low incomes. The administration costs of means-tested benefits such as Pension Credit are high but these are not borne only by those who claim them.

3. State pensions are not subject to investment risk and longevity risk is not borne by the individual as much as under Defined Contribution schemes. This is especially important for those on low-mid incomes who cannot bear much risk.

4. State pensions do not require individuals to make a choice about a system they do not understand. Such choices in private pensions have an administration and regulation cost.

Perceived strengths of private pensions:

1. Private pension schemes allow more flexibility and choice, both when contributions are made and in what pension is provided.

2. Private pensions encourage a sense of ownership. This could lead to better understanding of their pension provision and encourage people to make more pension contributions[65]. Ownership means that people have more of a stake in the economy working well.

3. Private pensions should be an important part of labour market competition. Employers use private pensions to attract new staff and employees use them to discriminate between employers.

4. Private pensions are easier and quicker to change and reform.

The 'right' balance between state and private provision

The state is likely to remain the major provider for many people as only the state can guarantee poverty prevention.

A switch to a high level of private provision may not be desirable for everyone. The 'right' balance depends more on structural social policy issues at the level of the individual than macro-economic considerations. Such decisions should include the fairness of the pension system, gender equality and individual ability to take on risk.

[64] As synthesised from the discussion in Seminar 1

[65] Although there is no evidence for this, it is a strongly held view of many industry practitioners

This view is developed as follows[66]:
1. The total resources available to the retired population are likely to be similar under different mixes of state or private pension provision.
2. The investment return potential of private pension saving does not always boost ultimate pension income.
3. Individual ownership may be more important in growing the resources available in the economy than whether a pension is funded or unfunded.
4. Flexibility in private pension savings increases the variability of pension outcomes for individuals.
5. Although most people agree that both state and private pension provision should be strong, there is no consensus on how state and private pensions should mix.

This argument provides support for the "40:60" measure being used as an interesting indicator of outcomes over time, but not for the setting of a target outcome.

The key driver of the real incomes of future pensioners is growth in economic output and not the extent to which pensions are funded. The evidence suggests that funding can have a beneficial effect on output, but that effect should not simply be assumed and may not be very large[67].

There are a variety of other ways to increase economic output, including increased labour market participation and an increased retirement age.

Addressing the balance between state and private pensions is not the right place to start the debate. Only when state provision is designed to adequately prevent poverty can we start addressing how we should provide higher levels of pensions.

The appropriate balance of state and private pensions varies from person to person depending on earnings. It is not feasible for those on low incomes to have 60% of their pension from private sources. People have other priorities for their income other than saving in pensions.

[66] More details on each of these points can be found in PPI (2005 SEM1)
[67] Points raised during the seminar discussions are shown in italics and presented in boxes

Points of consensus

- The main role of the state in pension provision should be the prevention of poverty in later life. However, the current system needs to improve to do that more effectively. Poverty prevention is not guaranteed because of imperfect take-up of Pension Credit.
- Both state and private pensions are important, although there are different individual preferences for policy to favour more of one than the other.
- The appropriate balance between state and private provision will vary from person to person according to earnings levels. It is very unlikely that a low earner would be able to have 60% of their pension income from private sources.
- Working longer is likely to be an important part of resources in later life. The key is to make possible the type of working that people want, for example more part-time and flexible working.
- Growth in the economy is more important for retirement income than the mix of private and public provision. The overall resources available to pensioners would be a similar level whatever the mix of state and private provision.
- Rather than continuing to act as the setting for a target outcome, the "40:60" measure may be more useful as an indicator of trends over time.

3. What should be the role of means-testing in state pensions?

The original paper for the seminar series was authored by Ruth Hancock, Stephen Pudney, Holly Sutherland, Geraldine Barker, and Monica Hernandez. This is a summary by the PPI of that paper.

A significant proportion of UK pensioners rely on means-tested benefits, with up to 50% of pensioners thought to be entitled to Pension Credit. If current uprating policy continues, the proportion of pensioners entitled to means-tested benefits will increase rapidly.

Means-tested benefits are considered to be good because they target resources on the needy. For those who take the opposite view, means-tested benefits are problematic because they suffer from non take-up, they discourage voluntary saving and they are complicated to understand. However, all these views are open to challenge.

Even if the scope of means-testing is reduced by pension reform (as many reform proposals urge) means-testing is likely to remain. There appears to be support for reducing reliance on means-tested benefits, especially Pension Credit, but opinion on how to do this differs.

The role of means-testing in the current UK pensions system
In the UK, the state pays three main types of benefits to pensioners: the flat-rate basic state pension, an earnings-related state pension and means-tested benefits. There are also benefits paid on grounds of disability which are not means-tested.

Pensioners can apply for three principal means-tested cash benefits:
- Pension Credit (PC) provides general income maintenance.
- Housing Benefit (HB) gives assistance with meeting rents and so is available only to those who rent their homes.
- Council Tax Benefit (CTB) reduces recipients' liabilities for the local property-based council tax. It is available to renters and owner-occupiers since both groups are liable for council tax.

PC is specifically for pensioners, although Guarantee Credit (one element of PC) is available for both men and women from age 60 whereas state pension age for men is 65. HB and CTB are also available to younger people but are higher for pensioners than others.

UK pensioners rely increasingly on means-tested benefits[68]:

- In 2002/3 around a third of all pensioners received means-tested general income maintenance and/or help with meeting rent or council tax.
- Pension Credit has increased the scope of means-testing, with up to 50% of pensioners thought to be entitled.
- If current uprating policy continues, the proportion of pensioners entitled to means-tested benefits will increase rapidly.

PC was introduced in October 2003. It consists of the Guarantee Credit (GC) and the Savings Credit (SC). The former replaced the Minimum Income Guarantee which worked along similar lines.

One of the main aims of the SC was to eliminate the 100% effective tax rate caused by the Minimum Income Guarantee – the situation where an extra £1 of retirement income reduces entitlement to means-tested benefits by the same amount. In contrast PC embodies an effective marginal tax rate which in most cases is 40% rather than 100%. However, since PC is taken into account for HB and CTB, recipients of all three benefits still face a marginal tax rate of 91%[69]. This point is not always fully appreciated. Some pensioners appear reluctant to claim PC because they fear, often rightly, that most of it will be taken back in lost HB and CTB[70].

It is useful to think of the means-testing taper as a tax rate on pension savings. Determining the right level of means-testing then depends on what is thought to be the optimal marginal rate of tax on saving. It is not clear what the optimal rate is, but it is unlikely to be zero. The argument that lots of people will be on means-tested benefits, and therefore effectively face a marginal tax on the first bit of saving, and that this shows that means-testing must have gone too far, is simplistic.

Only a minority of current pensioners receive state pension payments which are above the GC threshold for a single person[71]. In September 2004, when the GC threshold for a single pensioner was £105.45:

- Just under a quarter (24%) of recipients of the state pension received £100 or more a week, and only 15% received £110 or more.
- The average payment was £98 a week[72].

[68] See Hancock et al (2005) for source information
[69] Calculated as 0.4 + (1–0.4) × (0.65+0.20). Note that this means that people who fail to claim PC but claim HB and/or CTB will get higher payments of HB and CTB. If they are entitled to both they will only miss out only 9p for every £1 of PC to which they are entitled but do not claim.
[70] Work and Pensions Committee (2005a)
[71] The GC threshold for a single pensioner in 2005/6 is £109.45
[72] DWP (2004 SPSS) Table SP6

In practice, therefore, it is non state pension income that keeps people free of means-testing. This has always been the case but a number of factors have contributed to an increase in the scope of means-tested benefits in recent years:

- The means-tested benefit thresholds were increased substantially in real terms in the period 1999-2001. The largest increases were for younger pensioners.
- Since then they have been uprated annually by earnings inflation while state pensions have risen by less[73].
- The introduction of the more generous Pension Credit brought those with incomes just above the Government's guaranteed minimum income level within the scope of means-testing for general income maintenance (they could already be entitled to Housing and/or Council Tax Benefit).

In introducing Pension Credit, the Government estimated that about one half of all pensioners would be entitled to it[74]. More recently it has said that there is evidence that eligibility for Pension Credit may be less than this[75]. However, if current uprating policies are maintained, it is clear that the proportion of pensioners entitled to Pension Credit will rise rapidly[76].

Arguments for and against means-testing

The standard argument in favour of means-testing is that it targets public resources where need is greatest. Only those with low incomes and (in the UK system) low capital are entitled to them. In contrast all those who meet contribution and/or other conditions (e.g. age) are entitled to receive non means-tested benefits be they millionaires or paupers.

Means-testing entails making trade-offs. Decisions need to be made on issues such as the level of state expenditure, market distortions that may occur as a result, and how best to target resources on the less well off.

The key trade-off is between cost and poverty alleviation. Means-testing is an effective mechanism for targeting limited state resources on the poorest pensioners.

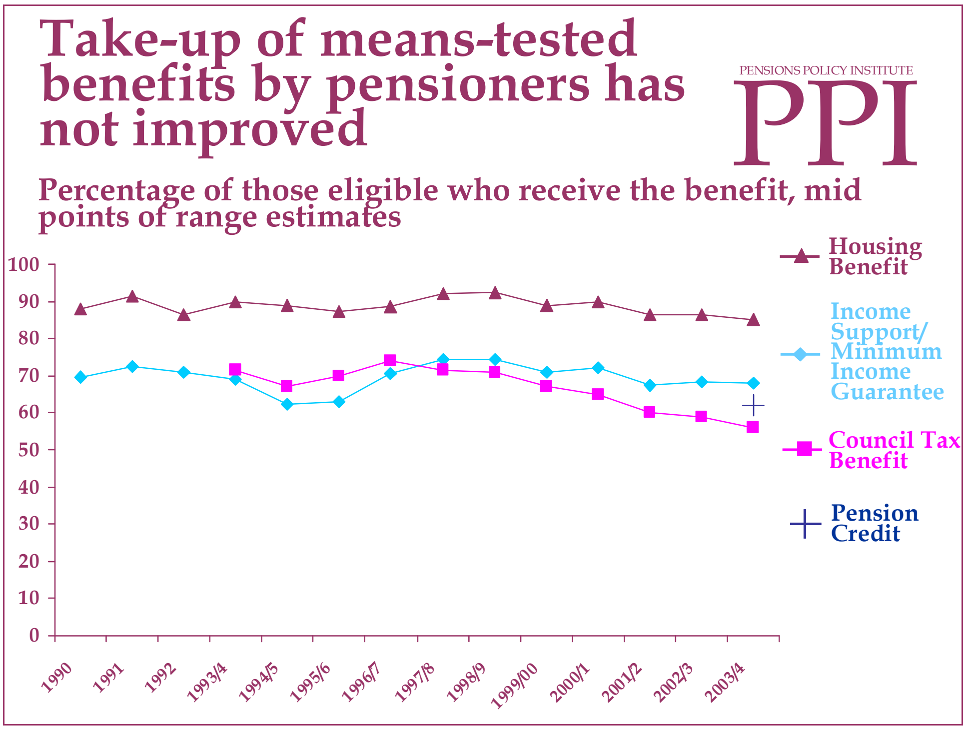
[73] Until 2000 the state pension was linked to price inflation. In April 2000, the low level of price inflation produced an increase of only 75 pence in the basic state pension. The political fall-out led in the next two years to increases in the basic state pension which were greater than the increase in average earnings (Pension Provision Group (2001)). The Government then committed itself to increasing the state pension by price inflation or, if greater, 2.5 per cent (HM Treasury (2002)).
[74] DWP (2001)
[75] Work and Pensions Committee (2005b) p. 2
[76] Emmerson (2005) and Steventon (2005)

Three main criticisms are usually levelled at means-tested benefits:

- They suffer from imperfect take-up (Chart 7). Official estimates are that in 2003/4[77]:
    - Between 62 and 74% of pensioners who were entitled to the Minimum Income Guarantee received it;
    - Take-up of Council Tax Benefit was between 53 and 59%;
    - Take-up of Housing Benefit was highest at between 82 and 88%.
    - Take-up of Pension Credit was between 58 and 66%.

  The estimate of Pension Credit take-up is adversely affected by the low take-up of Savings Credit (Chart 8).

Chart 7[78]



Because of the uprating policy, people become entitled for Pension Credit during their retirement. As more people are living longer, this will become an increasing issue. The problem of low take-up is exacerbated because it is difficult for a pensioner to know when they have become entitled.

[77] DWP (2006 IRB)
[78] DWP (2006 IRB) and earlier issues

Chart 8[79]

Take-up of Savings Credit is significantly lower than take-up of Guarantee Credit

Take-up of Pension Credit for households receiving different types 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%

- Means-testing reduces the return to saving and may therefore discourage voluntary pension and other retirement saving[80].
- Means-tested benefits are complex to understand and costly to administer.

There is a specific trade-off concerning uncertainty, as people do not know how much they will receive in retirement. This makes planning on an individual level very difficult.

Other issues which arise include:
- Whether the existence of means-testing makes it unfair to compel people to save for themselves if that reduces their entitlements to means-tested benefits.
- Whether means-testing is the best way to provide for special (but not necessarily uncommon) and individual-specific needs. For example, the means-tested thresholds are increased for people with disabilities[81]. Housing and Council Tax Benefit are available for low income pensioners and currently provide help with the rents and council tax actually paid by claimants[82].

[79] DWP (2006 IRB). Estimates relate to October 2003 to March 2004, the first 6 months of Pension Credit. Figures rounded to the nearest 10,000. The figures for estimated eligible households show a range because of the uncertainty involved in the calculations.
[80] It also reduces the return to paid work. Note there is no ability to work test for entitlement to means-tested benefits for pensioners. The issue of incentives to work is addressed by Emmerson (2005).
[81] This is despite the fact that non means-tested benefits are available for people with disabilities and are in most cases excluded from assessable income in the means tests for cash benefits
[82] In recognition that HB provides little incentive for claimants to seek cheaper accommodation, an alternative system with fixed rent allowances is being piloted

But some of these arguments are open to challenge:
- Non take-up is another way in which resources are targeted where they are most needed because take-up is higher amongst those with larger entitlements.
- Any stigma associated with means-tested benefits may encourage saving to avoid dependence on them.
- Non means-tested retirement benefits also discourage voluntary saving by reducing the amount of saving needed to achieve a given income level.

On the other hand:
- Non take-up implies that there are costs, including psychological costs, of claiming means-tested benefits. This suggests that pensioners value £1 of income of means-tested benefits less than £1 of other income. So pensioners who claim their entitlements enjoy lower well-being than those on the same level of non means-tested income.

The impact of means-testing on existing pensioners must be considered independently from that likely to be felt by future pensioners. Pension Credit can rescue existing pensioners from poverty when they are no longer able to change their savings and consumption behaviour. Future pensioners, especially women, are most at risk of losing the benefit of private saving because of the means-testing system.

Options and challenges for the future

There appears to be wide scale support reducing reliance on means-tested benefits. Many current suggestions for state pension reform have been aimed at increasing the number of pensioners who have state pension rights which take them (and keep them) above the Guarantee Credit level. Combined with abolishing the Savings Credit element of the Pension Credit, such a policy would reduce the numbers of pensioners subject to means-testing for general income maintenance. But it would still leave many within the scope of Housing or Council Tax Benefit unless these two benefits were made significantly less generous.

A higher Basic State Pension, at the level of the Guarantee Credit, would raise everyone above the poverty line and would eliminate many of the disincentives to private saving.

However, because of features of the current pension system, transition to a less means-tested system will be difficult.

The UK State Earnings Related Scheme (SERPS) gave more state pension to people on high incomes. The current State Second Pension (S2P) is intended to move towards a more flat-rate distribution, but this will take some time. Targeting additional resources to the poorest pensioners is therefore complicated by there being in place a system which channels more resources to richer pensioners.

It may be that there are other ways of targeting that can be more easily implemented. Increasing the state pension age, encouraging greater participation in the workforce and affluence testing are three such ways.

One seemingly attractive alternative to target resources on the poor is through affluence testing, where the state withholds state pension from, say, the richest 20% via the taxation system rather than making the poorest 80% have to claim it. However, affluence testing is likely to be politically controversial. Those most affected are likely to be those who are the most politically articulate. For example, the 'Surcharge' affluence test in New Zealand was controversial and eventually abolished. Further, as affluence testing is targeted on a small group, it is not likely to raise a great deal of money to redistribute to the larger group.

Even with a policy which ensures that more people retire with state pension rights which free them from means-testing for general income maintenance, few see this as a route for abolishing means-testing altogether. There would still be a need for a safety net for those who had not accumulated sufficient pension rights to take them, and keep them, beyond the scope of means-tested benefits throughout retirement. In this context the problem of non take-up seems likely to remain the biggest challenge for reforming the current means-testing system.

Recent research[83] suggests that the process by which benefits are delivered appears to be an important influence on take-up. It may be that the solution lies in streamlining the process of claiming and delivering means-tested benefits rather than in simplifying the rules.

There are ways to design the system to reduce the stigma associated with means-testing and therefore to increase take-up. One way would be to make the application process automatic, for example, with a claim for one benefit, such as Pension Credit, automatically triggering a claim for another benefit, such as Council Tax Benefit.

Points of consensus

- Means-testing is an effective short-term method of targeting resources to the poor.
- The increasing extent of means-testing means that it is a politically unsustainable policy in the long term.
- This is partly because it is a generally disliked policy but also because it forces a number of difficult trade-offs related to how the state can best use its limited resources.
- Because of this, means-testing should be considered against alternative ways to target state resources, for example, by raising state pension age or through affluence-testing.

[83] See Hancock et al (2005) Annex 1

4. Should state pensions be universal or contributory?

It is widely recognised that the state's main role in pension provision, that of poverty prevention, needs to be improved[84]. Reform proposals have concentrated on three different ways to improve the Basic State Pension (BSP): improve the coverage, increase its level, and maintain its relative value by indexing in payment to earnings. Reforming just the BSP level and value has less impact if inadequate coverage means that there are people who are still not eligible to receive the full benefit.

In order to assess options for improving coverage, the PPI investigated whether the eligibility criterion for the state pension should be on a contributory basis or on a universal, or residency, basis[85]:

- Under a contributory system, eligibility for state pension is decided by how many National Insurance contributions you have paid or been credited. Partial pension can be paid for less than the full number of years.
- In the residency system, eligibility is determined by how long you have lived in the UK.
- A third option might be to reduce the number of qualifying years needed for a full pension in a contributory system, from 44, to say, 20 years.

The work-based nature of the BSP means that low earners, part-time workers and carers are particularly susceptible to receiving less than the full BSP. As women predominate in these groups, gender equality is now a critical part of pension reform. Half of women over state pension age receive the full BSP, compared to 9 out of 10 men[86].

The current contributory system could be modernised to achieve better its objectives. A residency-based system has always been considered to be a feasible alternative, as it would provide better coverage than the current contributory system and is seen by many to be fair and simple to understand. However, there are concerns that it is too radical, so reforming the current contributory system may seem like the less risky option.

[84] See PPI (2005) Briefing Note 18
[85] Throughout this Chapter 'universal' is taken to mean that the pension entitlement is based on the number of years than an individual has been resident in the UK. The residency requirement could cover a large or small number of years, and be based on residency before or after state pension age.
[86] House of Commons *Hansard* 17 March 2005 Column 425W

How has the contributory system evolved in the UK?
The principal objective behind the UK's contributory pension system has changed from Beveridge's 1940s idea of 'adequacy for all' through the reforms of the 1970s which placed more emphasis on accruing rights as a reward for work.

'Adequacy for all' as envisaged by Beveridge[87] meant that all those who were in work and able to do so would contribute, and all members of society would receive a retirement income sufficient to eradicate pensioner poverty. However, this ideal was compromised from the start, and means-testing expanded because of financing difficulties.

Due to an inadequate state pension and patchy occupational pension saving, debate grew through the 1950's, focused on how the state pension related to pre-retirement earnings. This culminated in the introduction of the State Earnings Related Pension Scheme (SERPS) in 1978. The concept of an earnings-related pension significantly broke away from Beveridge's ideal of flat-rate contributions and universal, flat-rate benefits.

Although the contributory system was retained and supported, the principle objective was changing, becoming ever more linked with the ideas of 'getting out what you put in', and 'accruing rights' based on a 'reward for work':

- **Accrued rights:** *The contributory principle… gives people confidence that, through the payment of their contributions, they can establish a right to benefit that will be honoured when they are unable to work and when the time comes for them to retire*[88].
- **Reward for work**: *The contributory principle…governs the conditions on which benefits are payable and ensures that benefits only go to those who have sustained membership of the scheme*[89].
  … since the ordinary man or woman would rather pay £1 a week as an insurance contribution than as income tax, and so feel that he or she had earned their own pension, the contributory principle was right…[90]

Is the current UK pension system contributory?
The current system is only partially successful at achieving the three contributory objectives that have developed since the 1940's:

- **Adequacy for all** has been lost as there are unequal outcomes, and many people not accruing a right to the BSP each year.
- The idea that the contributory system protects the expected value of **accrued rights** is hard to substantiate as the National Insurance Fund does not operate in that way.
- The contributory pension as a **reward for work** is becoming less true, with a weakening link between contributions made and benefit received.

[87] Beveridge (1942)
[88] DHSS (1971) para 19 p. 7
[89] DHSS (1971) para 19 p. 7
[90] Jay, *Change Fortune,* pp. 250-1 in Timmins (2001) p. 194

Adequacy for all

'Adequacy' refers to both the level of benefit and the number of people covered. The objective of adequacy for all has been lost as:

- The level of the current contributory pensions is below that defined to be adequate by reference to the minimum income from means-tested benefits. On average for people now reaching state pension age, men receive 24% NAE and women 15% NAE[91] from the BSP and S2P. The Guarantee Credit element of Pension Credit aims to ensure that all people over state pension age[92] receive a minimum income of 21% NAE (£109.45 pw for a single person in 2005/6). However, imperfect take-up means around 30% of all individuals entitled to Guarantee Credit are currently not claiming (around 1.4 million individuals)[93].
- There are unequal outcomes, with 4.5 million people not accruing a right to the BSP each year (Chart 9).

Gaps in coverage mean that people who might be judged to be 'deserving' do not accrue a contributory pension. Overall, of the 4.5 million people not accruing BSP, 2.2 million are in identifiable situations which some may see as 'deserving': working, caring, studying or a combination of these[94].

There are a further 2.3 million people not accruing BSP for other reasons, and it may be that half of these are also in situations that some might consider 'deserving'. For example, people who are unemployed but not receiving an unemployment benefit, or sick or disabled and not receiving a disability benefit[95]. Most of the remaining 'undeserving' group are looking after the home (but without caring responsibilities) or retired[96].

[91] DWP (2005 SPSS), including contracted-out equivalent
[92] Over age 60 until 2010 when an increase in the age of eligibility to 65 starts, to be completed by 2020
[93] PPI calculations based on DWP (2006 IRB)
[94] PPI analysis based on the Family Resources Survey 2003/4. See PPI (2005 SEM3).
[95] This could be because they do not have a good enough contributory record, they may not meet all the criteria for a benefit, they have other income to live on, or because a partner is in work or claiming benefit
[96] For men this is retired and below 60 as any man aged 60 or older automatically receives a credit to the BSP

Chart 9[97]

4.5m people do not qualify for a contribution to BSP each year

PENSIONS POLICY INSTITUTE PPI

The number of working age people (16 to state pension age) who have accrued a qualifying year for the BSP by method of accrual (UK, 2003/4)

	Number of people (millions)		
	Qualifying through earnings	Qualifying through credits, including HRP	Not qualifying
Men	13.5	3.7	2.0
Women	10.3	5.0	2.5
Total	23.9	8.6	4.5
Total as a % of working age people	64%	23%	12%

Recent Government projections suggest that men and women reaching state pension age in 2030 will receive an average of 95% of the full BSP[98]. The projections assume that younger women (aged 40 - 44 now) who have been more likely to work than their predecessors and have benefited from HRP when looking after children do not have large gaps in contributions in later life.

This is far from certain, with increases expected in providing care in older ages and the existing gaps in HRP and credits for carers. If women of this age qualify for fewer than 20 of the possible 23 extra years of BSP before reaching SPA, average entitlement would fall below 90% of the full BSP[99].

Accrued rights

The idea that the contributory system protects the expected value of accrued rights is hard to substantiate as the National Insurance Fund (NIF) does not operate in that way. The NIF is not a perfectly ring-fenced fund in which contributions are hypothecated to pension benefits. The contributory system provides less protection for the expected value of accrued rights that might be believed to be the case. In fact, the contributions give right to a unit of benefit but the value of that unit can be changed by legislation.

[97] PPI estimates derived from DWP (2006 CQY). The chart shows entitlement only in one year but the BSP received depends on lifetime history. Figures rounded to the nearest 0.1 million and have been updated since the original Seminar paper.

[98] DWP (2005 WP). Previous projections showed women reaching SPA in 2030 receiving an average of 87% of full BSP.

[99] PPI analysis based on DWP estimates. See PPI (2006) Briefing Note 24.

It is…the words "insurance" and "contributions" which suggest an analogy with a private pension scheme. But, from the point of view of the citizens who contribute, national insurance contributions are little different from general taxation which disappears into the communal pot of the consolidated fund. The difference is only a matter of public accounting.[100]

A reward for work

The contributory pension as a reward for work is becoming less true, with a weakening link between contributions made and benefit received. The idea that the state pension should be a reward for work was enhanced by SERPS, which gave more contributory pension to people who had earned more.

This feature is now being gradually withdrawn. The successor to SERPS, State Second Pension (S2P), introduced in 2002, provides a more generous pension for people on low to moderate earnings than SERPS did. Over time, S2P will become even less earnings-related if current indexation plans are maintained[101].

The effect is that over the next 50 years, S2P will become essentially a flat-rate benefit, so that the same pension is accrued by people of different earnings and the same contribution record. This means that eventually the contributory pension system will no longer reward high wages.

This does not mean that there is no longer any reward for work in the contributory system. As benefits are linked to contributions paid while working, the system is work-based. However, because of the increasing use of credits, this type of 'reward for work' is also declining.

Why has a universal pension been considered as an alternative?

The basic objective of the residency or universal model is to give every person over state pension age who qualifies by a residency criterion the state pension benefit, emphasising the 'all' in 'adequacy for all'.

There are different ways in which a universal pension could work, but the objective is similar to the original Beveridge concept of 'adequacy for all'. Different models are used around the world[102]. For example, in Denmark and the Netherlands it is part of a multi-tier state system and in New Zealand it is the only state pension.

[100] Lord Hoffman, House of Lords Opinions of the Lords of Appeal for Judgement in the Carson case, [2005] UKHL 37, 26 May 2005, para 24

[101] The Lower Earnings Threshold (LET), which marks the upper bound of the flat-rate part of S2P, is currently indexed to earnings. The Upper Earnings Limit (UEL), which marks the maximum earnings on which benefit is accrued, is indexed to prices. Over time, assuming earnings grow faster than prices, the LET catches up with the UEL.

[102] See PPI (2003 SPM) for more details of how other countries are placed on the spectrum between universal and contributory

Two detailed proposals have been made for the UK:

- NAPF[103]: *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. This report considers a Citizen's Pension of at least £105 a week in 2004 terms* [£109 in 2005 terms], *indexed to earnings, as this is the current minimum level of income a person over pension age would have through Pension Credit.*
- Pensions Commission[104]: *Our preferred way forward would therefore build on the present two-tier system... Make future accruals of BSP rights individual and universal. (By individual we mean each person accrues entitlement in their own right rather than through their spouse. By universal we mean based on residency rather than contribution records or eligibility for credits.)*

The universal pension has been considered as an alternative to the contributory pension before in the UK, but the preference has been to keep the contributory system. In the 1970s, New Zealand's Citizen Pension was considered in light of UK reforms that culminated in the introduction of SERPS. It was thought that the universal pension was administratively difficult compared to a contributory system, and not to offer any obvious other benefits.

Recognising that state pension reform is now needed in the UK, and with an emphasis on gender equality, the contributory vs. universal debate has become more active today. The New Zealand system is often held up in comparison.

In her speech in Seminar 3, Susan St John made the following points regarding the New Zealand pension system[105]:

… the New Zealand model for retirement incomes … comprising a flat-rate taxable universal pension … at age 65 based on residency, supplemented by voluntary unsubsidised private saving. The pension is non-contributory so that unpaid and paid contributors to society, be they homemakers or brain surgeons are treated the same. Even if there has been no history of paid work at all, no-one is excluded on this basis. Coverage is almost complete, with just a few choosing not to receive it or failing to qualify on residential grounds.

It is not just that it is very simple, but it is also very effective in achieving a decent share of income for everyone in retirement, regardless of their former attachment to the paid work force. It is set so that it cannot fall below 65% of the net average wage for a couple, with higher rates for single and living alone. As a result, pensioners have largely fallen out of the poverty statistics.

[103] See NAPF (2004) for details on how a universal pension could work, including measuring residency, costs and distributional effect and transition practicalities

[104] Pensions Commission (2005) p .10

[105] Susan St John (2005) speech, Seminar 3, *What can the New Zealand experience of universal pensions offer the United Kingdom debate?*

In New Zealand, another attraction of the universal pension is that entitlement is on an individual basis. This is again excellent for women in a time of changing social arrangements including more divorce, widowhood, living alone and co-habiting arrangements. Incomes between men and women are much more equal in retirement as a result. Women live longer on average, so getting a gender neutral pension is another plus. The net present value of the pension at age 65 is a huge capital sum, far outstripping other financial or housing saving for the average woman.

Entitlement to New Zealand Superannuation (NZS) is for each individual. NZS is often referred to as "65% (of National Average Earnings) at 65". This is because each eligible individual in a couple receives 32.5% of NAE. An eligible single person living alone receives a higher amount (42% of NAE).

What arguments are made now for contributory and universal?
A universal pension has support as it is simple and inclusive (Box 3).

Box 3: Reasons put forward in support of a universal pension in the current UK debate

1. **Simplicity**: *We believe the State would offer greater clarity via a single, State pension for all, linked to earnings, based ideally on a clear residency test….Communicated regularly, this structure would give much more clarity to consumers about what the pension 'promise' is from the State…* [106]
2. **Less pensioner poverty**: *There seems little reason to operate a complex accounting system to track NI contributions and credits over each person's working life in order for them to qualify for a full or partial basic state pension which in any case will be supplemented by means-tested benefits…We therefore recommend that the basic state pension should be paid on the basis of citizenship rather than contribution record*[107].
3. **Every individual would be treated fairly** in the sense that the same state pension would be received regardless of life history, and without making judgements about which circumstances 'deserve' a credit: *It would be desirable to address some of the gaps and inequities which exist among today's pensioners as a result of the past operation of the contributory system. The best way to do this in a targeted fashion and within tight medium-term public expenditure constraints would be to make the BSP universal in payment above a specific age, such as 75*[108].
4. **Cheaper to administer: …** *44 year histories of National Insurance contribution records would not need to be so detailed and accrued benefit calculations would no longer need to be updated annually…*[109]
5. **Future state pension expenditure can be planned with more certainty**: *The cost of* [a universal pension] *is a direct function of the number of older people…so sensitive to demographic changes only….. In the UK system there are … major areas of future cost uncertainty…*[110]

[106] Aviva/Norwich Union (2005)
[107] House of Lords Select Committee on Economic Affairs (2003) para 8.10
[108] Pension Commission (2005) p .10
[109] NAPF (2004) p. 7
[110] O'Connell (2004 CPNZ)

A recent public attitudes survey found strong support for the principles of a universal pension[111]:

- Over half the respondents supported the view that everyone should receive a flat rate of state pension (rather than the state pension being earnings-related).
- 80% of respondents agreed with the statement that "women should get the same state pension as men, even if they stayed at home instead of going out to work".

Linking contributions and pension benefits to work still has support, despite some uncertainty as to what that means in practice (Box 4).

Box 4: Reasons put forward in support of a contributory pension in the current UK debate

1. State pension benefits should be linked to contributions paid: *'National Insurance' is still a good brand name….There is much to be said for a system that conveys this idea* [of redistribution across people's lifecycles.] *Given the imperfection of the system, this is close to saying that the system is a myth, but a useful myth for the population to believe in*[112].

2. Accrued rights prevent political manipulation: *The citizen's pension would be set at an arbitrary level by the government of the day. At any time, pensioners, who are forming an increasing proportion of the electorate, could vote for its increase*[113].

3. State pension benefits should be a reward for work: *The government should provide a contributory or credit-based flat rate non-means tested first tier pension at a level which aims to ensure that nobody who has worked, undertaken unpaid caring duties during their working life, or has for some other good reason undertaken little or no paid work, should be faced with absolute poverty in retirement*[114].

4. Coverage can be extended by widening the eligibility criteria: *We want to reform the way the contributory system works to help the many people who at present are not able to build up a contributory basic state pension because they are low earners or because they take career breaks to care for children or sick relatives*[115].

5. A residency eligibility criterion might not be straightforward: *There are a number of issues which need to be considered before full-hearted support is given to* [a Citizen's Pension]… *'who is a UK citizen? In an increasingly open EU labour market when would it be fair to grant a full UK BSP to those who had worked or lived for only a short period in the UK?*[116]

6. Ideological attachment: *Maybe it's just because I'm a Conservative that I'm inclined towards reforming the contributory principle rather than abolishing it*[117].

[111] NAPF (2005) p. 5
[112] Hills (2004) pp. 353-4
[113] Booth and Cooper (2005) p. 28
[114] SPC (2005)
[115] Conservative Party (2005)
[116] ACA (2005)
[117] Conservative Spokesman on Work and Pensions, David Willetts, in a speech at IPPR on 13 December 2004

Public attitudes to the contributory principle are thought to be generally positive overall, but research on this reflects that[118]:

- The public tend not to know or understand how the contributory system works.
- The public like National Insurance contributions (NICs) because they believe that NICs fund the NHS.
- A perceived willingness to contribute more in NICs than in taxation has rarely been tested, as they are compulsory.

The current system could be modernised
As the contributory system is not achieving its objectives, ways to modernise it to deliver better against the contributory objectives have been proposed. The main issue for men is that self-employed people are currently outside of S2P, although inside BSP. This could be addressed by making the S2P eligibility criteria more like the current BSP criteria – and the Pensions Commission suggested this[119]. For women, the problem is around low earnings and caring situations for the BSP. As there are more women than men at all adult ages, and 60% of people aged over 70 are women[120], the gender issue has received a great deal of attention.

Although successive governments have attempted to adapt the current system to meet these changes, it is still not seen to be sufficient. Further proposals have been considered to reform the contributory framework to alleviate gender inequalities[121]:

- Reduce the Lower Earnings Limit (LEL) to bring more low-paid workers into the National Insurance system.
- Abolish the '25% rule' which only allows any BSP to be paid if at least 25% of the necessary qualifying years[122] have a contribution or credit.
- Replace Home Responsibilities Protection (HRP)[123] with a positive credit calculated by counting the number of hours caring each week, with hours over a certain number, in specific circumstance such as caring for a child of a certain age, or an older person in need of care.

The effect of these proposals would be gradually to include more women in the contributory Basic State Pension, but not all would automatically be included. There would still be gaps, it would be difficult to make the reforms retrospective and the system would increase in complexity.

118 House of Commons Select Committee on Social Security (1999) para 52
119 Pensions Commission (2005)
120 GAD (2005)
121 For example, Age Concern and Fawcett Society (2004), and EOC (2005). Age Concern suggests these are first steps and supports more radical reform.
122 Entitlement is based on the number of years in which people 'qualify'. To receive a full pension men need to qualify for 44 years and woman for 39 (increasing to 44 by 2020). Partial pension can be paid to someone with fewer than the full number of years.
123 Although HRP is not fully a credit, it reduces the number of qualifying years needed to get a full BSP

PPI assessments show that a modernised contributory system may still not be as good as a universal pension, largely because the universal system would resolve the problem of gaps in contributory records:

- There will still be at least 2.3 million people a year who fail to accrue rights to a contributory pension, even after the modernisation of credits as described above[124]. Some of these people would 'deserve' to be covered.
- A more complicated set of credits would make it more difficult for people to understand how their pension is calculated.
- Because of the gaps in coverage, means-tested benefits will be needed by more people over state pension age with a modernised contributory system than with a universal pension.
- The modernisation of the contributory system is likely to take a long time to be effective. Transition to a universal pension can be better for the current generation of people (mostly women) with an 'unfairly' incomplete contributory record.
- The current method of collecting revenues (National Insurance contributions) can be maintained for both systems. Complexities of administration exist in both cases: for mobile workers with the universal and contributory systems and for carers in the contributory system.
- The state 'promise' of future benefits can be clearer with a universal system, and protected under both systems by better ring-fencing contributions.

How should we decide between contributory and universal?
Perceptions of what the two methods 'mean' – as opposed to what they would actually achieve in practice - will inevitably cloud judgements as to which is the best option.

It may be that the question comes down to is it 'better the devil we know'?

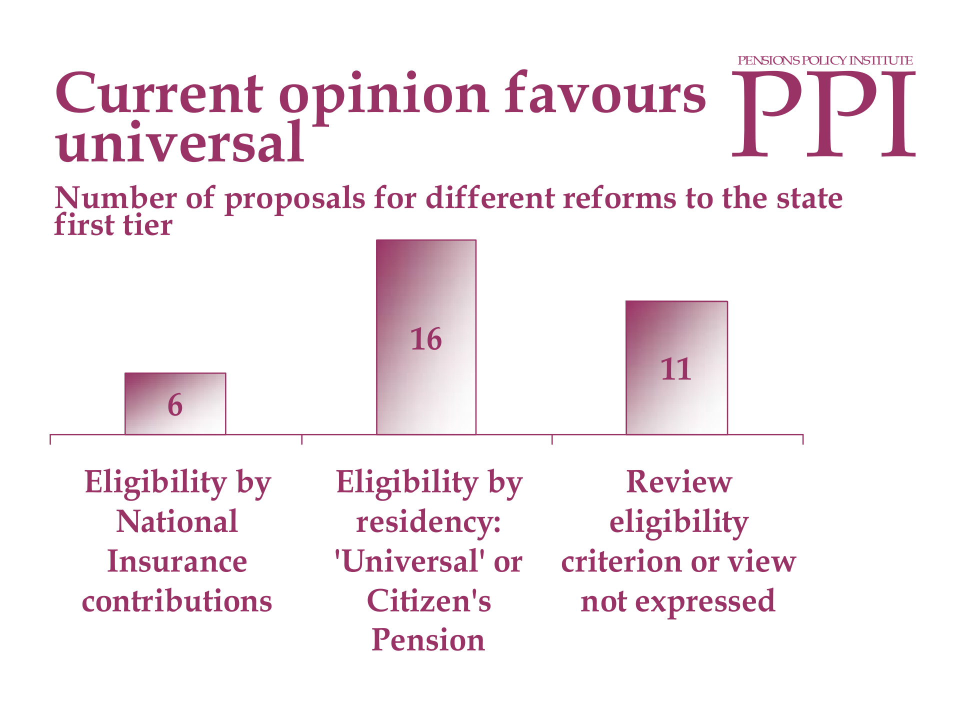
- A universal pension is still likely to be better than a modernised contributory pension in delivering adequacy for all.
- Current preferences appear to be with the universal pension, although the contributory method has the advantage of requiring least practical change.

There is relatively little analysis of the two options available. This means that the debate is often in terms of opinion, perhaps based on ideology, rather than facts.

[124] PPI calculation based on Family Resources Survey 2003/4 and DWP (2006 CQY)

At this stage of the debate, organisations making reform proposals tend to prefer the universal pension over the contributory pension, with others agreeing that further analysis should be done[125]. Few are actively supporting the contributory method (Chart 10).

Chart 10



A third option could be to reduce the number of qualifying years used in calculating a pension, from 44, to say, 20. This could increase coverage and be made to be retrospective. However, some concerns and uncertainties would remain. How low would the reduction in qualifying years need to go to make a significant difference to the level of coverage? And is it necessary to retain complex rules and administration to determine eligibility for the BSP if the aim is for virtually everyone to become eligible?

Points of consensus

- Improvements to women's state pension income are central to pension reform. At the very least, technical issues such as the design of credits need to be addressed.
- Improving the contributory system through increasing the number of activities qualifying for credits would increase significantly administrative complexity without removing all of the gaps.
- Much is assumed about what the public thinks is 'fair', and public support is cited in support of both contributory and universal pensions. Continuing research into public perceptions of fairness would be helpful.

[125] From an analysis of pension reform proposals made late 2004/early 2005 by organisations involved in various pension-related fields. See PPI (2005) Briefing Note 18 for further details.

5. Should earnings-related pensions be voluntary or compulsory?

Concerns over the future adequacy of the state pensions system have reinvigorated debate as to whether the state should be directly involved in providing an earnings-related pension or compelling people to save in a private earnings-related saving scheme.

Compulsory earnings-related pensions are declining in the current pension system. Some people support them, but they are expensive and the benefits are disputed. Reinvigorated voluntary saving may be preferable to extending compulsion but there is uncertainty as to whether the state's role in enabling and incentivising voluntary saving can go far enough. Well encouraged and regulated, voluntary earnings-related provision on top of a reformed state foundation pension scheme might be able to meet the objectives of a compulsory scheme.

Why do we have a compulsory earnings-related pension today?
The UK currently has a compulsory state earnings-related pension. The first such model, the Graduated Retirement Scheme (GRS), was introduced in 1961:

- To compensate for an inadequate Basic State Pension.
- To provide a state alternative to occupational pensions, which had low and unequal coverage.

In 1978, the GRS was replaced by the State Earnings-Related Pension Scheme (SERPS) which was intended to provide a more generous 25% of band earnings[126] after 20 years contributions. The pension would be higher for higher earners, but capped.

However, SERPS was cut back soon after it was introduced. This was despite a reduction in the value of BSP, which from 1980 became linked only to prices. As a result, the scheme never managed to achieve 25% NAE on top of a BSP of 25% NAE as envisaged.

In 2002, SERPS was replaced by the State Second Pension (S2P) which was intended to provide a more generous pension for low to moderate earners and people not earning.

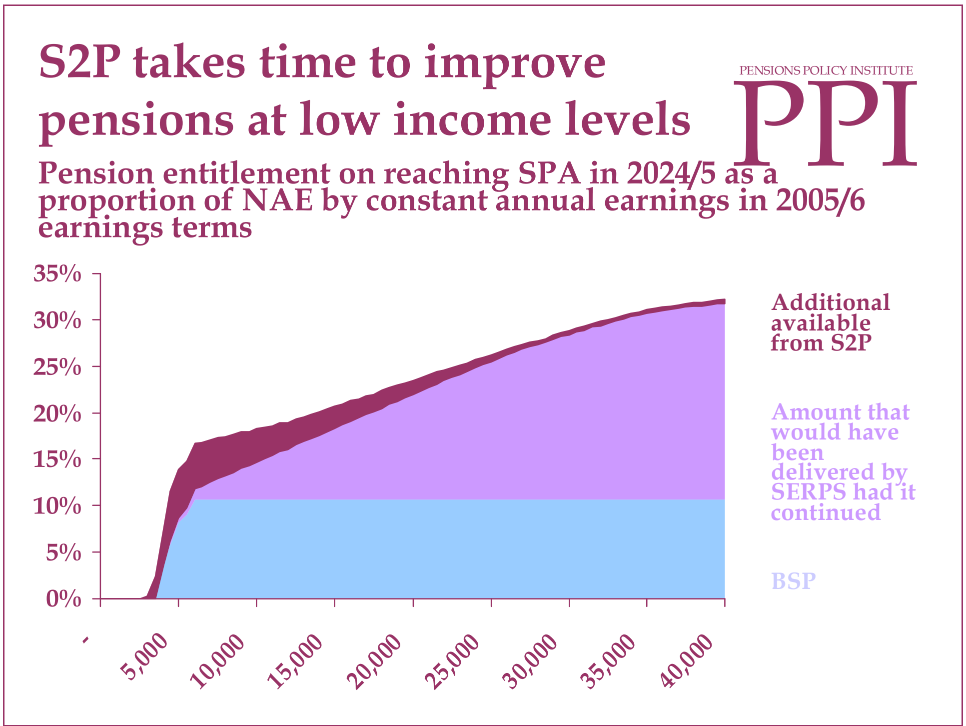
[126] Annual earnings up to a maximum of 53 times the weekly Upper Earnings Limit (UEL), and less a deduction of 52 times the weekly Lower Earnings Limit (LEL)

S2P is less earnings-related than SERPS was. If current indexation plans are maintained[127], S2P will become even less earnings-related, becoming a flat-rate benefit over the next 50 years (so that the same pension is accrued by people of different earnings).

This is all the more salient due to the decreasing value of the price-indexed BSP, which currently stands at a low of 16% NAE. The increasing generosity of S2P for low earners only partially makes up for the shortfall in BSP, still does not cover everyone and takes time to come fully into effect.

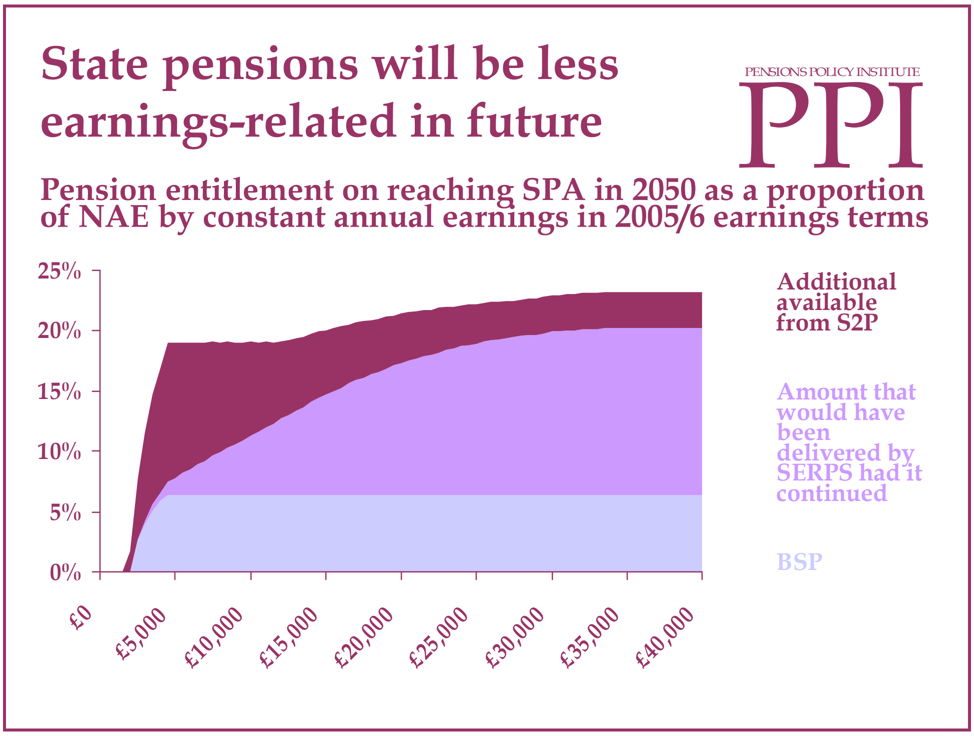
As a result BSP and S2P are likely to combine to produce a range of outcomes for the next 40 years before becoming almost a flat-rate pension, irrespective of earnings, for people with a full contribution record. In 20 years time BSP and S2P combined will produce a pension at age 65 worth between 15% of NAE for people with consistently low earnings and 30% of NAE for people with consistently high earnings (Chart 11). In 50 years time, everyone with a full contribution record will receive around 20% of NAE at age 65 (Chart 12). People with time not qualifying for BSP or S2P will receive less than these amounts[128].

Chart 11[129]



[127] The Lower Earnings Threshold (LET), which marks the upper bound of the flat-rate part of S2P, is currently indexed to earnings. The Upper Earnings Limit (UEL), which marks the maximum earnings on which benefit is accrued, is indexed to prices. Over time, assuming earnings grow faster than prices, the LET catches up with the UEL.
[128] These figures assume that people work continuously from age 16 to age 64. See PPI (2005 SEM3) for a discussion of the impact of working fewer years.
[129] PPI calculations, assuming working continuously from age 16 to age 64

Chart 12[130]



With a low, flat-rate state pension system, the importance of voluntary provision increases. Many people still do not have voluntary pension provision. Only 43% of people of working age are making contributions to an occupational or personal pension[131]:

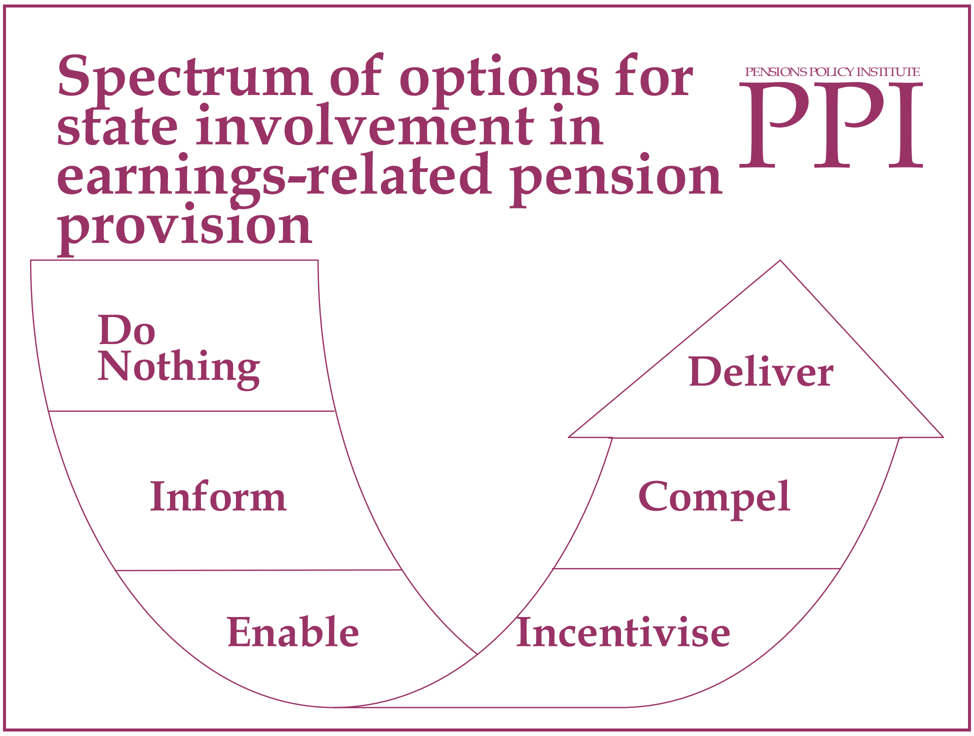
- 4 million people with access to an occupational pension do not join[132].
- 7.8 million people are not working[133], and 13.6 million[134] people are working but do not have access to an occupational pension scheme.
- Employers appear to be reducing the generosity of occupational pensions in light of low investment returns, increasing longevity and increasing regulation[135].

Therefore, the main issues for extending coverage further are how to increase take-up rates and the level of contributions, and how to include non-earners.

There are a wide range of options for state involvement in earnings-related pensions (Chart 13). At one end of the spectrum, the state could have no involvement at all. At the other end is the original role envisaged for SERPS, where the state delivers an earnings-related pension directly.

130 PPI calculations, assuming working continuously from age 16 to age 64
131 DWP estimates based on the Family Resources Survey 2004/5
132 DWP (2004 SSC)
133 ONS (2005)
134 PPI analysis from DWP (2005 STPP) and ONS (2005)
135 See PPI (2005 SEM2)

Chart 13



Between these extremes there are a range of alternatives, including:
- Inform - for example, providing a state pension forecast showing how much state pension might be received at state pension age and how different saving rates could improve retirement income.
- Enable – through removing barriers to voluntary private saving. For example, facilitating auto-enrolment into occupational pension schemes to make it easier for people to save voluntarily.
- Incentivise – for example, give tax relief on pensions contributions.
- Compel – for example, compelling all employers and /or employees to contribute a certain amount to an occupational pension scheme.

These options are not mutually exclusive. Indeed the state already offers information as part of the Informed Choice programme, guidelines for auto-enrolment and incentives through tax relief.

Reform options

Reform options that have been proposed for the pension system can be categorised into two groups, depending on which part of the state pension system they aim to reform:
- Reforms to abolish compulsory earnings-related provision and concentrate state resources on providing as high a flat-rate state pension as possible.
- Reforms to retain and/or improve compulsory earnings related-provision (through either the state or private pension sector). Most reform proposals including these options also usually include an improved flat-rate first-tier state pension.

Compulsory earnings-related pension provision could be in either the state or private pension sectors[136]. Some of the arguments refer to both types of compulsory provision, while others are only relevant to one or other of them.

The primary role of the state is poverty prevention; otherwise, reliance on means-testing will increase. A rise in state spending on pensions is inevitable, even just to catch up with that spent in other countries. However, the state cannot afford to provide both poverty prevention and earnings-replacement.

Arguments for compulsory earnings-related pensions
Compulsory earnings-related provision is argued by some[137] to be the way to avoid inadequate retirement incomes. They suggest that such provision:

- *Could minimise the risk of future disappointment by providing a pension that relates to individuals' pre-retirement income.* A big drop in living standards in retirement could cause disappointment and could happen for a number of reasons:
  - If people have no access to a voluntary private pension[138], and so rely heavily on the state pension.
  - Because people are 'myopic', or short-sighted, about saving, and inertia keeps them from saving.
  - Because reliance on private saving involves risk.
- *Could save the state money.* Compulsion could reduce the likelihood of 'political moral hazard', which refers to the risk that people become lobbyists for ad hoc increases in the state pension if they are allowed to make bad savings decisions that they later come to regret[139]. The need for means-testing could be reduced by limiting the number of individuals not saving. Also the cost of providing incentives for private pension saving through tax relief could be reduced. By reducing the costs of voluntary saving, largely dictated by the need for advice, marketing and regulation, compulsory state schemes can be cheaper to administer.
- *Could encourage growth in the voluntary private pension sector.* A compulsory earnings-related state scheme aims to get people as close as possible to their achieving their appropriate replacement rate in retirement, which could then act as an incentive to make additional private provision in order to close the gap[140].

[136] In the current system the compulsory pension is into the State Second Pension (S2P) but employers or individuals can choose to place this tier of compulsory provision into a private pension through the mechanism of contracting-out
[137] Those who support private compulsion include: EEF, Help the Aged, GMB, TUC and Which? Those who support retaining / improving S2P include: Aegon, Association of British Insurers, Age Concern, CBI, Equal Opportunities Commission, GMB, Legal and General, Society of Pension Consultants, TUC and Which?
[138] As any state earnings-related provision is likely to be compulsory, voluntary provision is assumed in this paper to always be in the private sector
[139] Turner (2005)
[140] Katona (1964) found that people save more when covered by a private pension. He explained his findings by borrowing the 'goal gradient' hypothesis from psychological research: according to this theory 'effort is intensified the closer one is to one's goal' (1964, p 4).

It is argued that retaining a compulsory earnings-related pension could lead to a revitalised voluntary private sector, particularly if at least part of the system were funded (for example through contracting-out)[141]. For example: *Contracting-out of the S2P has an important role to play, as a stepping stone for those wishing to move from total reliance on the state to a mix of state and private retirement provision. In the past, contracting-out rebates have helped the Personal Pension accounts of new savers to reach critical mass. Contracting-out could do so again for another generation of savers, but this will require an increase in the level of National Insurance rebates, to restore once again the situation of positive bias in favour of contracting-out*[142].

- *Could provide a positive effect on the economy, along with a clear incentive to work.* Compelling people to save in a private pension can boost the economy if this leads to an increase in total saving.
- *Will maintain the status quo and avoid disrupting the existing pension provision framework.* Some organisations raise concerns over state pension reform proposals that suggest abolishing S2P. These concerns focus on, for example, losing the contracting-out rebate, the inclusivity of those whose employer is too small to provide an occupational pension or who are not working, the achievement of replacement rates, and offering a low risk option for low earners.

It is very difficult for people in their 20's and 30's to know what their income requirements will be when they reach their 70's, and how they can go about achieving that level of income. Even if they act entirely rationally, it is uncertain whether those actions will result in what they want.

If the state focuses entirely on poverty prevention then it is unlikely that everyone, throughout the entire earnings spectrum, will buy in to it. An earnings-related retirement benefit is more likely to address the concerns of middle to high income earners.

141 ABI (2005)
142 Legal and General (2005)

Arguments for voluntary earnings-related pensions
An alternative point of view is that the main role of the state in pension provision is poverty prevention, a role that is best served by providing as high a flat-rate pension as possible, alongside voluntary earnings-related provision.

Supporters of this point of view[143] argue against the perceived attractions of compulsory earnings-related pension provision. They suggest compulsory earnings-related provision:

- *Is unlikely to be affordable without undermining poverty prevention.* Different possible social policy objectives of pensions policy can be ranked according to how generous they are, and how much they cost (Chart 14). Supporters of compulsory earnings-related provision place a strong emphasis on the state meeting all of the possible objectives through compulsory provision. However trying to meet all objectives is expensive: if there is a limit to how much can be afforded, more earnings-related provision has to result in a lower first-tier state pension. Also, the distribution of earnings-related provision is different: higher income people get more than lower income people. People earning less than £10,000 each year (and those with interrupted work histories) would receive more state pension from a single flat-rate system (Chart 15).

  An earnings-related state pension can also actively undermine the long term security of the flat-rate first-tier of state pension provision. The introduction of SERPS in 1978, with its apparent increase in the generosity of the state pension system, may have made it easier to change the indexation of the Basic State Pension in 1980.

[143] Supporters include: British Chambers of Commerce, Friends Provident, Help the Aged, Hewitt, Liberal Democrat party, National Association of Pension Funds, National Consumer Council, Norwich Union, Pensions Management Institute, TUC and Watson Wyatt

Chart 14

Possible social policy objectives of pensions policy

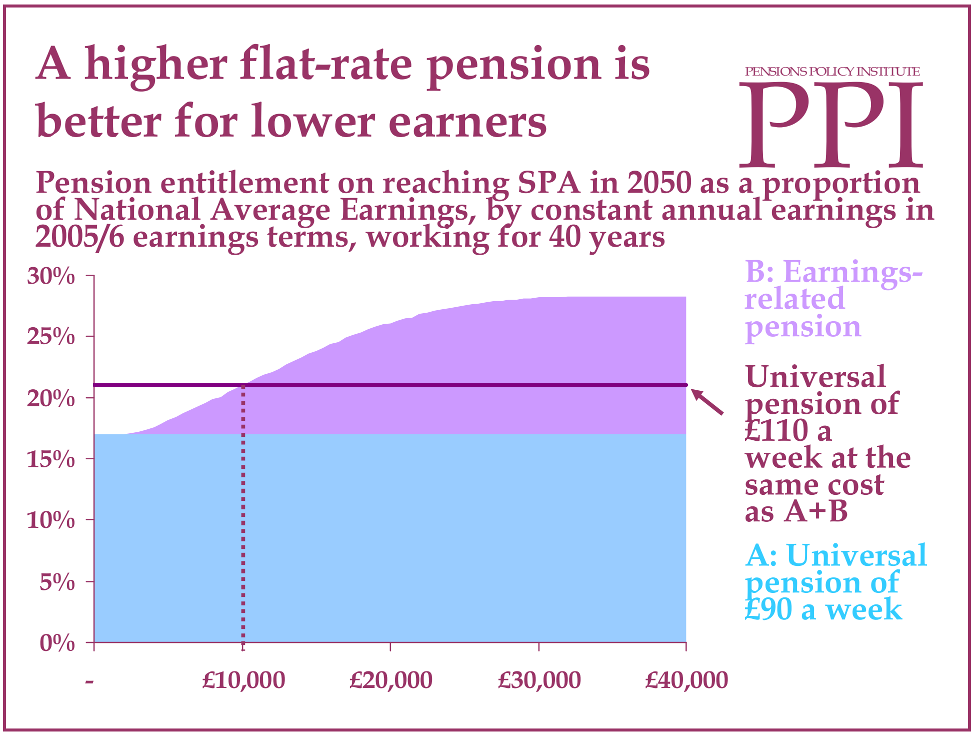
PENSIONS POLICY INSTITUTE PPI

Least expensive

1. Alleviation of poverty
2. Prevention of poverty
3. Belonging and participation in the community
4. Continuance of economic status

Most expensive

Chart 15[144]



[144] PPI analysis, assumed that individuals remain at the same earnings level and work for 40 years – see appendix for further details

- *Could increase the need for means-testing and other government costs.* If having compulsory earnings-related pension provision is only affordable with a flat-rate pension below the current Guarantee Credit level, there will still be a significant role for means-testing in preventing pensioner poverty. This is because:
  - Low earning people are more likely to rely on means-tested benefits when reaching state pension age.
  - Government may need to underwrite compulsory private pension provision (including contracted-out contributions).

- *Is unlikely to be able to guarantee an adequate pension income.* This is because:
  - Different individuals will have different requirements and strategies for building up retirement income.
  - A compulsory earnings-related system will not be generous enough to meet the income requirements of everyone.

- *Could undermine voluntary private saving through added complexity, increased regulation and consequently higher costs.* BSP and S2P have numerous different eligibility and contribution rules, means-tested benefits further complicate the system and contracting-out is poorly understood. Complexity should be avoided as it can increase inertia and act as a barrier to saving, and can increase the costs of voluntary provision for individuals.

- *Would not have a significant impact on the economy.* Economists differ over whether evidence supports the claim that compulsory private leads to higher saving. A better voluntary approach alongside a simpler state pension system could result in a system with as much saving in private pensions as a compulsory system, and therefore be just as good for economic growth.

- *Does not have consensus support (especially compulsory <u>private</u> provision), so is unlikely to be a practical policy option.* Opinion within the business community regarding compulsion is inconsistent and unclear. Opinion within the general public is contradictory. Although there is support in principle, it is heavily qualified:
  - People who are already saving in a private pension scheme are more likely to support compulsion. For example, of 73% of survey respondents who support compulsion, only 26% support a level that would make a difference to their own behaviour[145].
  - Preference for compulsion is reduced if compelled saving is perceived as a trade off with wages or salary[146].
  - Opposition to compulsion is strongest amongst the self-employed, people without private pensions and part-time workers.

[145] ABI (2004)
[146] ABI (2004)

Compulsory private saving has many disadvantages, particularly as it would be seen as a tax. The public favour compulsion in theory, but support is qualified, and reduces significantly when perceived as a trade-off with wages.

Voluntary saving has not been given a fair chance in this country, as the system sits on top of an extremely complex state system. Incentives to save are rendered less effective due to complexity and over-regulation of the pension system.

It is difficult to determine any clear lessons from the number of different international models of compulsory private pension provision[147]. Each has a different level of reliance on compulsory contributions, but each has problems with one or more of:

- The level of the pension.
- The coverage of the pension.
- The high costs of provision.

A compulsory private element was introduced to the Australian pension system due to the belief that means-testing was increasing and private saving was reducing…Voluntary saving collapsed almost completely when compulsion was introduced. However, this effect proved to be temporary. Approximately 45% of the workforce now contribute to voluntary pensions. Also, there is no evidence of political moral hazard since people do not think that they are actually paying for their state pensions as there is no National Insurance system in Australia. The state does not guarantee pension income from the compulsory private schemes, as it has never been deemed necessary. While expenses are high as compared with state systems, service levels are also a lot higher, for example, the issuing of half yearly benefit statements, and a tracing service for private pensions from previous employments.

Can a voluntary system meet the objectives of a compulsory system?
Properly encouraged and regulated, voluntary earnings-related provision on top of a reformed state foundation pension scheme might be able to meet the objectives of a compulsory scheme. For example[148]:

- A flat-rate state pension system could provide a better income for low earners, reducing means-testing, and so is better placed to avoid disappointment in retirement for this group.
- The simplicity and certainty of a single flat-rate state pension system would make it easier to understand how much voluntary saving would be necessary. Reduced complexity and regulation would also lower costs and so provide a further boost to voluntary saving. Compared to an earnings-related system, low earners will need to save less to achieve a target replacement income, and high earners will need to save more[149].

[147] See PPI (2005 SEM4) for more examples of international models
[148] See PPI (2005 PC2)
[149] NAPF (2004)

- A national auto-enrolment scheme could widen access to retirement saving. It could also be extended to those without access to an occupational pension scheme, for example through a vehicle similar to the proposed KiwiSaver, an auto-enrolment savings vehicle that operates through the workplace and is planned to be introduced in New Zealand in April 2007[150]. The Pensions Commission has since proposed a similar scheme but with compulsory employer contributions[151].
- Savings incentives might work better if they were more transparent and better targeted. There is no evidence that tax incentives increase the overall level of saving. The current system of tax relief is also regressive, in that higher earners receive a higher rate of tax relief, and so receive more state support for a given level of private pension contribution. Higher earners are also more likely to belong to private pension schemes[152], and so be making contributions that attract tax relief.
- Better information can play a role in a simpler system, enabling individuals to make better (if not perfect) decisions.

Points of consensus

- The role of the state ought not to stop at the poverty prevention first-tier, but should at least extend to encouraging second-tier voluntary pensions.
- Re-invigorated voluntary saving may be preferable to more compulsion but there is uncertainty as to whether the state's role in enabling and incentivising voluntary saving can go far enough.
- It is not at all clear that there is wide support for greater compulsion for second-tier pensions, and in particular compulsory private earnings-related pensions are seen to be problematic.
- The existence of contracting-out complicates the consideration of any policy change to second-tier pensions.
- Ways in which carers and other people who cannot work can be included in a compulsory pension that is based on making contributions through the workplace must be further researched.
- It is uncertain as to whether a reinvigorated contracting-out function could increase voluntary pension provision. The number of people contracting-out is decreasing and there is uncertainty over the evidence that it is contracting-out as opposed to incentives that encourage saving.

[150] New Zealand Government (2005)
[151] Pensions Commission (2005)
[152] Curry and O'Connell (2004)

6. How does the interaction of state and private pensions affect incentives to work and save?

The main paper for this seminar was authored by Carl Emmerson. This and the supporting PPI paper are used to structure this chapter.

There are different ways to fill the so-called 'savings gap', that is, to maintain current average standards of living for pensioners relative to the rest of society:

- If state spending on pensions is not increased, then reversing the trend of falling private saving and working longer would be needed, or,
- A combination of more spending on state pensions and working longer could close the 'gap' even if private saving does fall as some predict.

Working longer appears to go with the flow of recent trends, while saving more appears to go against them.

Incentives to work longer and save more are important parts of the policy mix that could be used to prevent future pensioners being relatively poorer on average than today's pensioners. But incentives for working and saving need to be considered in the context of what could plausibly be delivered by state pension reform.

Why are saving more and working longer important?
To fund a retirement income of any size, more money has to be contributed into a pension today than used to be the case because:

- We are living longer on average[153].
- Expected future returns to pension funds are lower than the returns seen in the past[154].
- The average amount received from state pensions is declining[155].

Actual contributions to private pensions are not keeping pace with this required increase, which has led to a suggestion of a 'savings gap', which could be filled by more voluntary or compulsory saving (usually just considering pensions)[156].

[153] O'Connell (2003 SPA)
[154] Pensions Commission (2004), Curry (2004)
[155] Curry & O'Connell (2004), O'Connell (2003 SPR), PPI (2004) Briefing Note 14
[156] See for example, Oliver Wyman and Co (2001)

Future retirement income could be – but not necessarily will be - increased by:

- Better state pensions,
- Higher private saving (Chart 16), and/or
- Working longer (Chart 17).

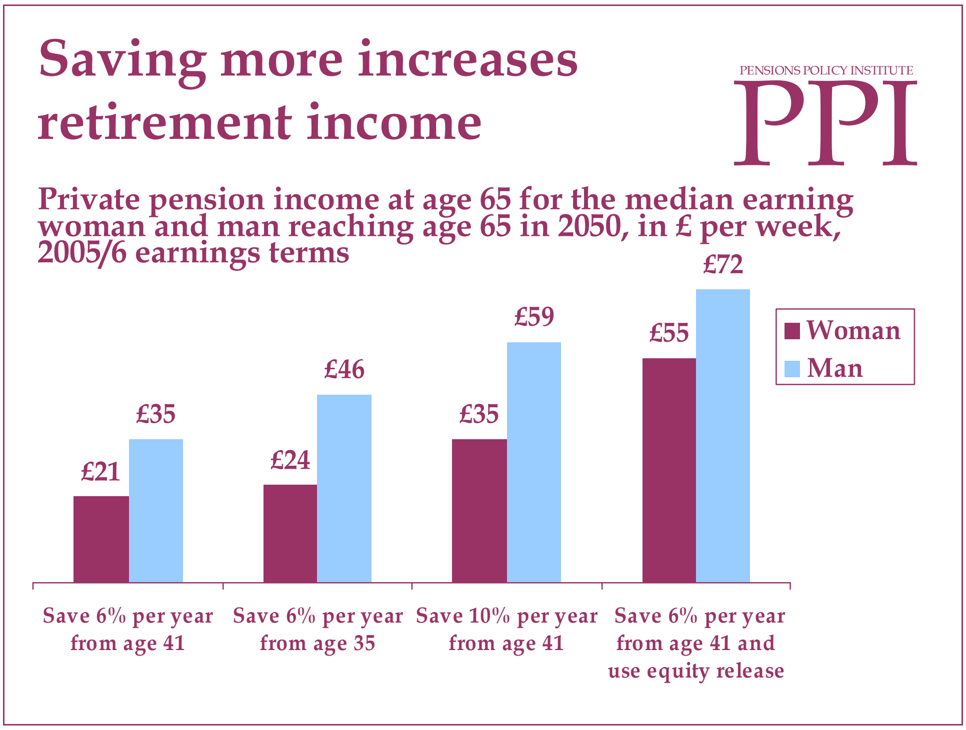
Increased saving for retirement could be through:

- Starting to save earlier,
- Making larger pension contributions, and/or
- Saving outside of a pension (for example in property[157]).

Working longer can increase private retirement income through:

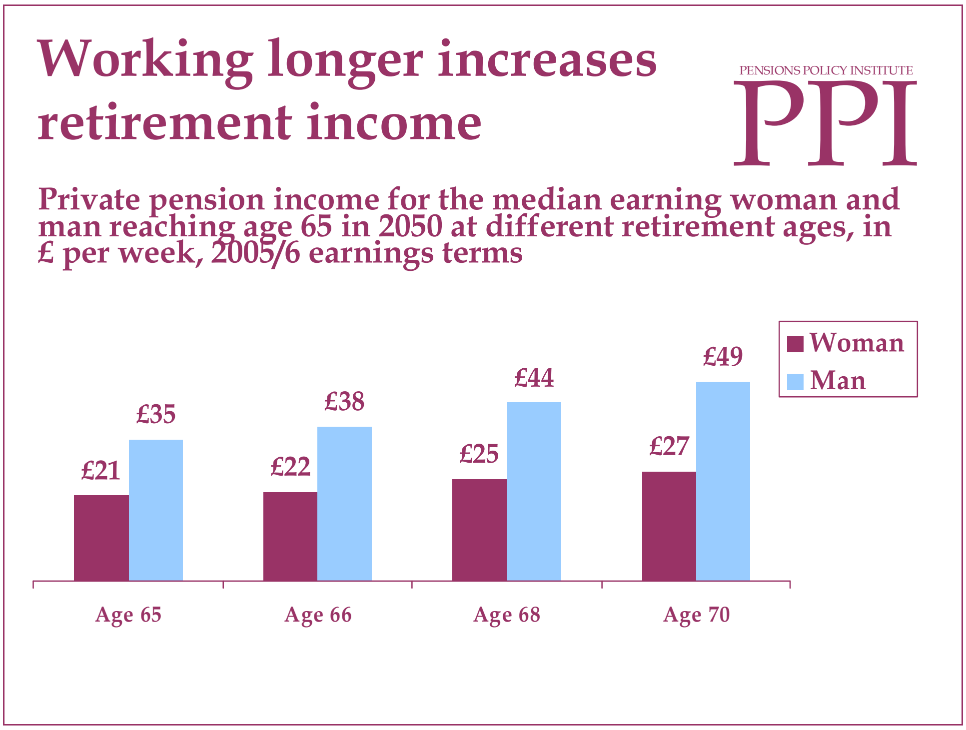
- Allowing more saving,
- Increasing the value of existing saving, and
- Reducing the length of retirement.

Chart 16[158]



[157] Although this may not be suitable for everyone – see Curry (2004) for further information
[158] PPI analysis using the Individual Model. For further information about the Individual Model see Appendix. The 'median individual' earns at median levels for his or her age and gender.

Chart 17[159]



Saving more or working longer does not automatically increase retirement income

Even if individuals do choose to save more or to work longer, retirement income will not always be higher (and a higher income should not be confused with a higher standard of living).

There is a trade-off between saving and working. Someone who saves more may choose to retire earlier if he or she has saved enough to achieve a target retirement income.

There is an 'opportunity cost' to taking private pensions later. Private pensions can be taken while still working, so retiring later does not necessarily mean pensions are taken later.

What are the trends in working at older ages and saving?

Working longer appears to go with the flow of recent trends, while saving more appears to go against them (Box 5):

- There has been an increase in the number of people working at older ages, and there are suggestions that these trends are likely to continue.

[159] PPI analysis using the Individual Model. For further information about the Individual Model see Appendix. The 'median individual' earns at median levels for his or her age and gender. 'Private pension income' is that estimated to result from voluntary saving at the levels shown in addition to Basic State Pension and State Second Pension or contracted-out equivalent.

- The Government has a long-term aspiration of an employment rate for working age people (including those aged between 50 and state pension age) of 80%[160], and is implementing policies to encourage working at older ages[161].
- Private pension saving appears to be in decline as employers switch from Defined Benefit to Defined Contribution provision. Also, there is evidence that people are starting to save later rather than earlier. It is not clear how much of this decline will be offset by increases in non-pension saving, including property.

Box 5: Key facts

- The proportion of people working aged between 50 and state pension age[162] increased from less than 66% for men and 60% for women in 1996 to 72% for men and 68% for women by 2005[163].
- The proportion of people older than state pension age in employment, increased from 7.6% in 1996 to 9.8% in 2005[164].
- The average retirement age for men is now 64, almost a year higher than in 1995. A similar rise occurred in the average retirement age for women, which is now 61.9 years[165].
- Of people now aged between 30 and 34, 33% had a private pension by age 24. This is a fall from levels of people 5 years older, 49% of whom had a private pension by age 24[166].
- There appears to have been a gradual decline in the proportion of people of working age making contributions to private pensions, with only 43% contributing in 2004/5 compared to 45% in 2000/1[167].
- The average contribution to a private pension scheme as a proportion of National Average Earnings in 2004 was 6.7%, compared to 6.0% in 1997[168].
- Contributions to Defined Benefit schemes are expected to fall by 60% from their 2000 level following a shift from Defined Benefit to Defined Contribution schemes[169].

160 HM Government (2005)
161 Such as anti-age discrimination legislation and policies to help people receiving Incapacity Benefit back in to work
162 65 for men and 60 for women
163 ONS (2005). Spring quarters from each year. Seasonally adjusted. Includes everyone working for one hour a week or more.
164 ONS (2005)
165 Pensions Commission (2005) p. 97
166 Curry and O'Connell (2004)
167 DWP estimates based on the Family Resources Survey, www.dwp.gov.uk/ofa/indicators/indicator-29.asp. Between 1996/7 and 1999/2000 the proportion of working age people making contributions to private pensions fell from 48% to 46%. These figures are not directly comparable with estimates for 2000/1 and after because of changes in the questions used in the Family Resources Survey.
168 PPI calculations based on data from the Inland Revenue and Penneck and Tily (2005). These figures do not include special contributions, which are employer contributions to a pension scheme that are not ordinary annual contributions, or contracted-out rebates.
169 Pensions Commission (2005) p. 57

What are the options for maintaining pensioners' incomes?
The current debate on future retirement income adequacy centres on filling the 'savings gap' that is predicted to open up.

To fill the 'gap' and maintain the current standard of living for pensioners relative to the rest of society:
- Without an increase in state spending on pensions, reversing the trend of declining private saving **and** working longer would be needed.
- A combination of more spending on state pensions and working longer could close the 'gap' even if the contribution made by private saving does fall as predicted.

Current debate is focused on a particular view of the future
The most often used minimum target for pension and saving policy is to achieve the same average level of income for each pensioner in future as today[170]. Under the Pensions Commission central assumptions, by 2050 a 'gap' appears between the 12.4% of GDP transferred to pensioners by state and private pensions and the 14.5% of GDP target[171], required to ensure that on average pensioners are not poorer relative to the rest of society than today[172] (Chart 18).

The central assumptions are based on current trends continuing:
- **State spending***:* The state is projected to transfer 7.6% of GDP to pensioners in 2050, based on the continuation of current policies[173].
- **Private saving**: The Pensions Commission central estimates of the contribution of private pensions to retirement income are based on a projected <u>fall</u> in overall contributions to private pensions of around one-third over the next 15 years, offset by an increase in the amount paid out by unfunded public sector pension schemes. The net result is a transfer from private saving of 4.8% of GDP in 2050, compared to a transfer of around 3.2% today[174]. The central assumptions assume the same transfer per pensioner through other saving in 2050 as today.
- **Longer working:** The Pensions Commission central estimate assumes that the average retirement age for women increases from 61.9 to 64, the same as it is for men today, as state pension ages are equalised[175].

170 This is suggested as the minimum target level by the Pensions Commission, Pensions Commission (2004)
171 This is the amount required in 2050
172 Pensions Commission (2005) p. 63 and 299
173 Pensions Commission (2005) p. 63
174 Pensions Commission (2005) p. 63 and 57, the central point of the range for private pension income in 2050 from 3.4% to 6.2%. This is based on private pension contributions falling from 4.4% of GDP today to 3.1% of GDP by 2030, and a real rate of investment return of 3% - 4%.
175 Pensions Commission (2005) p. 97 and Pensions Commission (2004) p. 17. Ideally this analysis would be carried out looking at changes in employment rates rather than average retirement ages, as for many people retirement is not a clear cut process. Increases in combinations of part-time working and taking pensions are likely to make it difficult to measure the age at which people 'retire'.

Without an increase in state spending on pensions both a levelling of private saving and working longer would be needed

If state spending on pensions remains as projected, closing the gap in resources transferred to pensioners by using only one of saving more or working longer in isolation is unlikely.

- Contributions to private pensions would need to increase above today's contribution level, as opposed to the Pensions Commission's central assumptions of a fall in contributions[176]. Even if contributions continued at broadly today's level[177] (the highest level assumed by the Pensions Commission) then, on average, pensioners would still be relatively poorer in 2050 than they are today.
- The average retirement age would need to rise from 64 to above 67 to close the gap completely through working longer.

But a combination of maintaining private pension contributions at current levels and increasing the average retirement age to 66 could close the gap.

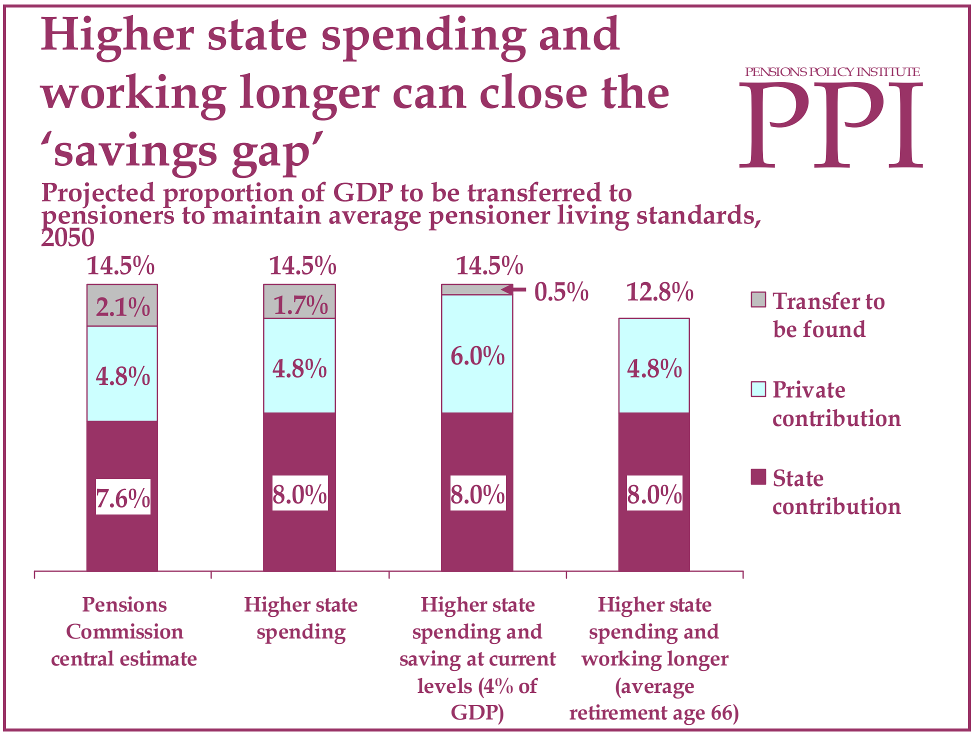
A combination of more spending on state pensions and working longer could close the 'gap' even if private saving does fall as predicted

Although there is likely to be a limit on how much state spending on pensions can increase, any increase would reduce the transfer of resources needed to be found from saving more and working longer. If state spending could be increased to around 8% of GDP by 2050, it becomes more plausible that **either** saving more **or** working longer could avoid pensioners becoming poorer on average[178] (Chart 18).

- Maintaining contributions to private pensions at today's levels (rather than falling) would still not transfer enough resources to avoid pensioners being poorer on average, but the gap to be filled by increasing saving or working longer would be less than 1% of GDP.
- If retirement ages increased in proportion with life expectancy to reach age 66[179], fewer resources would need to be transferred to people over state pension age to maintain average income levels. Even with falling contributions to private pensions enough resource would be transferred to avoid future pensioners being poorer on average than today's pensioners.

[176] The Pensions Commission central estimate is of a fall in contributions to private pensions of around one-third over the next 15 years
[177] Assuming contributions of 4% of GDP per year, compared to the current level of 4.4% per year
[178] This chapter analyses the impact of saving more, working longer and higher state spending in aggregate, but does not look specifically at how changes in saving, working and state pensions would impact on different types of individuals (for example, women and low earners). While there are obvious implications for policy, an in particular which policy response would be most appropriate for different parts of the population, such an analysis is beyond the scope of this chapter.
[179] Pensions Commission (2004) p. 46

Chart 18[180]



Extract from the paper prepared by Carl Emmerson

In terms of private pension saving the incentives provided by the Government are complicated, and vary by a number of factors. For example the tax-free lump sum is a greater subsidy to those expecting to pay higher rate tax in retirement than those expecting to pay basic rate tax. In addition the tax advantages of contributing to a private pension depend not only on individual characteristics, but also whether the contribution is formally made by an employer or an individual. Both of these features are difficult to justify.

In terms of retirement behaviour there are a number of reasons to expect retirement ages to increase over the next few years (as they have done over the last 10 years), not least as healthy life expectancies are likely to continue increasing. In addition the increase in the age at which individuals can qualify for the Pension Credit Guarantee will tend to increase work incentives, as would any move to increase pension ages in pension schemes such as those for public sector workers. Reforms to Incapacity Benefit and shifts from defined benefit pensions towards defined contribution pensions might well also increase the proportion of older working age individuals in employment. Given continued expected improvements to healthy life-expectancy it might be that the state pension age should increase from 65 at some point in the future (which would further improve work incentives), in which case the earlier individuals can be informed of any change the better.

[180] PPI analysis based on Pensions Commission (2005)

Points of consensus

- In general, people want to be able to work longer. This is a good thing and should be encouraged through the labour market.
- The labour market will need to adapt to enable people to work longer. For example, people in highly stressful work environments may have to change to different jobs earlier. Increasing opportunities for part-time and flexible working are necessary.
- The state should help to overcome any disincentives to save more that exist in the current pension system. For example, it is widely thought that limiting the extent of means-testing and reducing the complexity of the state pension system would help people to understand and trust what pension they will get from the state and so make the saving decision easier.
- With a higher state pension, the state would have to do less to encourage people to save.
- Ways of redesigning the current system of regressive tax incentives to be more effectively targeted should be reconsidered despite the administrative difficulties of changing the system. For example, it could be more cost effective to target tax incentives on employers rather than employees. A tax system that is easier to understand could encourage private pension saving.

Appendix: Modelling details

Charts 4, 5 and 6 in Chapter 2 and Charts 11, 12 and 15 in Chapter 5 and Charts 16 and 17 in Chapter 6 use the PPI Individual Model to estimate the amount of state or private pension income that individuals with different levels of earnings might expect to receive when they reach age 65 in 2050. This appendix outlines some of the assumptions used.

The Individual Model
The Individual Model (IM) is a model that simulates pension income for individuals and households reaching state pension age today and in the future[181].

The main characteristics of the IM
The model uses a set of assumptions about an individual's working and pension contribution history, the performance of the economy and the uprating conventions used in the pensions system.

State pension entitlement is calculated according to the individual's work and National Insurance history. The 'rules' used are the current rules projected into the future, assuming no changes to the current system.

Private pension accrual also depends on the individual's work history. For each year in which private pension is accrued, contributions are made into a money-purchase pension scheme (such as a stakeholder pension) by the individual and/or the employer.

State and private pension accruals are used to calculate weekly pension income from state pension age:

- State pension provision can include Basic State Pension, Graduated Retirement Benefit, State Earnings Related Pension (SERPS), State Second Pension and other state benefits such as Winter Fuel Allowance and Pension Credit.
- Private pension provision includes pension saving and can include other forms of savings (such as housing). Future streams of private pension provision are calculated through annuity purchases.

Illustrative Individuals
Typical policy analysis assumes that individuals remain in full-time work at the same earnings level from the day they leave education to the day they reach 65. Rather than use these artificial assumptions, the individuals analysed in Charts 4, 5, and 6 in Chapter 2 and Charts 16 and 17 in Chapter 6 illustrate some of the range of characteristics that exist in the working population that affect current and future pension income. They are similar to individuals used in previous PPI studies.

[181] See Curry (2003)

The illustrative individuals used are:

- An illustrative man: He worked mainly full-time from age 21, but was unemployed for two years in his twenties and worked part-time between age 55 and age 60.
- An illustrative woman: She started work at the age of 21, working full-time until age 28. She then had a career break to care for a child for six years, but the break did not coincide with the financial year, so she lost two credits to BSP and S2P. She returned to part-time work for five years. She then worked full-time until taking another career break for 5 years in her 50s to care for an elderly relative, for which she received no carer benefits or credits. She returned to full-time work again, until reaching state pension age.

Earnings

The illustrative man and woman are analysed here using different levels of earnings. The earnings levels used are based on the earnings received at different ages. For example, the illustrative woman with median earnings is assumed to have the median earnings of all full-time employed 21 year-old women when she is aged 21, and the median of all full-time employed 22 year-old women when she is aged 22. This allows a more realistic earnings profile than using the median or average earnings of all workers throughout the working life. Earnings tend to be higher in the middle of working life than at younger and older ages (Tables A1 and A2).

Table A1:[182] Earnings in 2005/6 earnings terms of the illustrative women

Decile	Earnings at 25	Earnings at 50	Final earnings
1st	10,400	10,400	9,000
3rd	13,600	14,100	10,800
Median	16,800	17,500	13,500
7th	20,400	24,300	17,600
9th	26,900	34,700	24,600

Table A2: Earnings in 2005/6 earnings terms of the illustrative men

Decile	Earnings at 25	Earnings at 50	Final earnings
1st	11,400	13,800	11,700
3rd	15,100	19,500	16,100
Median	18,300	25,100	21,300
7th	23,200	32,600	25,900
9th	32,400	50,200	50,200

[182] ONS (2004). The PPI only updates its modelling assumptions annually to allow different pieces of modelling work to be compared. Deciles points to divide the earnings distribution into 10 groups each of which contains the same number of workers, so for example, 30% of females earn below the third decile of the female earnings distributions and 60% earn below the 6th decile.

Charts 11 and 12 in Chapter 5 and Chart 15 in Chapter 6 show how state pension income depends on earnings under the current pensions system and possible reform options. Since these charts do not illustrate particular individuals, they assume constant annual earnings, rather than assume that earnings vary by age.

Replacement rates

Chart 4 in Chapter 2 illustrates how much of the median earning woman's retirement income would come from state and private sources, if she saves in order to reach a target level of pension income at retirement. Her target level of pension income is found by multiplying her final salary by a replacement rate (Table A3).

Table A3:[183] An estimate of the amount of income that the illustrative women might require in retirement, based on the target replacement rates (income at age 65 as a proportion of final salary) suggested by the Pensions Commission, in £ per week, 2005/6 earnings terms

Decile	Final earnings per year	Target replacement rate	Targeted weekly pension income
1st	9,000	80%	£138
3rd	10,800	70%	£146
Median	13,500	70%	£181
7th	17,600	67%	£227
9th	24,600	67%	£317

Contracting-out

A similar analysis is in Chart 6, which shows how much the median earning woman would need to save in order to have 40% of her retirement income coming from the state and 60% from private sources. If the definition of "income from private sources" includes income from contracted-out pension, then a key determinant is whether she contracts-out. Analysis is presented on the basis that she is contracted-in and on the basis that she is contracted-out for part of her career.

Where she is contracted-out, the analysis assumes she is contracted-in until age 40 and then contracts-out for 15 years before contracting back in at age 55 at the 'pivotal age'[184]. This means that around 40% of her State Second Pension entitlement is contracted-out[185].

She is assumed to neither gain nor lose out by contracting-out. Effectively, the percentage rebate rates were assumed to be actuarially neutral in the long

[183] Pensions Commission (2004). An update of this analysis was not included in the Commission's final report.
[184] Contracted-out rebates are capped so that at older ages (above the so-called 'pivotal age') the actual rebate is less than the actuarial equivalent of the State Second Pension given up. See PPI (2005 PP) for more details.
[185] For comparison, the latest projections by the Government Actuary's Department assume that 36% of employees will be contracted-out in 2020, falling to 31% by 2060. GAD (2004 QR).

term, set using the same assumptions on investment returns that the IM uses to model the individuals' private pensions.

Comparing flat-rate and earnings-related pensions
Chapter 5 showed that people earning less than £10,000 each year (and those with interrupted work histories) would receive more state pension from a single flat-rate system that costs the same. This section of the appendix looks at how the amount of pension income that alternative pension systems deliver depends upon the number of years of contributions as well as earnings.

The following pension systems would cost broadly the same in 2040[186]:

- A universal pension paid at the level of the Guarantee Credit (21% of National Average Earnings (NAE), currently £109 a week) uprated in payment in line with earnings growth.
- A universal pension paid at £90 a week (17% of NAE) uprated in payment in line with earnings growth, and an earnings-related pension based on the SERPS scheme that was in place immediately before the introduction of State Second Pension in 2002.

However, each system has different distributional consequences: Under the higher flat-rate system, lower earners and higher earners receive the same. Under a lower flat-rate system supplemented with an earnings-related pension, higher earners receive more than lower earners. When comparing these alternative systems, there is therefore a 'pivotal' earnings level (See Chart 15 in Chapter 5):

- People earning more than this will get more from the earnings-related system.
- People earning less than this will get more from the flat-rate system.

Assuming everyone works for 40 years (from age 20 to age 59) at the same earnings level, the pivotal earnings level would be £10,000 a year. Currently 49% of the working age population (including the self-employed and those with no earnings at all) earns less than this.

The pivotal earnings level is sensitive to the number of years that people have earnings:

- If people earn for more years, the pivotal earnings level is lower, as the earnings-related system gives a higher pension to people who work for longer. If people work for 45 years (20 to 64), the pivotal earnings level would be £9,000 a year. Currently 46% of the working age population earns less than this.
- If people earn for fewer years, the pivotal earnings level is higher, as the earnings-related system gives a lower pension to people who work for longer. If people work for 35 years (20 to 54), the pivotal earnings level would be £11,000 a year. Currently 51% of the working age population earns less than this.

[186] PPI analysis based on the Aggregate and Distributional Models

The state pension system

Except in Chart 15 in Chapter 5, which considers alternative pensions systems, the current pension system is assumed to continue, with the same uprating conventions as are used today:

- The Basic State Pension and State Second Pension are assumed to be increased in line with prices when in payment. The Basic State Pension level is assumed to remain the minimum income level for entitlement to Savings Credit.
- The Guarantee Credit is assumed to be increased in line with earnings.
- The Lower and Upper earnings limits for State Second Pension are assumed to increase in line with prices. The Lower Earnings Threshold (the LET – the 'flat-rate' part of State Second Pension) is assumed to increase in line with earnings. The Upper Earnings Threshold is assumed to increase to reflect the changes in the LET, ensuring that higher earners receive the same in State Second Pension as they would have received in SERPS. However, when the Upper Earnings Threshold overtakes the Upper Earnings Limit, it is assumed to be uprated in line with prices.

Macroeconomic assumptions

- Prices are assumed to grow by 2.5% each year.
- Earnings are assumed to grow by 2.0% per year in excess of prices.
- Investment returns earned on private pension contributions are assumed to be 2.0% per year in excess of prices and after expenses.
- Annuity rates are calculated consistently with the assumed investment return and the mortality underlying current market annuity rates, adjusted to allow for future expected mortality improvements.

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