PENSIONS POLICY INSTITUTE
PPI

Follow up to PPI evidence to Pensions Commission

This note to the Pensions Commission is intended to clarify and extend the comments made by the PPI at the meeting on 18 March 2005 on three topics:

1. The choice between an earnings-related and a flat pension
2. The consequences for national savings of abolishing contracting-out
3. Raising state pension age

We were asked to respond to your specific questions, which were based on what sounded like strong hypotheses. In making contrary arguments, our concern is to keep to our remit, which is to ensure that the pensions debate is based on all the available evidence.

Topic 1: The choice between an earnings-related and a flat pension

1. As we did in our meeting, we take as a given in what follows that more money is spent to achieve a first tier which is stronger than the current Basic State Pension (BSP).
   - There seems to be a prevailing consensus that there should be a strengthened first tier, avoiding means-testing as far as possible, so that the state provides a flat-rate pension of say, 22%-25% NAE for all, as an insurance against poverty caused by 'living too long'.
   - Strengthening is likely to mean both increasing the level and coverage of the pension. However this is done, it will have a cost beyond the expected future cost of the current pension system[1].
   - To spend <u>less</u> money on the first tier, in order to favour an earnings-related second tier is possible, but it would exacerbate the current problem of poverty and inequality, and would seem to be against what most pension-interested groups are calling for.

[1] But note that the future cost of the current system may be underestimated by Government projections, see PPI Submission to Pensions Commission, Para 103

2. To have an earnings-related pension on top of the first tier requirement, yet more money needs to come from somewhere, but it is not clear how much would be available.
   - There is a real question as to whether the UK political economy will ever allow more money on pensions than that needed for the 22%-25% NAE to all. Although SERPS reform (on top of a good BSP) intended for the state to pay for as much as 40-50% NAE, it never actually did so, and the prevailing view for long-term Government planning has been that the % GDP to be spent on pensions should not increase at anything like the rate at which the number of people over state pension age is increasing. To raise state expenditure on pensions beyond the 22-25% NAE benchmark will therefore need a commitment to tax rises or other cost cutting that we have not yet seen, and which cannot be taken for granted.
   - You proposed that there might be more money available if, instead of the state paying the extra, there was compulsion into private savings accounts: effectively the funded, probably individually owned option is more acceptable and able to raise more resources. But individual ownership has only been popular in the UK with an added incentive – which is itself additional state expenditure.

3. But assume there is more money available to pay for a second-tier (whether from a compulsory state or private vehicle) on top of an improved flat-rate first tier. The question remains whether the best use of spending that extra money is an earnings-related pension or a further increase to the flat-rate pension. You have put forward some arguments for favouring an earnings-related pension. Below we expand on the three reasons we discussed for instead favouring increasing the flat-rate pension:
   - Political moral hazard and individual myopia are not inherently the result of not having an earnings-related pension
   - A flat-rate alternative is better for low earners
   - An earnings-related pension increases complexity and system cost

Political moral hazard and individual myopia are not inherently the result of not having an earnings-related pension

4. As one piece of evidence, the UK has had both an earnings-related pension and a 'savings gap', whereas New Zealand has neither[2]. Of course, there are many differences between the two countries' systems, but it is a reasonable hypothesis that one cause of the apparent lack of political moral hazard and individual myopia in New Zealand might be that the NZ government has consistently given a clear, complete and realistic message on what pension it will provide[3]. The population appears to act fairly rationally about saving.

5. The current UK pensions system and government practice do not give a clear, complete and realistic message on retirement income expectations. It seems highly likely that the risk of political moral hazard and individual myopia is high because the information is:
   - **Complex** (because the system is complex), so is not an obvious call to action.
   - **Uncertain**: individuals cannot rely on achieving their forecast state pension, because, for example, it is possible they will have gaps in their future contributory record, and the means-testing system can change at short notice[4].
   - **Incomplete** e.g., only the forecast pension at state pension age is available and people are not told of the impact of price-linking after then. Useful contextual information such as how long they can expect to live on their pension is not given[5].
   - **Inconsistent**: alongside exhortations to save more, the tone of the political message is about how much government is giving away to pensioners.

[2] 'Savings gap' is used as shorthand for a shortfall being indicated in the income people might reasonably be expected to want in retirement, and what they are likely to get, on assumptions of future work and savings behaviour, in the type of calculation the ABI, the DWP, the Pensions Commission and the NZ Treasury have done

[3] See *Citizen's Pension: Lessons from New Zealand*, PPI (2004)

[4] See PPI submission Para 130

[5] We wrote to the Pensions Minister in September 2004 suggesting that life expectancy at age 65 is put on pension forecasts. Chris O'Brien at the University of Nottingham has recently published research suggesting that knowing this could improve take-up of voluntary pensions by as much as 50%.

6. This suggests that the government, by simplifying the system and communicating information better, can invigorate voluntary private pension provision and:
   - Give people better understood realistic expectations of what the government would provide for them in retirement, reducing the risk of political moral hazard.
   - Help people plan for retirement income as far as they are able, reducing the risk of lower income through myopia.
   - Help providers of private pensions 'sell' their product more easily.

7. This alone is not necessarily an argument for a flat-rate rather than an earnings-related pension, but it does suggest that other approaches might work to reduce political moral hazard or individual myopia. A compulsory earnings-related pension is not necessary or sufficient to do so.

8. Neither a flat-rate nor an earnings-related pension is likely to eliminate political moral hazard or myopia. People are myopic about later life and saving[6]. There is always a risk that people will get to retirement, think that they do not have enough and blame the government.

Low earners (£10k-£20k pa) are better served by as high a universal flat system as possible

9. An earnings-related pension will give more to higher earners than lower earners[7]. In the trade-off decision of how best to spend any additional money available, lower earners will get more if less has to go to higher earners. But lower earners will get less if the additional money is distributed according to earnings. The better solution for low earners would be as high a flat-rate pension as possible.

10. This is highlighted by the average pension income from SERPS/S2P for women converging with the average for men[8]. This is because S2P is becoming more flat-rate rather than earnings-related. This favours women as they are lower earners generally and because more credits are now paid to some non-earners (mainly women).

[6] More research on why this is and what might change it would be extremely useful
[7] Note also that people do not necessarily stay low earners, so looking at a particular earnings band gives only a partial analysis. What is really important is lifetime household income.
[8] Shown for example by DWP analysis presented at the Women and Pensions seminar on 22 March 2005

11. Higher earners are best placed to access voluntary occupational and personal saving and get the benefit of tax incentives. So any compulsory earnings-related element skews further the advantage of higher income people and increases income inequalities in later life.

12. Higher compulsory contributions into second tier pensions would hit the lowest earners hardest, as they are likely to have to find new money to put into compulsory savings. Higher income people are more likely to be saving the compulsory amount already.

13. If the flat-rate first tier is strengthened (which we are taking as a given in this note), lower income people would be helped particularly, so that the need for a second-tier pension for this group is reduced. The benefit for lower income people from a strengthened first tier comes from:
    - Increasing the absolute level of the pension.
    - Extending the coverage of the first tier, by filling the gaps in the contributory system or making it universal, would tend to favour lower income people disproportionately as it is lower income people (people with periods of no or low earnings, such as women) who tend to have gaps in their contributory record.
    - Indexing the first tier pension to earnings (or at least higher than prices) benefits everyone as the gap that other pension has to fill to reach a target replacement ratio at pension age is smaller. This could be as significant a benefit to low earners as adding an earnings-related second tier[9].
    - Indexing the first tier pension to earnings improves longevity protection after taking the pension disproportionately for people more dependent on the state pension.

[9] Comparing for example, given a flat price-indexed first tier starting at 25% NAE at age 40, the additional benefit at age 65 from the alternatives of, first, earnings-indexing the flat first tier, or, second, adding an earnings-related tier of 20% of earnings. Earnings-indexing the first tier pension is also of course a possible factor in the absence of a 'savings gap' in New Zealand, just as it is a factor for why the UK 'savings gap' appears large.

14. Some low earners are covered by occupational schemes. There is a real issue of access to and level of additional saving for people on low earnings. Invigorating voluntary occupational pension provision should help[10], and a simplified strengthened first tier would help with that objective[11]. But it is not clear that, with both these measures, there necessarily needs to be a further compulsory pensions solution:
    - Simple and low risk non-pension personal saving such as Cash ISAs or National Savings should not be forgotten[12].
    - Government does not have to use the DWP to deliver an alternative pension. A National Savings pension product sponsored by the government might be a low cost vehicle, more attractive to some than a stakeholder pension.

An earnings-related pension increases complexity and system cost

15. Any earnings-related system increases complexity from having another set of rules, or element to a set of rules. In the UK, the continuance of an earnings-related second tier is likely to mean the continuance of contracting-out, and if so, the continuance of a complexity that many organisations – including those that might be thought to have a vested interest in it continuing – suggest is not outweighed by any benefit[13].

16. Complexity means more advice is needed, which higher income people are able to access more easily than lower earners. The costs of administration and regulation in the system increase because of complexity. Lower income people with smaller accounts bear a disproportionately higher share of that cost.

[10] For example, mechanisms such as compulsory enrolment with an opt-out
[11] For example, see Chapter 3 of NAPF (2004) *Towards a Citizen's Pension*
[12] We also discussed investigating the extent to which ISAs and non-pension saving are being used by lower income groups
[13] The organisations that have stated the complexity of contracting-out is not a price worth paying for the potential benefit of the system include: the NAPF, the British Chambers of Commerce, Norwich Union, Friends Provident, Watson Wyatt, Mercer, Hewitt Bacon & Woodrow and The Pensions Management Institute. Others suggesting contracting-out should end include the House of Lords Economic Affairs Committee and the Pensions Reform Group.

17. Comparing an earnings-related second-tier pension and a flat-rate pension of the same overall expenditure: with the earnings-related option higher income people would need to have less pension saving in the private sector and lower income people would need to have more[14]. This means that the costs of the private pensions sector increase, as it is more costly for the private sector to access and 'sell' pensions to lower income groups. It also increases the risk that lower income groups are not accessed by the private sector, and so miss their target replacement ratio.

Other points on earnings-related vs. flat-rate pensions

18. The arguments above have been set out to reply to a specific hypothesis that the state needs to intervene in some way to compel an earnings-related pension. There are other questions which we would see as at least as important. For example:
    - The issue of whether to index the first tier to earnings rather than prices is significant, particularly to lower earners, as discussed in Paragraph 13 above. Adding an earnings-related second tier to a price-linked first tier means that the some of the second tier ends up just filling the gap of the declining first tier, as S2P is doing currently. This suggests that the initial questions to be considered would include: *How might the first tier be strengthened, what need for a second tier pension would different income groups then have, and what further money will then be available to pay for a state earnings-related tier?*
    - The state already intervenes very heavily (compared to other countries) to regulate, incentivise and encourage voluntary private earnings-related pensions[15]. No organisation appears to have researched sufficiently the cost/benefit of these interventions. To answer the question *How can the state best provide, arrange or facilitate for people to reach a target replacement ratio*?, it would seem necessary to compare the potential cost/benefit trade-off of improving these interventions with the cost/benefit trade-off of compulsory alternatives (state or private).

[14] For a given set of target replacement ratios
[15] See PPI submission Paras 134-137

19. Some organisations are calling for retention of a compulsory earnings-related pension (in the state and/or the private sector). But many organisations ignore, or cannot allow properly for, the cost trade-off for a better flat-rate pension compared to an earnings-related pension. They might come to a different conclusion if a cost limit were imposed.

20. Further, a state or private compulsory earnings-related pension is not the only way of meeting the various stated objectives behind the proposals:
    - One stated objective for a state second tier pension seems to be that for lower earners, the private sector will not be appropriate. This objective can logically lead to a higher flat-rate state pension (which would be better for lower earners), not only to an additional earnings-related pension. One possible argument for making the additional pension earnings-related might be that to gain political acceptance for higher contribution rates the benefit would have to be seen to be greater for higher contributors. However, this does not seem to be proven: the rise in National Insurance contributions for the NHS was accepted even though higher earners do not get greater value from the NHS[16].
    - Another stated objective for an earnings-related state pension is to allow the state to provide pensions to carers beyond the first tier pension to compensate for not being in the labour market and so missing out on occupational provision, even though the carer may not have had an occupational pension while at work. Specific additional carer's credits to a higher flat-rate pension could satisfy this objective without having an earnings-related pension.
    - If the objective is to retain contracting-out, then that could be done with a single flat-rate pension, by offering the ability to contract-out of the top slice[17].

[16] We are now in a different situation than when proposals for an earnings-related state pension were originally being debated in the UK. In the mid-1950s, National Insurance contributions were flat-rate. The introduction of an earnings-related pension brought with it the opportunity to make contributions earnings-related and so raise more revenue.
[17] As suggested by Scottish Widows and Prudential

Topic 2: The consequences for national savings of abolishing contracting-out

21. You asked about the impact of abolishing contracting-out, specifically the impact on national savings. In the first instance, abolishing contracting-out would reduce national saving, removing future rebates going into occupational or personal pensions. Some organisations have also argued that if contracting-out was abolished, Defined Benefit pension provision would also be significantly reduced. However:
    - A reduction in national saving does not mean a fall in economic growth.
    - The actual impact on national savings is likely to be smaller than expected at first glance.
    - Other changes introduced alongside abolishing contracting-out can offset the direct fall in savings.

A reduction in national saving does not mean a fall in economic growth

22. As highlighted in your macro-economic work, there is not necessarily a direct link between savings rates and economic growth, particularly in an open economy with developed financial markets[18]. The countries with the lowest rates of national saving (the US and the UK) appear to have better economic growth than countries with much higher national savings rates[19].

23. Faster economic growth is probably more desirable (for the population as a whole as well as future pensioners) than a higher national savings rate, but neither is the main objective of pension reform.

The impact on national savings is not as high as at first glance

24. National savings could be reduced by the abolition of contracting-out in two ways:
    - Directly through the loss of the contracted-out contribution[20].
    - Indirectly if voluntary pension contributions currently 'incentivised' by contracting-out are reduced.

[18] For example Barr (2000) *Reforming pensions: Myths Truths and Policy Choices* and Turner (2003) *The macro-economics of pensions* both point out that higher savings need not lead to higher growth. The implication of this is that lower domestic saving need not lead to lower growth, especially where any reductions can be filled by investment from overseas.
[19] PricewaterhouseCoopers (2005) Economic Outlook March 2005
[20] Assuming that the money raised is spent, rather than used to reduce the budget deficit and therefore increase government saving

25. Over two-thirds of contracted-out rebates (£7.2bn in 2004/5) are currently paid to Defined Benefit (DB) occupational pension schemes[21]. However, half of this is not strictly speaking 'saving'. As we discussed, more than 1/3 of contracted-out rebates are 'paid' to unfunded public sector schemes and are simply a transfer from one government pot to another.

26. The remaining £3 - £4bn is paid to private sector DB schemes, and ending contracting-out would reduce savings directly by this amount. A number of organisations also argue that ending contracting-out would lead to the closure of some DB schemes, further reducing voluntary savings by employers or employees.

27. However, the backdrop to this debate is the expected continued decline of private sector DB schemes, which in itself will reduce the national savings rate whether contracting-out is abolished or not. The possible impact of abolishing contracting-out on national savings has to be set in the context of:
    - Many of the DB schemes that people fear will close if contracting-out is abolished may close anyway, for other reasons such as GN11/FRS17, increasing longevity, lower expected long-term returns, the cost of the PPF, and changes to accommodate tax simplification.
    - DB schemes, on changing to other forms of benefit structure, are choosing to contract back in, so contracting-out is declining anyway.

28. Around £3bn a year is currently paid into personal pensions directly by the Inland Revenue in contracted-out rebates. The rebates to personal pension schemes are currently 'actuarially neutral' rebates. Without a financial incentive built in, providers are not selling large numbers of new contracted-out pension arrangements.

29. The lack of sales of contracted-out plans suggests that abolishing contracting-out would not have a significant impact on voluntary saving in private pension schemes.

[21] Inland Revenue statistics table 1.5

30. Providers argue that there should be more incentive within contracting-out. But the rationale for this – that 'on-selling' more voluntary contributions will be facilitated - has not to our knowledge been proven to hold. Further, any incentive will have a cost in further state expenditure.

31. The overall impact on national saving is likely to be much less than the current amount of contracted-out rebates of £11 – 12bn (around 25% of total pension contributions). It would be perhaps less than half of this amount, and declining.

Other changes can offset the direct fall in savings

32. If contracting-out is abolished alongside other changes in state pension policy, increases in voluntary saving could offset the direct reduction in national savings from the loss of contracting-out rebates[22].
    - Abolishing contracting out in itself would reduce the burden of regulation on pension administration, selling and advice, reducing barriers to voluntary pension saving. This may encourage companies to start or continue to provide or sell pensions, or at least stop a source of discouragement.
    - If the state pension system is simplified, for example to a single high-level flat-rate universal pension, the private pensions market would be more closely aligned to those who would 'need' private pensions. Lower earners would receive a higher proportion of target income from the state than they do today, so have less need to save. Higher earners would receive a lower replacement rate from the state, and so need to save more to reach a target income level. This is the group where private pension provision is more likely to be affordable, and profitable for providers.
    - Some of the money not paid out in contracted-out rebates could be used to provide incentives for voluntary saving (if not all of it is redirected to current pension spending).

[22] See NAPF (2004) *Towards a Citizen's Pension* for detailed arguments on the possible impact of a Citizen's Pension and the loss of contracting-out on occupational and personal pensions

Topic 3: Raising state pension age

33. You asked about our preference for setting a schedule for state pension age (SPA) increases, rather than using the method used in Sweden (which calculates the appropriate pension according to the life expectancy of each cohort when they reach age 65)[23].

34. Our suggestion is based on the assumption that it must be better to give people as much certainty in their pension planning as possible, rather than leaving uncertainties to be resolved at such a late age that options to deal with 'bad news' are limited.

35. What we had in mind was something along the lines of:
    - Government sets out a proposed schedule of planned state pension age increases, justified by increasing life expectancy, but reflecting the political reality that small increases are easier. For example: For people currently aged [35-45], the state pension age will be [67], phased in according to a more detailed gradual timetable. For people currently aged [25-35], the state pension age will be expected to be [69], again with a gradual timetable.
    - Government sets out a schedule of [5]-yearly reviews.
    - Each of the state pension ages will be reviewed so that they can only be moved upwards no less than [15] years before the planned SPA and down no less than [5] years before the planned SPA; both movements needing to be justified by life expectancy changes being better or worse than that projected in the justification of the planned schedule.

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[23] See PPI submission Para 91