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Assessment of the costs of Norwich Union's proposals for state pension reform

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Contents

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Summary

1. This document provides an independent assessment of the costs of Norwich Union's proposals for state pension reform.

2. The proposals include the introduction of a universal or Citizen's Pension with eligibility based on residence rather than on National Insurance Contribution records and the ending of new accruals to State Second Pension (S2P) and contracting-out.

3. A Citizen's Pension could either:
   - Replace Basic State Pension (BSP), at a higher level, and pay existing S2P accruals in full in addition. This would result in an immediate gain for all pensioners.
   - Offset both BSP and S2P accruals from the amount of Citizen's Pension payable. This results in an immediate gain only for pensioners with low state pensions, who are most likely to be poorer overall.

4. A Citizen's Pension at the Guarantee Credit level of £105 per week is affordable in the UK, now. If the second ('offset') approach were taken, a Citizen's Pension could be introduced with a net saving of £5 billion if it were introduced at £105 per week and indexed to earnings. If instead the first approach were taken, there would be a small cost in the short run.

5. If a Citizen's Pension were set at £115 per week rather than at £105, there would be a net cost in the short-run under both methods.

6. In the long-term, the cost of a Citizen's Pension increases but can still remain within the 'funnel of doubt' for the projections of the future cost of the current system, if designed appropriately. This means that although it is projected to cost more than the current government projections of the future costs of the current system, it is not certain to cost more than the current system, and could in fact cost less. The

funnel of doubt results from the uncertainty in the future cost of Pension Credit.

7. For the cost of a Citizen's Pension to remain within the funnel of doubt for the future cost of the current system in the long-term, it could be either set at:
   - The Guarantee Credit level of £105 per week with or without a reduced rate for couples and no change to State Pension Age (SPA);
   - The higher level of £115 per week but with a reduced rate for couples (and no change to SPA); or
   - The higher level of £115 per week and with no reduction for couples, but with an increase in SPA to 70 (although there would still be a cost in the short-term under this option).

8. For the long-term cost of a Citizen's Pension to remain comparable to the current government projections of the future cost of the current system, it could still be set at the Guarantee Credit level of £105 per week but with **either** a reduced rate for couples **or** an increase in SPA to 70.

9. Depending on how a Citizen's Pension was introduced, ways to pay for the increasing cost of a Citizen's Pension may have to be found. This is likely to be the case under any plausible pension system, including the current one, as the population ages. It could be afforded by one of the following, or a partial combination of each: a switch of some state spending from other areas to pensions, an increase in taxes, an increase in SPA and a restructuring of tax relief for private pension saving.

10. To use only one of these levers might not be desirable. A more realistic approach might be to transition to a Citizen's Pension with a package of incremental changes: for example, keep less tax advantage in private pension savings and increase slightly state spend on pensions until a future increase in SPA can take effect.

11. Restructuring tax relief for private pension saving may increase tax revenue. Even if the full amount of revenue currently forgone was raised, it would not be enough to finance the extra cost of a Citizen's Pension in the long-term. This means that restructuring tax relief on private savings would have to be part of an overall package consisting also of switching state spending from other areas to pensions, increasing taxes or increasing SPA.

Introduction

1. Norwich Union's core proposals for state pension reform are[1]:
   - The introduction of a universal or Citizen's Pension with eligibility based on residence rather than on National Insurance Contribution records, set at the Guarantee Credit level or above
   - Ending new State Second Pension (S2P) accruals
   - Ending contracting-out
   - A significant retreat from means testing.

2. The Pensions Policy Institute (PPI) is independent and does not make policy recommendations, but exists to contribute facts and analysis to help all commentators and policy decision makers. The PPI has extensively analysed a Citizen's Pension and provides this note for Norwich Union having been commissioned to provide an independent of the costs of Norwich Union's proposals for state pension reform**.**

3. This assessment:
   - Examines the potential short-term and long-term costs of introducing the reforms proposed by Norwich Union.
   - Compares these costs with the potential costs of the current state pension system.
   - Looks at possible options for meeting any additional future costs: a switch of some state spending from other areas to pensions, an increase in taxes, an increase in State Pension Age (SPA) or a restructuring of tax relief for private pension saving.

4. This assessment considers the introduction of a Citizen's Pension at the Guarantee Credit level of £105 per week and the higher level of £115 per week and indexed to earnings, with and without a reduced rate for couples.

5. Norwich Union proposes to stop new accruals to S2P but to recognise fully S2P (or contracted-out) accruals that have already built-up. This means that no pensioner will lose out in the transition to a Citizen's Pension.

[1] Aviva/Norwich Union Response to the Pensions Commission's First Report, January 2005

6. This report considers two choices for dealing with these accrued state rights[2]. Both choices become equivalent in the long-term as accrued state rights under the current system are exhausted, but the offset method will be less expensive during the transition period.
   - **'Addition':** A Citizen's Pension replaces Basic State Pension (BSP), at a higher level. Existing State Second Pension (S2P) or contracted-out accruals are paid in full in addition. This results in an immediate gain for all pensioners.
   - **'Offset'**: A Citizen's Pension tops-up existing accruals to BSP and S2P[3] combined to £105 (if introduced at £105 per week). A Citizen's Pension paid is the maximum of £105 (indexed to earnings) and the accrued state rights (indexed to prices). This means that any pensioner receiving less than £105 from the accrued state rights would immediately have that income increased to £105. Any pensioner receiving more than £105 from accrued state rights would carry on receiving the higher amount. This results in an immediate gain only for pensioners with low state pensions, who are most likely to be poorer overall.

7. The cost of National Insurance rebates for contracting-out is currently £12bn per year[4]. Norwich Union proposes the ending of contracting-out and this would mean that these rebates no longer need to be paid. The projections in this assessment assume that the money 'saved' is available to help pay for a Citizen's Pension in the short-term.

8. The projections in this assessment also assume that Savings Credit is abolished overnight. The net saving from the introduction of a Citizen's Pension at the Guarantee Credit level of £105 per week could be used to protect existing Savings Credit payments. Initially this would cost £1 billion, but would reduce quickly[5]. A Citizen's Pension at the higher level of £115 per week would remove the need for this protection.

[2] For a more detailed description of the addition and offset methods, see pages 13 to 17 of National Association of Pension Funds (NAPF) (2004) *Towards a Citizen's Pension*
[3] Including contracted-out S2P equivalent
[4] PQ David Willetts 26 May 2004 House of Commons *Hansard* Column W1718
[5] PPI calculations based on DWP Pension Credit statistics and GAD 2002-based mortality assumptions

Short-term costs

9. A Citizen's Pension at the Guarantee Credit level of £105 per week is affordable in the UK, now. A Citizen's Pension will result in a net saving in the short-term if introduced at £105 per week using the offset method, after savings from contracted-out rebates have been taken into account (Table 1).

Table 1[6]: The short-term cost in addition to the current government projections for the future cost of the current system of a Citizen's Pension at £105 per week in the UK, £bn in 2004/05 prices

	"Addition"	**"Offset"**
	No couples' reduction	**No couples' reduction**
	SPA 65	**SPA 65**
2006/7	-1.2	-5.2
2007/8	0.3	-4.0
2008/9	1.1	-3.5
2009/0	1.9	-3.0
2010/1	2.8	-2.4
2011/2	3.6	-1.9
2012/3	5.0	-0.8
2013/4	6.0	-0.1
2014/5	7.0	0.6
2015/6	7.9	1.2

10. If a Citizen's Pension were set at the higher level of £115 per week, there would be a net cost in the short-run under both methods. There would be an estimated cost of around £5 billion in 2006, rather than a saving of £5.2 billion.

11. The costs would be lower if a Citizen's Pension was set at a reduced rate for couples. This report considers the long-term costs of setting a Citizen's Pension at a reduced rate for couples but detailed short-term costs have not been done.

[6] PPI estimates, assuming that the Savings Credit and contracted-out rebates are abolished and the Citizen's Pension is introduced in 2006/7. Savings from other means-tested benefits and additional income tax are based on PQ Steve Webb 29 April 2004 House of Commons *Hansard* Column W1243. The figures for the offset method have been adjusted to take into account of the lower gross cost of offsetting a Citizen's Pension against accrued state rights. The estimated cost of contracted-out rebates is based on PQ David Willetts 26 May 2004 as above and on projections from GAD.

Long-term costs

12. The cost of a Citizen's Pension is projected to increase in the long-term but it can be designed so that it still remains affordable.

13. If a Citizen's Pension were introduced at the Guarantee Credit level of £105 per week (Table 2):
    - There would be an extra cost of 2% of GDP to be found by 2053.
    - The extra cost would be halved, to about 1% of GDP by 2053, if a Citizen's Pension were set at a lower rate for couples.
    - If instead SPA were increased to 70 by 2033, there would be little extra cost in addition to the cost of the current system.

Table 2[7]: The long-term cost in addition to the current government projections for the future cost of the current system of a Citizen's Pension at £105 per week in the UK, as a percentage of GDP

	"Addition"	"Offset"	"Offset"	"Offset"
	No couples' reduction	No couples' reduction	Couples' reduction	No couples' reduction
	SPA 65	SPA 65	SPA 65	SPA 70
2013/4	0.5%	0.0%	n/a	0.0%
2023/4	1.4%	0.7%	-0.1%	0.7%
2033/4	2.0%	1.4%	0.5%	-0.7%
2043/4	2.3%	1.9%	1.0%	0.2%
2053/4	2.1%	1.9%	1.0%	0.0%

[7] Costs of a Citizen's Pension are PPI analysis. Current system estimates are taken from GAD and DWP projections for the 2004 Budget. Cost of accrued state rights (SERPS/S2P and COD) estimated from GAD and DWP. The missing values for 2013/4 are not available from the PQ on which the short-term projections are based. With the couples' reduction the level of a Citizen's Pension for couples is 1.6 times the level of a Citizen's Pension for single individuals.

14. If a Citizen's Pension were introduced at the higher level of £115 per week (Table 3):
    - There would be an extra cost of 3% of GDP to be found by 2053.
    - The extra cost would be reduced to about 2% of GDP by 2053 if a Citizen's Pension was set at a lower rate for couples.
    - If instead SPA were increased to 70 by 2033, there would still be about an extra 0.8% of GDP to be found by 2053.

Table 3[7]: The long-term cost in addition to the current government projections for the future cost of the current system of a Citizen's Pension at £115 per week in the UK, as a percentage of GDP

	"Addition"	"Offset"	"Offset"	"Offset"
	No couples' reduction	No couples' reduction	Couples' reduction	No couples' reduction
	SPA 65	SPA 65	SPA 65	SPA 70
2013/4	n/a	1.2%	n/a	1.2%
2023/4	2.2%	1.3%	0.5%	1.3%
2033/4	2.9%	2.2%	1.2%	-0.1%
2043/4	3.2%	2.8%	1.8%	1.0%
2053/4	3.1%	2.9%	1.9%	0.8%

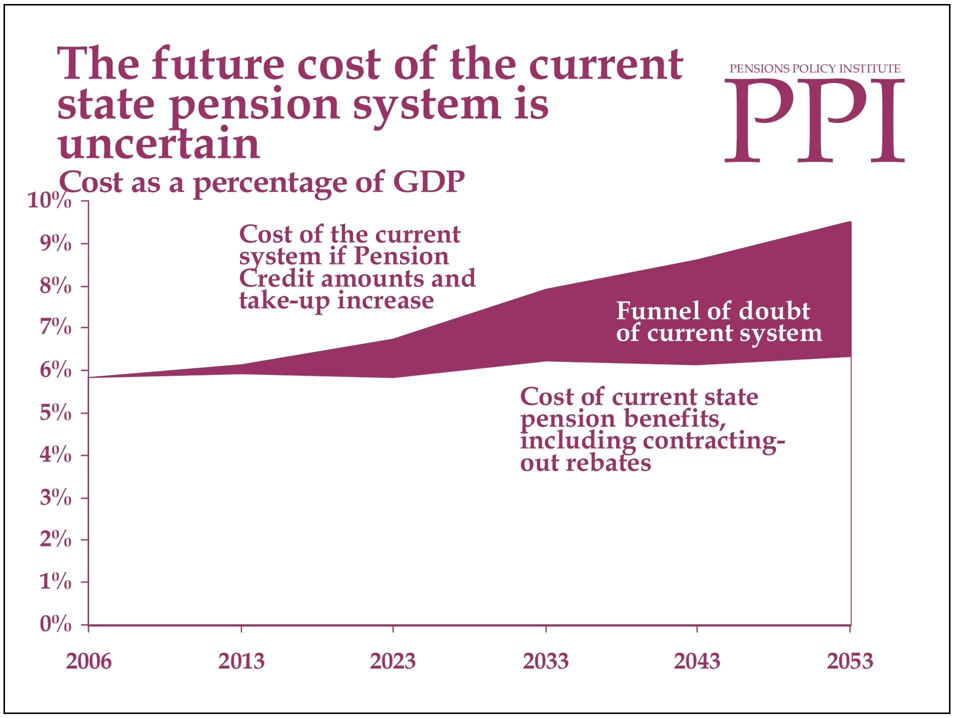
15. The long-term estimates for 2023 and beyond in this report over-estimate the likely actual cost, so that the actual long-term cost may be lower than shown:
    - No allowance has been made for savings on Housing Benefit and Council Tax Benefit, or increased income tax receipts. This might be expected to reduce the cost in 2053 by around 0.5% of GDP.
    - There should also be some administration cost savings from switching from the resource-intensive checking on National Insurance contribution history to a residency test, and from no longer needing so much Pension Credit administration.

Design of an affordable Citizen's Pension

16. This section shows that a Citizen's Pension can be within the funnel of doubt for the projections of the future cost of the current system, if it is designed appropriately. This means that although it is projected to cost more than the current government projections of the future cost of the current system, it is not certain to cost more than the current system, and could in fact cost less.

17. State expenditure on pensioners and contracted-out rebates is expected to grow slightly over the next 50 years. However, future expenditure on the current pension system could be higher than expected. Projections of Pension Credit costs are very sensitive to the amount of other income older people have from savings and earnings (Chart 1).

Chart 1[8]

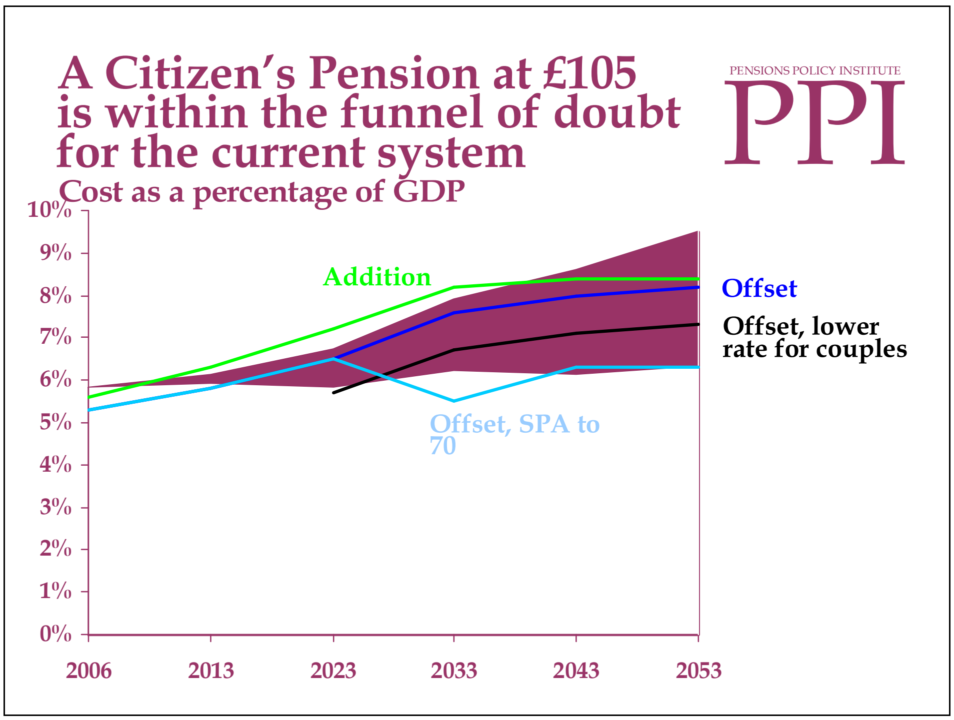


18. The estimated long-term cost of a Citizen's Pension is more certain, as it depends only on the number of pensioners and the level of benefit as a percentage of average earnings. These uncertainties are also inherent in the current system[9].

[8] PPI estimates based on data from DWP and GAD for the 2004 Budget. The upper estimates are based on take-up increasing from 75% to 100%, and income taken into account for Pension Credit increasing in line with prices rather than earnings. The upper bound illustrates the maximum possible cost, rather than the likely possible cost. It is theoretically possible for the cost to be lower than the minimum shown, but this is unlikely. Recent DWP projections for the 2005 Budget use slightly different assumptions than those shown and are lower. However, the projections of a Citizen's Pension would also be lower on the revised assumptions.
[9] The uncertainty in the projections of the cost of the current system resulting from the number of pensioners in the future is not shown in the funnel of doubt in Charts 1 to 3, to enable a fair comparison to be made with the cost of the Citizen's Pension

19. If a Citizen's Pension were introduced at the Guarantee Credit level of £105 per week (Chart 2):
    - The cost would be within the funnel of doubt for the projections of the future cost of the current system if introduced using the offset method.
    - If in addition SPA were increased to 70 by 2033, a Citizen's Pension would cost no more than the current government projections of the future cost of the current system.
    - Setting a Citizen's Pension at a lower rate for couples but keeping SPA at 65 would be an alternative way to improve the affordability of a Citizen's Pension.

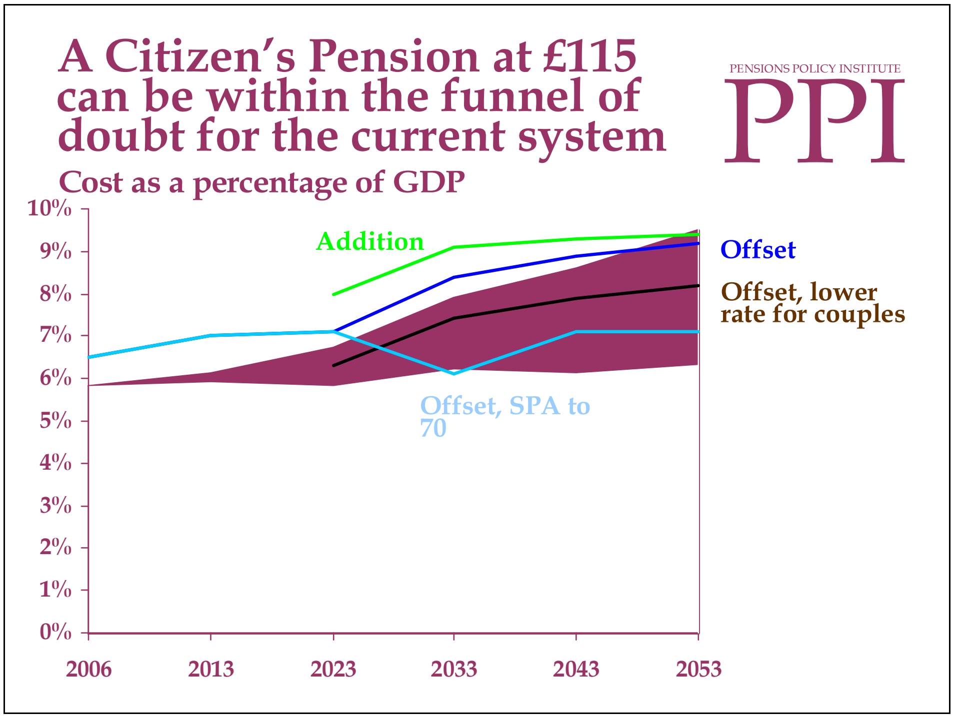
Chart 2[10]



[10] This report considers the long-term costs of setting a Citizen's Pension at a reduced rate for couples but detailed short-term costs have not been done

20. If a Citizen's Pension were introduced at the higher level of £115 per week (Chart 3) the cost could be within the funnel of doubt for the projections of the future cost of the current system. However, either:
    - It must be set at a lower rate for couples, or
    - SPA must increase, or
    - A mixture of both must happen.

Chart 3[11]



[11] This report considers the long-term costs of setting a Citizen's Pension at a reduced rate for couples or using the addition method at £115 per week but detailed short-term costs have not been done

Options for meeting future costs

21. This section explores how any cost above the cost of the current system could be met by a partial combination of a switch of some state spending from other areas to pensions, an increase in taxes, an increase in SPA and a restructuring of tax relief for private pension saving.

22. Depending on how a Citizen's Pension is introduced, ways to pay for the increasing cost may need to be found. But this is likely to be the case under any plausible pension system, including the current one as the population ages, as Chart 1 shows. As an illustration, if a Citizen's Pension was introduced at £105 per week with no reduction for couples then the estimate is that at the peak in 2043 the additional cost is up to 2 percentage points of GDP. It could be afforded by one of the following, or a partial combination of each:
    - **Switch some state spending from other areas to pensions.** Finding all the extra cost would be difficult. 2% of GDP is 40% of the spend on education or 20% of that on health.
    - **Raise taxes allocated to pensions.** If this were the only lever used, the total tax take would have to increase by less than 5% by 2041.
    - **Increase the State Pension Age.** If this were the only lever used, SPA would have to rise to 70 by 2033 (Table 2).
    - **Restructure tax relief for private pension saving gradually.** Even if restructuring raised all the revenue that is currently forgone, it would not be enough to finance the extra cost of this Citizen's Pension design.

23. A more realistic approach might be to transition to a Citizen's Pension with a package of incremental changes: for example, keep less tax advantage in private pension savings and increase slightly state spend on pensions until a future increase in SPA can take effect. A change in the system of tax relief might mean that SPA has to increase to less than 70.

24. Norwich Union has asked the PPI to consider the impact of varying the system of tax relief, to either a single rate system or a system of matching contributions.

25. The state currently forgoes around £20 billion or 1.8% of GDP in revenue per year on tax relief[12]. Restructuring tax relief for private pension saving may increase tax revenue. Any restructuring is unlikely to raise all of the 1.8% of GDP because some individuals may divert their saving into other tax exempt savings vehicles, such as Individual Savings Accounts (ISAs).

26. Even if the full 1.8% of GDP were raised, it would not be enough to finance the extra cost of a Citizen's Pension after 2043 (Table 4). This means that restructuring tax relief on private savings would have to be part of an overall package consisting also of switching state spending from other areas to pensions, increasing taxes or increasing SPA.

Table 4[13]: The long-term cost in addition to the current government projections for the future cost of the current system of a Citizen's Pension as a proportion of estimated expenditure on tax relief for private saving

	£105	**£105**	**£115**	**£115**
	"Offset"	**"Offset"**	**"Offset"**	**"Offset"**
	No couples' reduction	**No couples' reduction**	**No couples' reduction**	**No couples' reduction**
	SPA 65	**SPA 70**	**SPA 65**	**SPA 70**
2013/4	0%	0%	66%	66%
2023/4	37%	37%	74%	74%
2033/4	76%	-39%	120%	-6%
2043/4	104%	11%	153%	56%
2053/4	105%	0%	160%	44%

27. Norwich Union have suggested that a single, flat rate of tax relief on private savings may reduce the cost of tax relief, and provide greater incentives to save for lower income individuals. A change to the system of tax relief might be desirable to rebalance the current bias towards providing higher earners with greater incentives to save than lower earners, who are currently the ones less likely to save[14].

[12] Curry C and O'Connell A, (2004) *Tax Relief and incentives for Pension Saving*, Pensions Policy Institute Report for Age Concern England, www.pensionspolicyinstitute.org.uk
[13] There are no long-term projections of the cost of tax relief, so the cost is assumed to remain constant as a proportion of GDP
[14] For an assessment of the advantages and disadvantages of different restructuring options, see Curry C and O'Connell A, (2004) *Tax Relief and incentives for Pension Saving*, Pensions Policy Institute Report for Age Concern England, www.pensionspolicyinstitute.org.uk

28. A single rate of tax relief of 30% such as suggested by Norwich Union would be cost neutral[15]. A single rate of less than 30% may increase tax revenue and this could be used towards paying for the increasing cost of a Citizen's Pension.

[15] PQ Lord Oakeshott of Seagrove Bay, 28 January 2004, House of Lords *Hansard* Column WA46