Response to Work and Pensions Select Committee inquiry to examine the feasibility of simplifying the UK benefit system

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Summary

1. This submission concentrates on the complexity in the pensions part of the benefit system, and in particular the complexity added by the use of means-tested benefits.

2. If complexity remains, the state pension system can more easily be changed by successive governments, as happened with SERPS. Pensions stakeholders feel very strongly that simplicity is desirable both to help people understand what they will get from the system, and because simplicity would make it harder for governments to change the system over time.

3. The need for simplicity has been recognised by the Government, who set simplicity as one of the criteria used to evaluate state pension reform proposals[1]. However, even after the current proposals in the State Pensions Bill come into force the problem of complexity in the state pension system and the uncertainty that it generates will remain.

4. Three areas of complexity have been identified in PPI research:
   - Complexity in qualification for state pensions, leading to uncertainty as to whether (and for how much) individuals qualify.
   - Complexity in having more than one state pension, even though the two pensions combined still give a relatively low level of income to many individuals.
   - Complexity though the continued extensive use of means-testing to support pensioners incomes. This can affect individual's incentives to save.

[1] Ref DWP White Paper

5. Pension Credit is complicated and adds significantly to the number of parameters on which an individual's future income depends. Further, it is not certain, as its parameters can be set at short notice in a Budget rather than being set in legislation (though the level of the Guarantee Credit will be set in legislation if the State Pensions Bill is passed). Small changes in these parameters can make a big difference to being eligible or not in future. So continued reliance on Pension Credit means that people (and their advisors) will continue to be uncertain about the income they can expect from the state in future and about the value of saving.

6. Means-tested benefits also add to complexity through:
   - The impact on savings incentives (relevant for the introduction of Personal Accounts); and
   - Incomplete take-up

7. The PPI's analysis shows that individuals' incentives to save in Personal Accounts depend on their circumstances. This is because their internal rate of return will depend on the level of contributions, the investment returns, and on how they are affected by the tax and benefit system. Although means-tested benefits are only one factor, there has been much discussion about the extent of means-tested benefits that will remain in the system after the reforms and the effect that this will have on incentives to save.

8. The PPI is planning to conduct further analysis to consider the impact of possible policy options that might improve the incentives to save for some of the individuals who may have incentives to save reduced by means-tested benefits.

The role of the Pensions Policy Institute

1. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI does not make policy recommendations, but exists to contribute facts and analysis to help all commentators and policy decision-makers.

2. This submission concentrates on the complexity in the pensions part of the benefit system, and in particular the complexity added by the use of means-tested benefits.

3. Throughout 2005 and early 2006 the PPI undertook a detailed study of the perceived problems with, and potential reforms for, the UK state pension system[2]. Complexity of state pensions, and in particular the complex interaction between state and private pensions, was identified as a problem with the current system.

4. During the research a widespread concern was expressed that pension policy, once reformed, should be sustainable and stable over time. Many experts believe that the best way to ensure stability is to have as simple and transparent a pension system as possible.

5. If complexity remains, the state pension system can more easily be changed by successive governments, as happened with SERPS in the 1980s and 1990s. Pensions stakeholders feel very strongly that simplicity is desirable both to help people understand what they will get from the system, and because it would make it harder for governments to change the system over time. However, a more complex system may be seen as more flexible, which could be an advantage.

6. The need for simplicity has been recognised by the Government, who set simplicity as one of the criteria used to evaluate state pension reform proposals[3]. The proposals currently passing through Parliament in the State Pensions Bill go someway to making the state pension simpler, moving to essentially a flat-rate state pension. However, the transition will take decades, and during transition the system will be far from simple.

[2] PPI (2006)***Shaping a stable pensions solution***
[3] DWP (2006) ***Security in retirement: towards a new pension system***

7. Currently there are roughly 100 parameters that define what any individual may receive from state pensions and Pension Credit. After the White Paper reforms, there will still be around 95 parameters. The problem of complexity in the state pension system and the uncertainty that it generates will therefore remain.

8. Three areas of complexity were identified in PPI research:
   - Complexity in qualification for state pensions, leading to uncertainty as to whether (and for how much) individuals qualify.
   - Complexity in having more than one state pension, even though the two pensions combined still give a relatively low level of income to many individuals.
   - Complexity though the continued extensive use of means-testing to support pensioners' incomes.

Qualification for state pensions

9. The proposals contained in the State Pensions Bill will go someway to reducing the complexity of the Basic State Pension (BSP). By reducing the number of qualifying years required to 30, it is estimated that 95% of men and women will qualify for a full BSP based on their own contributions. This compares to 85% of men and 30% of women today[4].

10. However, complexity will still remain in qualification for the State Second Pension (S2P), where the amount received will still depend on whether an individual qualifies each year, on the number of years qualified, and to a large (though decreasing) extent on how much individuals earn.

More than one state pension

11. Complexity will remain within the state pension system even when S2P become flat rate. There will be in effect two flat-rate state pensions (S2P may not become flat-rate in accrual until 2030, or possibly even 2036[5] after changes announced in the recent Budget), with different qualification criteria and increasing by different amounts once coming into payment.

[4] DWP (2006) ***The gender impact of pension reform***

[5] Assuming that the recent increase in the Upper Earnings Limit for National Insurance contributions feeds through directly to the band of earnings eligible for State Second Pension

12. This means that individuals will still not be certain about how much pension they will receive from the state. The Government has suggested that an individual with a full working history and median earnings reaching state pension age in 2050 would receive combine BSP and S2P of £135 a week. . However, PPI analysis suggests that the majority of pensioners will have a lower income from state pensions than this on reaching state pension age in 2050[6]

13. With a simpler system, based on a single state pension, there is also less room for future Governments to change part of the state pension system without public debate. Having only one tier of state pension rather than two means that it is not possible to trade one pension off against the other – for example, to allow for a more generous second tier by reducing the value of the first.

14. Complexity within the system also makes it easier for other policy changes to have unintended consequences for pensions policy. For example, the recent announcement in the Budget that the Upper Earnings Limit for National Insurance contributions will be aligned with the earnings limit for paying higher rate tax from April 2009 could extend the band of earnings that qualifies for S2P. If this does occur, S2P will not become flat rate in accrual until 2036, rather than 2030 as intended in the 2006 White Paper.

The impact of means-tested benefits on saving

15. Pension Credit is complicated and adds significantly to the number of parameters on which an individual's future income depends. Further, it is not certain, as its parameters can be set at short notice in a Budget rather than being set in legislation (though the level of the Guarantee Credit will be set in legislation if the State Pensions Bill is passed). Small changes in these parameters can make a big difference to being eligible or not in future. So continued reliance on Pension Credit means that people (and their advisors) will continue to be uncertain about the income they can expect from the state in future and about the value of saving.

16. Means-tested benefits also add to complexity through:
    - The impact on savings incentives; and
    - Incomplete take-up

[6] PPI (2006) ***An evaluation of the White Paper state pension reforms***

The impact on savings incentives

17. The impact of means-tested benefits on savings behaviour is also becoming more important in the context of the Government's reforms to introduce a system of auto-enrolment into Personal Accounts. The PPI has been investigating the factors that are likely to affect the suitability of the new system of Personal Accounts for different individuals.

18. Personal Accounts could give many people access to a low-cost pensions savings product with an employer contribution for the first time. As a result of the low charges and employer contribution, incomes from saving in Personal Accounts are likely to be higher than incomes from saving in Stakeholder Pensions for many people.

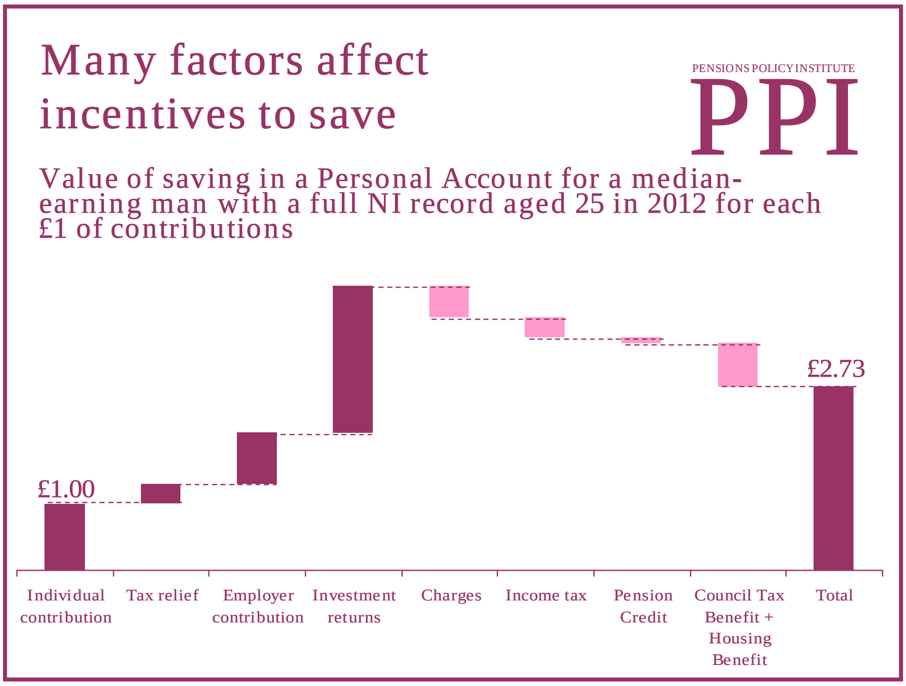
19. The PPI has analysed the incentives to save in the new Personal Accounts by calculating the internal rate of return that different hypothetical individuals could receive when contributing to a Personal Account[7].

20. Returns from saving in Personal Accounts will vary from person to person:
    - An individual's contribution, their employer's contribution, the tax relief and the investment returns on these contributions could all increase the value of an individual's Personal Account.
    - On the other hand, income tax, charges, and any means-tested benefits that the individual may otherwise have been entitled to if they had not saved in a Personal Account could reduce the value of the individual's Personal Account.

21. How these factors interact is complex, so that the internal rate of return will vary from individual to individual. Chart 1 shows how these factors interact for a median-earning man with a full National Insurance record who is aged 25 in 2012.

[7] PPI analysis using the Individual Model. The 'internal rate of return' is the nominal interest rate that the individual receives on his or her individual contributions to Personal Accounts, after allowing for the effects of tax relief, employer contributions, investment returns, charges, income tax and means-tested benefits. It should not be compared with investment returns on other forms of saving.

Chart 1[8]



22. In the PPI's analysis, hypothetical individuals are categorised by being at low risk, medium risk or high risk of Personal Accounts being unsuitable for them, depending on the internal rate of return that they are likely to receive[9].

23. People at 'low risk' of Personal Accounts being unsuitable for them are likely to receive back the value of their individual contributions to Personal Accounts protected for inflation, together with a full investment return on their contributions. Examples are:
    - Single people in their twenties in 2012 with full working histories.
    - Single men in their forties and fifties in 2012 who have a full working history and large additional savings.

[8] PPI calculation. For more information see PPI (2006) ***Are Personal Accounts suitable for all?***
[9] For a full discussion of the PPI analysis conducted and the benchmarks used see PPI (2006) ***Are Personal Accounts suitable for all?***

24. People at 'medium risk' of Personal Accounts being unsuitable for them would receive back the value of their individual contributions, protected for inflation, and some investment returns on their contributions, although they may not receive full credit for the investment returns. This group includes:
    - Single people in their twenties in 2012 with low earnings and broken working histories, whether because of caring breaks or unemployment.
    - Single people in their forties and fifties in 2012 with low earnings and full working histories.
    - Single people in their twenties in 2012 who stay opted in to Personal Accounts while employed, and then become self-employed at a later date.

25. People at 'high risk' of Personal Accounts being unsuitable for them are likely to receive back less than the value of their contributions into Personal Accounts. This group includes:
    - Single people who are likely to rent in retirement and have no additional savings. These people may be entitled to less Housing Benefit in retirement as a result of their saving in Personal Accounts.
    - Although they would not be auto-enrolled, single people in their forties and fifties in 2012 on low to median incomes who are self-employed.

26. Other factors can affect whether or not Personal Accounts are suitable:
    - Returns from saving in Personal Accounts could be higher for people who are married at some point in retirement, rather than always single as the above examples assume. The majority of pensioners are married at some point in their retirement, so this could improve suitability for many people.
    - It may still be advisable for some people in the high-risk category to save. For example, they could have a strong preference to smooth consumption over their lifetime.
    - Conversely, it may not be advisable for some people in the low-risk category to save, for example if they have high levels of debt. Levels of both secured and unsecured debt appear historically high and a sizeable minority of people carry over credit card balances from month to month.
    - Whether contributions are affordable will depend on individual preferences on current expenditure and saving.

27. If Personal Accounts are not suitable for everybody, then this does not necessarily mean that individuals should not be auto-enrolled. But it does have important implications for what information is needed to help people make informed decisions about whether they should opt-out.

28. Policy options may exist to reduce the risk of Personal Accounts being unsuitable for some of the individuals who are auto-enrolled. Potential options include:
    - The provision of generic advice to assist people to decide whether they should stay in or opt-out of Personal Accounts.
    - Not auto-enrolling some groups of individuals, for example, today's older people or people with low earnings.
    - Changes to the tax or benefit system, for example, increases to the trivial commutation limit or making pension saving 'invisible to means-tested benefits.

29. The PPI's analysis shows that individuals' incentives to save in Personal Accounts depend on their circumstances. This is because their internal rate of return will depend on the level of contributions, the investment returns, and on how they are affected by the tax and benefit system. Although means-tested benefits are only one factor, there has been much discussion about the extent of means-tested benefits that will remain in the system after the reforms and the effect that this will have on incentives to save.

Pension Credit and other means-tested benefits

30. There are currently a number of means-tested benefits for which individuals over state pension age may be eligible. These benefits include:
    - Pension Credit
    - Council Tax Benefit
    - Housing Benefit

31. Pension Credit (PC) consists of two elements, Guarantee Credit (GC) and Savings Credit (SC). When PC was first announced, the Government's aim in introducing GC was stated as ensuring that the poorest people over age 60 have a minimum level of income, while the aim in introducing SC was to reward savings[10].

[10] Department of Social Security (2000) ***Pension Credit: A consultation paper***

32. Both GC and SC are means-tested benefits, so the amounts individuals receive will depend on how much income they have in retirement. Pension Credit is a way of targeting Government spending where the need is greatest.

33. Official estimates for eligibility of PC in 2004/5 were presented as a range: from 44% to 49%[11]. Estimates for current eligibility continue to be uncertain because of data limitations.

34. There has been much debate about the likely extent of means-tested benefits that will remain after the Government's state pension reforms have been introduced.

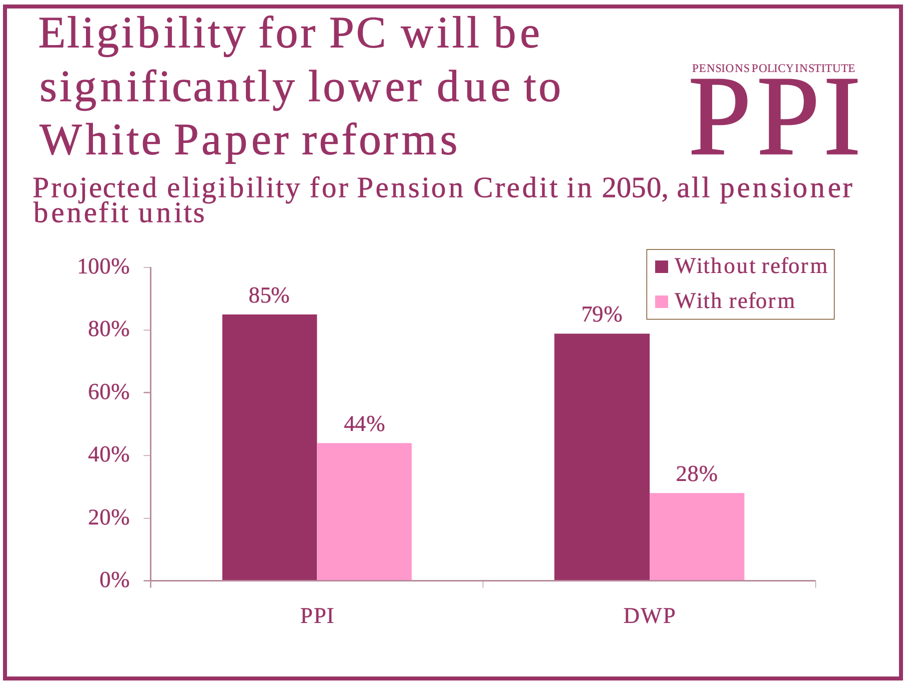
35. Neither the DWP nor the PPI produce projections about the future proportion of pensioner benefit units eligible for Council Tax Benefit or Housing Benefit. However, both publish projections of the future proportion of pensioner benefit units eligible for Pension Credit, under the recent White Paper proposals.

36. Projecting future levels of Pension Credit eligibility is difficult. In order to project future Pension Credit eligibility, one first has to project how much income pensioners will receive from four different sources:
    - Basic State Pension: the proposed reduction in the number of years required to qualify for a full BSP to 30 will mean that incomes from BSP will be more certain in future. In 2050, the majority of people will be entitled to the full BSP.
    - State Second Pension: how much State Second Pension (S2P) individuals will have depends on how many years they qualify for S2P and, until S2P becomes flat-rate, how much they earn.
    - Private pensions: the amount of income from private pensions will depend on how much individuals and/or employers contribute, on how contributions are invested, and on annuity rates.
    - Other savings and earnings: the amount of income from other savings will depend on how much people save and how these are invested. The amount of income from earnings will depend on the availability of employment opportunities, and willingness to work.

[11] PPI estimate based on DWP (2006) ***Income Related Benefits Estimates of Take-Up in 2004/2005***

37. Both the PPI and the DWP agree that the White Paper proposals are likely to mean a large fall in future Pension Credit eligibility, relative to what would be the case in the absence of reform (Chart 2). Estimates, however, differ about the extent of that reduction.

Chart 2[12]



38. Given the inherent uncertainties in projecting future eligibility to PC, the PPI has calculated a range of possible outcomes[13]. The need for a range is underlined by the nature of modelling. Modelling can most robustly be used to show the differences between different policy options, rather than to 'forecast' outcomes under any one particular policy option.

[12] PPI analysis using the Distributional Model. DWP figures from DWP (2006) ***Pensions Bill Regulatory Impact Assessment.*** Note that in past publications PPI projections for Pension Credit eligibility are shown rounded to the nearest 5%, to reflect the inherent uncertainty. Here, projections are shown to the nearest 1% to allow for detailed comparisons.

[13] The lower end of the range, at 1/3, is close to the DWP estimates. See PPI (2007) ***Incentives to save and means-tested benefits***

Incomplete take-up

39. PC has imperfect take-up. It is a benefit that has to be claimed but not everybody who is eligible claims. Around three-quarters of households who are eligible for the GC element (whether or not they are also eligible for the SC element) take up their benefit[14]. Take-up is lower for households who are only eligible for the SC element with less than one-half of such households taking-up their benefit.

40. Council Tax Benefit is a rebate scheme to provide help with up to 100% of an individual's council tax. In 2004/5, between 50% and 55% of 'pensioner benefit units[15]' were entitled to Council Tax Benefit. Take-up of Council Tax Benefit in 2004/5 was estimated to be between 53% and 58%[16].

41. Housing Benefit is designed to help with housing costs. This includes rent and some accommodation related service charges. Around 20% of pensioner benefit units were eligible for Housing Benefit in 2004/5. Take-up is relatively high; between 81% and 87% took-up this benefit in 2004/5[17].

Further analysis

42. The PPI is planning to conduct further analysis to consider the impact of possible policy options that might improve the incentives to save for some of the individuals in the high and medium risk groups identified.

43. The PPI has been commissioned by the Equal Opportunities Commission to produce a report looking at the implications of altering the limits for trivial commutation of small pension funds and the capital limit s for means-tested benefits. This is due to be published in May 2007.

44. Individuals with small amounts of pension saving may be able to 'trivially commute' their pension saving and take 100% of it as a lump sum. This means that the individuals are not obliged to buy an annuity that would give them a very small monthly income.

[14] Midpoint of ranges of take-up estimates by caseload in DWP (2007) ***Pension Credit Estimates of Take-Up in 2005/2006***

[15] A pensioner benefit unit refers to a single person or a couple that can apply for the benefit

[16] DWP (2006) ***Income Related Benefits Estimates of Take-Up in 2004/2005***

[17] DWP (2006) ***Income Related Benefits Estimates of Take-Up in 2004/2005***

45. Taking lump sums can increase the return from saving because of how means-tested benefits work:
    - If an individual bought an annuity with his or her saving, then all of the income from that annuity would normally count in the calculation of his or her entitlement to means-tested benefits.
    - A lump sum provides an individual with capital. Capital is also taken into account in the calculation of entitlement to means-tested benefits. However, the first £6,000 of capital (the 'capital disregard') is not included in the calculation.

46. The policy options analysed for the EOC will increase both:
    - The trivial commutation limit, so that more individuals can take their pension saving as a lump sum rather than an annuity, and
    - The capital disregard, so that a greater amount of capital is not taken into account in the calculation of entitlement to means-tested benefits.

47. Other policy options that may be analysed later this year by PPI include different ways of treating income from pension savings when calculating entitlement to means-tested benefits. For example
    - Disregarding all private pension saving from the calculation of Pension Credit.
    - Introducing a limited disregard of private pension income in the calculation of Pension Credit.
    - Incorporating private pension income within the existing disregard of capital (currently the first £6,000 is not counted in the calculation of Pension Credit).