PENSIONS POLICY INSTITUTE

PRESS RELEASE
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“Reducing reliance on Pension Credit is possible” says Pensions Policy Institute

The PPI today publishes *Transition trade-offs: Options for state pension reform*.

The Pensions Commission recommended detailed reform to the Basic State Pension and State Second Pension, in order to stop future growth of the means-tested Pension Credit.

The PPI paper analyses in detail 8 other state pension reform options that make different trade-offs to those made by the Commission, and evaluates them against the Government’s 5 tests for state pension reform.

“There is widespread agreement among pension experts that the pension system needs reform and that reform should start with the state pension” said Alison O’Connell, Director of the PPI.

“The consensus is, as the Pensions Commission said, that there should be more pension and less means-testing by Pension Credit.”

“Indexing the Basic State Pension (BSP) in line with earnings is the minimum requirement to slow the rapid future spread of Pension Credit. But by itself earnings-indexing the BSP will not reduce the numbers eligible for Pension Credit”.

“The Pensions Commission proposals were more generous than just earnings-indexing the BSP. But their proposals would not significantly reduce the proportion of older people still eligible for Pension Credit from its current level of 50%. The value of saving would remain uncertain for many people”.

“It appears that the Government, like the Pensions Commission, prefers incremental changes to the current complex multi-tier pensions system. One danger in that approach is that the well off gain more. Under the Commission’s proposals the most well off would receive £25 a week more compared to the least well off receiving £5, in 2030”.

The Commission recognised the significant benefits of a simpler solution but, because of specific concerns, preferred a more complicated route. This PPI paper addresses these concerns.

“We offer 3 different ways a simple, single-tier state pension can be afforded within the same cost range as the Commission’s proposals. Each of these solutions could be better for the less well-off”.

“And by reducing eligibility to Pension Credit to only 10% of older people, a simple, single state pension would provide a solid foundation for voluntary pension saving, whether through the NPSS or otherwise”.

ENDS

Transition trade-offs: Options for state pension reform

Summary of conclusions

The broad construct of the Pensions Commission's proposals is consistent with the consensus view of pensions experts.

However, many experts urge a simpler solution to meet the Government's tests for pension reform more effectively. This would involve a faster transition to the ultimate end-point and combine the two state pensions into one. This preference for a simpler solution is explained by unpicking the policy trade-offs made by the Commission:

1. **Earnings or prices?** The Commission proposed fully uprating the Basic State Pension in line with earnings. This is necessary to maintain state pension income in retirement and prevent people slipping back onto Pension Credit at older ages.

2. **Residency or contributory?** The Commission proposed using a mix of residency and contributory criteria for state pension. There is public support for better coverage of state pensions, so that they would be given to most if not all people over state pension age. This could be achieved by a residency criterion or by improving the existing contributory criteria. A residency criterion seems easier to understand from an individual's point of view, but changing the existing contributory system may be easier for Government to implement. Improving coverage is only part of the solution and makes little difference to the number of people on Pension Credit.

3. **One or two tiers?** The Commission proposed maintaining the current two tiers of state pension, Basic State Pension and State Second Pension. This retains unnecessary complexity and gives more to higher income people.

   Crucially, a single-tier system could be much more effective at reducing the proportion of pensioners who have to rely on means-testing through Pension Credit, from 50% today to around 10%. The Commission's proposals would only reduce the proportion to around 45%, which is still historically high. Pension Credit makes it difficult to meet the Government's test of promoting personal responsibility, as it makes the value of saving uncertain.

4. **Slow or fast transition?** The Commission proposed a very long transition, taking more than 50 years. A faster rather than slower transition would be simpler and more transparent. It would limit the time available for future changes, so is more likely to be sustainable.

The Commission recognised the benefits of a simpler solution but recommended against it. However, all their concerns can be met. In particular, their concerns about cost and distributional implications of the simpler solution are less significant than feared. A simpler solution can be afforded within the cost range suggested by the Commission.

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The report can be downloaded from www.pensionspolicyinstitute.org.uk

Notes for editors

The Pensions Policy Institute (PPI) is an independent research organisation, focused on pension provision. Its aim is to improve information and understanding about pensions (state and private) through research and analysis, discussion and publication. It does not lobby for any particular issue, but works to make the pension policy debate better informed.

The Government's 5 tests for state pension reform (announced by John Hutton on 24 November 2005) are:

- Does it promote personal responsibility?
- Is it fair?
- Is it affordable?
- Is it simple?
- Is it sustainable?

A single-tier pension with individual entitlement set at the Guarantee Credit level (£114 a week for singles and £87 for each individual in a couple) could reduce the proportion of pensioner benefit units eligible for Pension Credit to around 10% (a pensioner benefit unit is a single person of state pension age or older, or a couple with one partner of state pension age or older).

How quickly eligibility for Pension Credit is reduced depends on the speed of transition to the new system, as shown in Chart 1. A short transition reaches 10% by 2010, a medium transition reaches it by 2030 and a long transition reaches it by 2060.

All three transition options could cost less than the Pensions Commission's proposals by better targeting existing state spending on pensions (Chart 2). Longer transitions give less to today's pensioners but may be easier to afford.

All of the options shown in Charts 1 and 2 have the Basic State Pension indexed at least to earnings. The charts show that by itself, earnings-indexing will not reduce the numbers potentially eligible for Pension Credit in future.

Chart 1

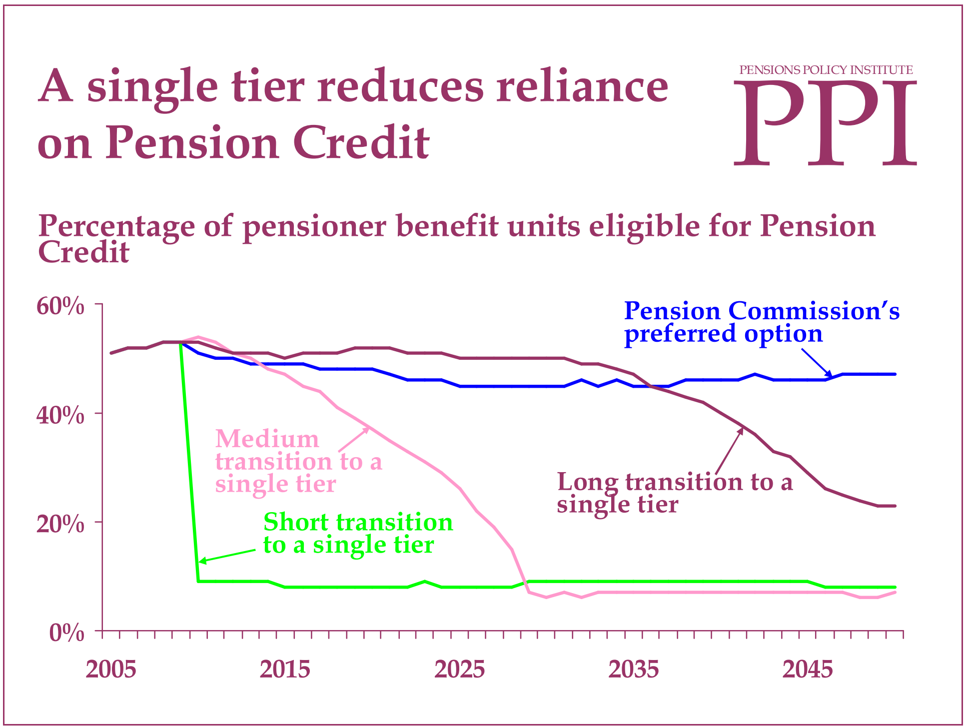

Chart 2

Affordable systems exist that reduce reliance on Pension Credit

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	Short transition: Increase BSP to the Guarantee Credit (GC) level in 2010. Stop S2P accruals.	**Medium transition:** Increase BSP faster than earnings to reach the GC level by 2030. Stop S2P accruals.	**Long transition:** Replace accruals to BSP and S2P with accruals to a new pension at GC level
Proportion eligible for PC	10% from 2010	10% from 2030	25% by 2050 10% from 2060
Possible ways of affording it	Use revenue from contracting-out **and** offset S2P from BSP	Use revenue from contracting-out **or** increase NICs by 1%	n/a
Remaining cost in 2010 (£1 bn for P Comm. proposals)	£1 bn	£6 bn saving	£1 bn
Remaining cost in 2020 (£10 bn for P Comm. proposals)	£7 bn	£2 bn	£1 bn

NB: BSP is Basic State Pension, S2P is State Second Pension