Submission to the House of Commons Work and Pensions Committee's inquiry into the introduction of Pension Credit

PENSIONS POLICY INSTITUTE

PPI

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Summary

1. The Pension Credit is intended to:
    - **Ensure the poorest people over age 60 have a minimum income**, by topping up income at least to the level of the Guarantee Credit.
    - **Reward saving**, by giving Savings Credit to those over state pension age who have some income above the Basic State Pension.

2. The Government also claims that the Pension Credit will help to **keep pension-related state spending within sustainable limits**.

3. This submission highlights what it takes for the Pension Credit to be successful on these policy aims. It finds that Pension Credit is not succeeding in meeting these aims, and it is not clear whether improving delivery can ensure the aims are met. The problem is the design of Pension Credit, especially the Savings Credit part.

4. The particular concerns are:
    - Guarantee Credit is doing some good in poverty avoidance, but take-up is less than 100% take-up, it is not guaranteed to keep its value in future, and its scope is being scaled back.
    - Savings Credit cannot act as a reward for saving even if delivery were excellent. It is too complicated and disconnected from the savings decision.
    - Savings Credit take-up levels are very low. There is no spur to claiming Savings Credit so eligible people may drift for some time not realising they need to claim.
    - Savings Credit is a real barrier to saving for today's workers.
    - The cost of Pension Credit may be significantly higher in future than Government projections suggest.
    - The cost of administering Pension Credit raises doubts about the efficiency of its delivery.

5. The submission concludes that, in addition to the problems highlighted above, **Savings Credit complicates pension reform**.

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The role of the Pensions Policy Institute

6. 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.

7. This submission is written by Alison O'Connell, Director, and Chris Curry, Research Director. Alison trained as an actuary and has over 15 years experience in the financial services industry and pensions policy. Chris has worked in pensions for the Government and the private sector for 10 years.

The aims of the Pension Credit

8. When the Pension Credit was first announced in 2000, its stated aims were to[1]:
   - **Ensure the poorest people over age 60 have a minimum income**, by topping up income at least to the level of the Guarantee Credit, and
   - **Reward saving,** by giving Savings Credit to those over state pension age who have some income above the Basic State Pension.

9. Since then, the Government has also stated that current policy (including the Pension Credit) will help to **keep pension-related state spending within sustainable limits**.

10. It is not clear that these aims are being met by the Pension Credit.

Ensuring the poorest have a minimum income

11. The Pension Credit is intended to ensure that the poorest people over age 60 have a minimum income, by giving those with no other income at least the level of the Guarantee Credit (currently £105.45 per week for singles and £160.95 per week for couples; around 22% of national average earnings, NAE).

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

12. The Guarantee Credit will be effective at this aim **if**:
    - All people who are eligible for the Guarantee Credit receive their entitlement, that is, take-up is 100%, **and**,
    - The level of the Guarantee Credit is increased annually in line with average earnings, **and**,
    - The age of entitlement is appropriate.

13. Pension Credit take-up is currently 74% of eligible households[2].

14. Take-up has been increasing as the new Pension Service beds in, but the monthly increase in the number of households receiving Pension Credit appears to be slowing (Table 1).

Table 1: Slowing of Pension Credit new entitlements[3]

Month	Increase in number of households receiving Pension Credit
June 2004	66,000
July 2004	52,000
August 2004	25,000

15. While there could be seasonal or other explanations for this short-term trend, it does suggest that it will get harder to increase the take-up rate beyond 75%.

16. In recent years the estimated take-up of means-tested minimum income benefits has been falling as the number of people entitled to them has increased. In 2001/2 (the last year for which official take up estimates have been published), between 63% and 72% of people entitled to the Minimum Income Guarantee were receiving it. Even when take-up was estimated to be at its highest in 1998/99 (the year before the introduction of the Minimum Income Guarantee), between 68% and 81% of people were receiving the benefit they were entitled to[4].

[2] Statement to the House of Commons by the Minister for Pensions 16 September 2004, House of Commons *Hansard*, column 185 WS for current claimants; compared to eligibility data from Department for Work and Pensions. These figures are not directly comparable to official estimates of take-up, which are based on survey data rather than administrative data.

[3] Ministerial Statements to the House of Commons

[4] Based on DWP and DSS publications *Income Related Benefits: Estimates of Take-Up* for years from 1996/7 to 2001/2 for take-up of Income Support for pensioners and the Minimum Income Guarantee (from 1999 onwards). These figures are estimated from survey data, rather than administrative data so are not directly comparable to the figures in paragraph 13 and table 2. The range indicates the confidence interval in the sampling.

17. The elimination of poverty depends on the take-up of Guarantee Credit being 100%. Some breakdown of take-up by type of Pension Credit benefit is possible, but not on the same basis as the current 74%. The latest figures, for May 2004, show beneficiaries receiving Pension Credit (rather than households) as a % of beneficiaries eligible (Table 2).

Table 2: Take-up of beneficiaries receiving different types of Pension Credit, May 2004

Type of benefit	Eligible beneficiaries 2004/5, '000[5]	Beneficiaries May 2004, 000[6]	Implied take-up
Guarantee Credit only	1,250	928	74%
Guarantee Credit and Savings Credit	1,700	1,452	85%
Savings Credit only	1,700	639	38%

18. The pattern of take-up is clearly higher for the 'poverty avoidance' part of Pension Credit than for the 'savings reward' part. Guarantee Credit may be more successful at taking pensioners out of poverty than the headline take-up figure suggests. **For tracking policy effectiveness, it would be useful to see take-up figures published monthly by type of Pension Credit benefit**.

19. The Government is assuming that the headline take-up rate remains at the 75% level[7] for the next 50 years in their long-term projections of expenditure on state pensions and benefits[8]. While putting the assumption in a projection of expenditure need not be related to achievable targets, it clearly makes more sense if they are.

20. It would be possible for the take-up rate for Guarantee Credit (with or without Savings Credit) to be 95% and the take-up rate for Savings Credit to be 50% and the overall take-up of Pension Credit to still headline at 75% by 2014[9]. This is because the number of beneficiaries eligible only for Savings Credit grows by two-thirds

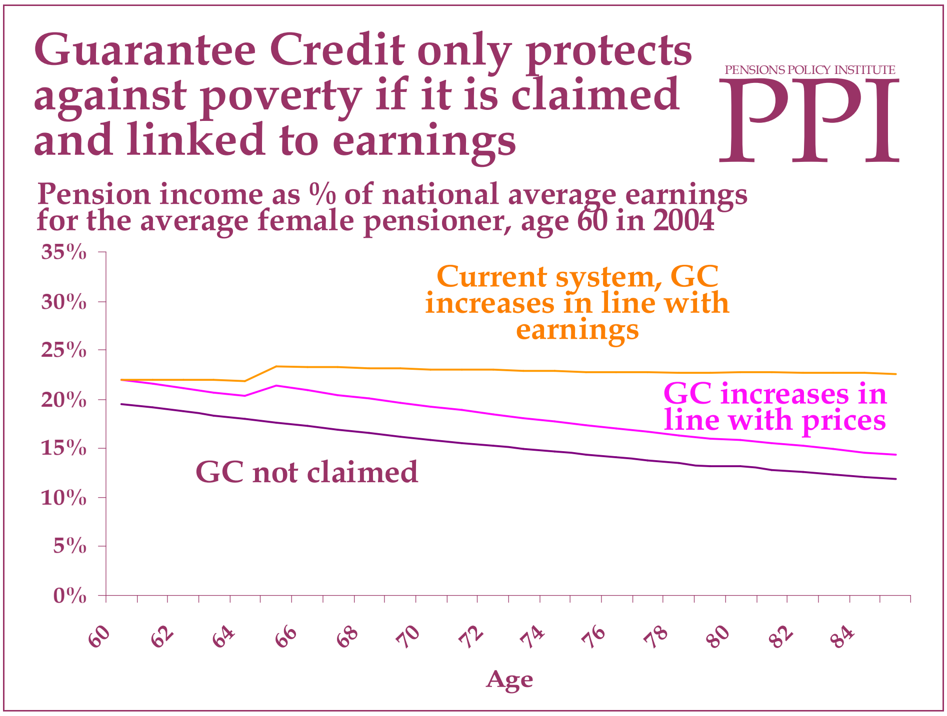
[5] Figures from the Department for Work and Pensions. A 'beneficiary' is the person eligible and his or her partner.
[6] DWP Pension Credit Quarterly Statistical Enquiry, http://www.dwp.gov.uk/asd/pcqse.asp
[7] PQ Mr David Willetts 13 September 2004 House of Commons *Hansard* column 1393W. 75% represents the proportion of pensioners entitled to any element of Pension Credit.
[8] DWP long-term projections, www.dwp.gov.uk/asd/asd4/long-term.asp consistent with HMT (2004) *Prudence for a Purpose: A Britain of Stability and Strength* Budget 2004; PPI Briefing Note Number 14
[9] PPI estimate based on DWP forecasts of eligibility

over the next 10 years (to 2.85m) and the number eligible for Guarantee Credit grows by only by one-fifth (to 3.5m). We understand that the DWP does assume different future take-up rates for Guarantee and Savings Credit which combine to the 75% headline. **For tracking policy effectiveness, it would be useful to see short-and long-term take-up targets published by type of Pension Credit benefit.**

21. The other crucial aspect of Pension Credit succeeding in poverty avoidance is that the Guarantee Credit level continues to increase annually in line with national average earnings, so that the minimum level of income a claimant has to live on keeps up with that in the rest of society.

22. While raising Guarantee Credit levels in line with prices reduces the number of people eligible for the benefit[10], it means that those left claiming the benefit become poorer relative to the rest of society (Chart 1).

Chart 1[11]



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[10] For example, Disney and Emmerson (2004) *Public pension reform in the United Kingdom: what effect on the financial well being of current and future pensioners?* Table 4.2

[11] PPI estimates using the Individual Model. Figures for an average female pensioner are derived from DWP administrative data on state pension entitlement and the Family Resources Survey.

23. Annual increases in Guarantee Credit levels are not set in legislation, but set at best one Parliament at a time. This introduces regrettable uncertainty into this important aspect of pension policy.

24. The eligibility age for Guarantee Credit is to be raised from 60 to 65 between 2010 and 2020[12]. This is logical in terms of consistency with the increase in the state pension age for women, with increasing longevity in general and with encouraging working at older ages. However, it is at odds with the Government's stated reason for not increasing state pension age – that it would discriminate against poorer men in manual jobs and/or in deprived regions who tend to have a lower life expectancy than the population average.

25. The poorest people aged 60-64 who would otherwise be eligible for Guarantee Credit (£105.45 per week for a single person) will instead be eligible for Income Support (£55.65 per week). The power of Guarantee Credit to protect against poverty is therefore being reduced at these ages. The effect of this depends on the income profiles of people aged 60-64 in 2020, but as of now, 59% of men claiming Guarantee Credit only are aged 60-64 and 36% of women[13].

Rewarding savings

26. The Savings Credit can reward saving **if**:
    - The rules for what counts as 'other income' to be rewarded under Savings Credit fairly recognises saving, **and**,
    - People eligible for Savings Credit recognise it as a 'reward' and take-up the benefit, **and**,
    - People saving now can be sure that Savings Credit will reward them for having done so when they reach pension age.

27. Savings Credit pays a benefit of 60p in the £ for any 'other income' being received in the gap between the level of the full Basic State Pension (BSP) and the Guarantee Credit level. The amount of Saving Credit then reduces by 40p for every £1 of income above the Guarantee Credit level. The maximum Savings Credit that can be received is £15.51 per week for a single person (£20.22 for a couple), and Savings Credit is no longer payable when income exceeds £144 per week (£211 for a couple).

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[12] Department for Work and Pensions (2002) *Simplicity, Security and Choice: Working and saving for retirement* page 101
[13] Department for Work and Pensions, Pension Credit Quarterly Statistical Enquiry May 2004, http://www.dwp.gov.uk/asd/pcqse.asp

28. There are many counter-intuitive aspects in the rules for the Savings Credit calculation. It is therefore difficult to say that the rules fairly recognise saving. For example:
    - Person A with £1 more other income than Person B could receive 40p less Savings Credit than B and only 60p higher total income. In effect, A's savings have been taxed at 40%. This is better than being taxed at 100% (which was the case with Minimum Income Guarantee before Pension Credit was introduced) but is not as good as not being taxed at all (which would happen if the state guaranteed a pension at least at the Guarantee Credit level).
    - Only saving above a full BSP is recognised. This disadvantages people who may have done the right thing and saved, but for some other reason did not get a full BSP. This situation tends to disadvantage mostly women who take time out of work to care for children and others. The average BSP received by a female pensioner today is 72% of the full BSP[14]; even by 2020 it is expected to be 86%[15].
    - 'Other income' includes 'saving' from State Second Pension (S2P, or its predecessor SERPS). So self-employed people, who do not join S2P, need to have done much more personal saving than, say, an employed person in an occupational scheme to get the same Savings Credit. Similarly, someone who was in an occupational scheme by luck rather than judgement (e.g., a compulsory scheme) gets Savings Credit, although he or she did not take any action to be rewarded.
    - Some people receiving Working Tax Credit (WTC) can get a Government boost to their savings that is then reinforced by Pension Credit. WTC is calculated on income net of private pension contributions, so a contribution to a private pension is offset by an increase in WTC (as well as attracting tax relief). The resulting pension can then also increase Pension Credit when it comes into payment. This seems to have come about not through careful design of the benefit system, but as an unforeseeable consequence of overlapping complex benefits.

[14] Department for Work and Pensions (2004) *State Pension Summary of Statistics: March 2004*. Based on a woman aged under 80.
[15] Government Actuary's Department (2003) *Government Actuary's Quinquennial Review of the National Insurance Fund as April 2000*

29. It is not at all clear that people eligible for Savings Credit recognise it as a 'reward'. The recipients of Savings Credit today did not know they would receive it, as it was not in place when they were facing savings decisions. In effect Savings Credit is currently rewarding people for having saved.

30. It is notoriously difficult for pension experts to understand Savings Credit. Even allowing that individual claimants do not need to understand the small print of the calculations, it is hard for individuals to understand why they are eligible to (or not) a certain amount from the Savings Credit. Compared to Guarantee Credit with the simpler message of "if your income is below £105 a week we will top it up", there is no simple connection an individual can make between the information they are giving to the Pensions Service and the decision on Savings Credit eligibility.

31. As seen in Table 2, the take-up rate of Savings Credit appears much lower than the take-up rate when there is eligibility for Guarantee Credit. The low take-up may be due to the sheer complexity and counter-intuitiveness of Savings Credit. It may also be that the average benefits are fairly small (£10 per week), except where there is eligibility for Guarantee Credit as well (£38 per week)[16]. It seems to hold more generally that people eligible for small amounts tend not to take-up benefits[17].

32. The other major design feature preventing a high take-up of Savings Credit is that eligibility creeps up as people become older. While most pensioners will be entitled to claim Pension Credit at some point in retirement, they generally become entitled to Savings Credit first and then Guarantee Credit. For example, a median earner who works throughout life, and retired this year at age 65 with some private pension income will become eligible for Savings Credit at age 76, and Guarantee Credit at age 99, if of course he lives that long (Chart 2).

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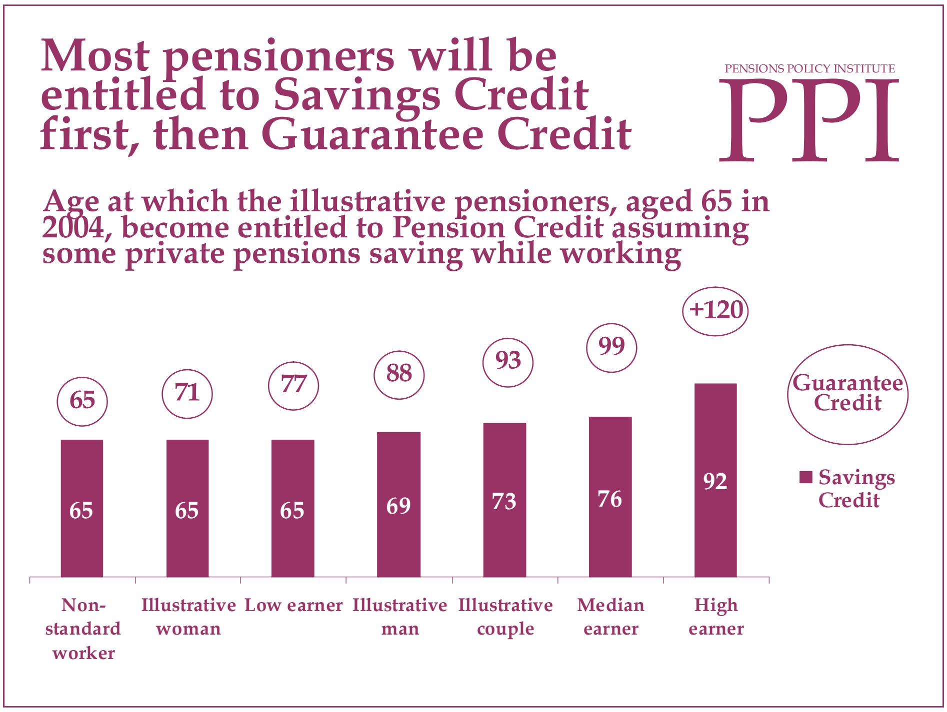
[16] Department for Work and Pensions Pension Credit Quarterly Statistical Enquiry May 2004. Average for Guarantee Credit only was £71.
[17] Hancock et al (2003) *The Take-Up of Multiple Means-Tested Benefits by British Pensioners: Evidence from the Family Resources Survey* Discussion paper in Economics 03/7 University of Leicester

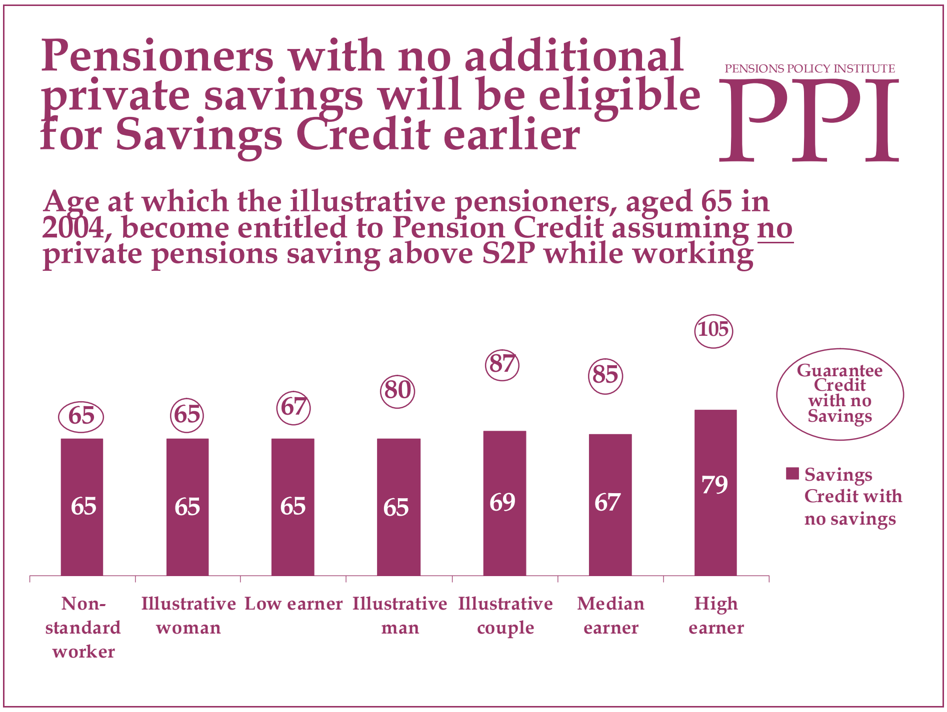
33. Pensioners with no saving above that in the State Second Pension (S2P) will get Savings Credit (because of their S2P) even earlier (Chart 3).

34. Most pensioners will become entitled to Savings Credit as eligibility is increasing very fast. The gap between the price-linked BSP and the earnings-linked Guarantee Credit increases faster then earnings; and it is this gap that determines the spread of Savings Credit entitlement.

35. The implication for pensioners is that they can be ineligible for Savings Credit one year then eligible the next. They may not have a spur to claim Pension Credit, so drift on for some time not realising that they could claim. They may have claimed once before, been found ineligible and then thought it was not worth claiming again. **With this design feature, and such complexity for a small benefit, it seems very hard to see how take-up for Savings Credit could ever increase to a level where it is an effective reward for saving.**

Charts 2 and 3[18]



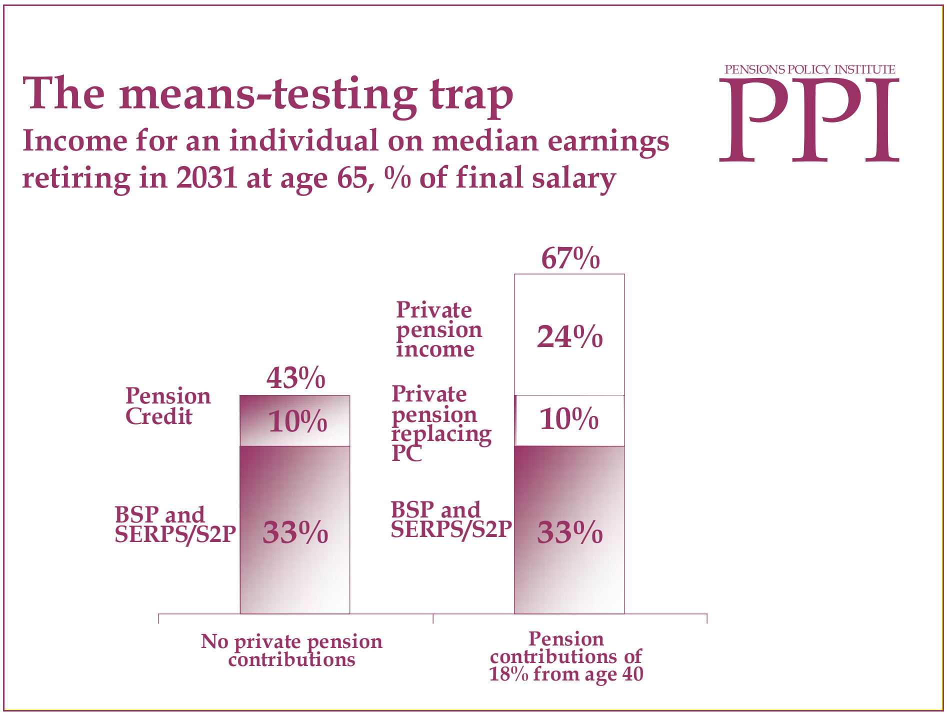


18 PPI (2004) *State Pension Reform: Managing Transition*

36. Savings Credit is intended as a reward to encourage people of working age to save now. The issues of complexity and the disconnect between action and reward apply to working age people similarly to the discussion regarding current pensioners in paragraph 30. It is exacerbated because the Savings Credit parameters are not set into the future. These parameters twenty or thirty years from now – indeed the very existence of Savings Credit - are impossible to guarantee. So it is difficult to see how Savings Credit can act as a reward for saving for today's would be savers.

37. Savings Credit was intended as a softening of the means-testing trap which existed when only Guarantee Credit was in place. With the full Pension Credit in place, the trap still exists (Chart 4). Someone on median earnings throughout a full-time career, aiming for a two-thirds final salary pension in 2031, would need to save 18% of salary from age 40, on top of S2P. 34% of his final salary would come from the private pension. But if he saved nothing, he would still get around a third of that saving (10% of final salary) from Pension Credit.

Chart 4



38. Savings Credit has complicated the calculation working out to what extent the means-testing trap bites – so to what extent it is worth saving – and that calculation is more sensitive to what the parameters in the calculation might be in future. It cannot be said with certainty that it always pays to save – except for people so far up the income distribution that they will remain clear of Pension Credit throughout their life. There are not many people that will definitely be in this category. This can be seen by:
    - Charts 2 and 3 show that most typical people will become eligible for Pension Credit at some point. It looks unlikely for only the 'High Earner' who earns twice median earnings throughout his career so represents someone in the top 6% of the working population by income.
    - It is estimated that 64% of pensioners will be eligible for Pension Credit by 2025 and 71% by 2050[19].

39. Individuals are not likely to attempt these calculations themselves, but any pensions adviser has to try to do so in order to be able to sell a pension product. Because there is such uncertainty in whether it is 'best advice' to save or not, and advisers tend to be cautious, sales of pension savings products falter. This applies both to sales to individuals and sales to groups of employees.

40. This confusion may also apply to employers, who question the value of providing an occupational pension to lower-middle income workers if the benefit will be caught in the means-testing trap.

41. In summary, **Savings Credit cannot act effectively as a reward for saving.**

[19] Disney and Emmerson (2004) *Public pension reform in the United Kingdom: what effect on the financial well being of current and future pensioners?* Table 4.2

Keeping state spend on pensions within sustainable limits

42. Pension Credit will help to take state pension-related spend within sustainable limits, **if**:
    - People do save as expected, **and**,
    - People take up the benefit as expected, **and**,
    - The cost of delivering Pension Credit, including the cost of encouraging people to claim, is reasonable.

43. Government long-term spending forecasts show that Pension Credit is the fastest growing component of cost: from 0.5% of GDP in 2003/4 (£5.1bn) to 1.5% of GDP in 2053.

44. These forecasts project how much state pension (BSP and S2P) people will have in future and also make assumptions about how much other income they will have. This enables the rules for Pension Credit to be applied to sample cases, and estimates made of how many people will be eligible for how much Pension Credit in future. Clearly, this calculation is very sensitive to the amount of other income brought into account. The assumption made is that all this 'other income' increases in line with earnings.

45. This seems a strong assumption to make. Contributions to private saving are at best flat (relative to earnings), whereas they should be rising if they are to provide growing pension incomes as the cost of pensions increases with longevity improvements. The potential growth in earned income over pension age is unclear.

46. Therefore **the long-term cost of Pension Credit may turn out to be much higher than assumed in Government projections**. If instead of growing at earnings, 'other income' grows at prices, then the cost of Pension Credit in 2050 could be 2 percentage points of GDP higher[20]. The growth of the other income is largely out of the control of Government. It is a concern that the barriers to saving put up by Savings Credit might actually prevent savings at a rate which will allow the cost of Pension Credit to be sustained.

[20] PQ Mr David Willetts 3 June 2003, House of Commons *Hansard* column 390W. This figure may be even higher in light of recent updates of the long-term expenditure projections.

47. The other uncertainty in the cost of Government projections for Pension Credit is the take-up rate. As seen earlier, the assumption made is that take-up remains at 75% for the next 50 years. If take-up were 100%, this could add another half a percentage point of GDP to the cost in 2053.

48. The 'funnel of doubt' for the cost of Pension Credit matters for Government planning of long-term state finances. It matters also to people of working age today. If there is a doubt whether Pension Credit can be afforded in future, so that it is suspected that a future Government may erode Pension Credit to keep costs down, then long-term personal financial planning cannot be made on secure assumptions about future state benefits.

49. The administration costs of Pension Credit are small compared to the cost of the benefit payouts. But it is still important that it is delivered efficiently. However, it is very hard from the available indicators to assess the efficiency of Pension Credit.

50. The overall DWP administration costs of paying benefits to pensioners increased from £255 million in 1997/8 to an estimated £500 million in 2003/4[21]. Part of this reflects the cost of introducing the Pension Credit – an estimated £285 million between 2001 and 2004[22]. The Pensions Service had to recruit 7,000 new staff to administer Pension Credit[23]. And advertising Pension Credit, to try and increase take-up, cost more than £15 million in 2003/4[24].

51. The DWP administration costs of paying benefits to pensioners, even after the one-off cost of introducing the Pension Credit has been paid, is still expected to be £455 million a year in 2005/6. This is £200 million a year more than the costs in 1998/9 (on as like for like as basis as possible from published figures)[25]. The annual cost of administering a means-tested benefit for 1 year (£54) is 10 times more expensive than paying a basic state pension (£5.40)[26].

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[21] Department for Work and Pensions (2004) *Departmental Report 2004* Table 5. The estimates have been adjusted to reflect the restructuring of the Department
[22] Department for Work and Pensions (2004) *Departmental Report 2004* Figure 25
[23] National Audit Office (2002) *Tackling Pensioner Poverty: Encouraging Take-up of Entitlements*
[24] Department for Work and Pensions (2004) *Departmental Report 2004*
[25] Department for Work and Pensions (2004) *Departmental Report 2004*
[26] As reported in evidence by the Department for Work and Pensions reproduced in the House of Commons Committee of Public Accounts (2003) *Tackling Pensioner Poverty: Encouraging Take-up of Entitlements.* Figures relate to the Minimum Income Guarantee in January 2003.

Savings Credit complicates pension reform

52. The PPI is pursuing a research programme looking at possible reform models for the UK's state pension system[27]. There is a growing consensus that there should be reform, largely because of the concerns over the widespread extent of means-testing with Pension Credit.

53. All reform proposals[28] made are based, in one way or another, on increasing the foundation state pension to a level at least at the Guarantee Credit level (£105 pw and indexed to earnings). This means that Guarantee Credit would still be in the policy mix, but only a minority of pensioners would be expected to be eligible for it.

54. It has become clear as the PPI has developed its work on modelling the economics of the current pension system, and possible future reform, that Savings Credit has introduced a major complication[29]. Designing a cost-effective and practical transition from the current system to any alternative is more difficult now that Savings Credit exists. This is because:
    - Any reform would probably involve scrapping Savings Credit, because the point of reform would be to reduce complex means-testing. But those pensioners currently receiving it could not have a drop in income, so some phasing out would have to be designed in. This could be by freezing current Savings Credit awards (or eligibility), or starting transition with the new state pension at a higher benefit than the ultimate level.
    - The designing-out of Savings Credit in transition would have a cost. Savings Credit is growing very fast: from 3.4m beneficiaries in 2004 to 5.1m in 2015, a ten-year growth rate of 50%; and the growth in Savings Credit only beneficiaries is 68%, from 1.7m to 2.85m. This means that it will be better to reform sooner rather than later.

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[27] See O'Connell (2003) *A Guide to State Pension Reform*; (2004) *State Pension Reform: The Consultation Response*; (2004) *Citizen's Pension: Lessons from New Zealand*; PPI (2004) *State Pension Reform: Managing Transition*, all PPI

[28] For example, the Conservatives, Liberal Democrats, CBI, TUC, ABI, NAPF, Age Concern, Help the Aged, EOC, IPPR, OECD

[29] Explored further in PPI (2004) *State Pension Reform: Managing Transition*