

PENSIONS POLICY INSTITUTE

PPPI

STATE PENSION REFORM:
THE CONSULTATION RESPONSE

State Pension Reform: The consultation response

Introduction	2
Summary of conclusions	3
1. Audience assumptions: Myths and realities	4
2. Feedback on the current pensions problems	10
3. Feedback on the criteria to test reform models	13
4. Feedback on the potential reform models	15
Acknowledgements and contact details	18
References	19

A Discussion Paper by Alison O'Connell
Published by the Pensions Policy Institute
© March 2004
www.pensionspolicyinstitute.org.uk

Introduction

In July 2003, the Pensions Policy Institute (PPI) published *A Guide to State Pension Reform*. This set out:

- An analysis of the current problems in the UK's pension system
- The criteria on which any proposed reform model should be tested
- A shortlist of potential reform models that the PPI plans to test

A number of consultation events were held with various organisations based around these issues. Many discussions with and notes from individuals have also contributed feedback. This document summarises the lessons learned and the planned refinements to the PPI agenda as a result.

Summary of conclusions

From the seminars and discussions the PPI has held, it is clear that there is widespread agreement on the problems with the current UK pension system. The issues on which there is most consensus are:

- That the system is too **complex**, and
- That state pensions are getting worse, because of the increasing extent of **means-testing**.

The most important features of a future state pension model are:

- **Sustainability**, as people wish there were political consensus to sustain a stable environment for pension planning and provision, and
- **Simplicity**, as people want pension provision to be understood and pension planning able to be done with confidence.

There was no widespread support for continuing with some form of the current pensions system, primarily because that implies some continuance of the current problems, particularly means-testing and the complexity of having many components.

The most widespread support was for a Citizen's Pension or for scrapping the state second pension and increasing the Basic State Pension. The main reasons given for choosing the Citizen's Pension were simplicity and fairness, especially for women. Preference for the higher BSP tended to be because it is less radical than a Citizen's Pension – it continues part of the current system rather than making a wholesale change.

Policy reform should of course be based on the facts, and will have to challenge some common myths about the current system. The pension myths evident from the consultation include:

- Everyone gets more or less the same state pension.
- The state pension will be minimal in future.
- Everyone has some private pension.

In fact:

- State pension is not universal and varies significantly by earnings and work history.
- The state, instead of taking a minimal role in pension provision, will set income levels for most pensioners.
- Most people of working age are not accruing private pension.

1. Audience assumptions: Myths and realities

This report starts with some commentary on the implicit assumptions about pensions that were evident from a number of the contributions. Many people, even if they work in the pension field, can automatically assume some things about pensions that are not, in fact, reality. Policy reform should of course be based on the facts, and will have to challenge some widely-believed myths.

This section sets out three of the most common pension myths and sets them against the realities. In summary:

Myth Number 1: Everyone gets more or less the same state pension.

Reality: State pension is not universal and varies significantly by earnings and work history.

Myth Number 2: The state pension will be minimal in future.

Reality: The state, instead of taking a minimal role in pension provision, will set income levels for most pensioners.

Myth Number 3: Everyone has some private pension.

Reality: Most people of working age are not accruing private pension.

Myth Number 1: Everyone gets more or less the same state pension

Many people spoke as if the Basic State Pension (BSP) was available to everyone. But many people do not have a full contribution record, so that they are entitled to less than the full BSP benefit.

30 million people of working age are currently accruing rights to BSP; 5 million are not (Chart 1). People do not accrue entitlement to the BSP if they are earning below the Lower Earnings Limit (£4,108 a year from April 2004), or in some cases if they are not working or seeking work¹. On average, women are, and will continue to be, entitled to less BSP than men².

The state second pension (S2P) is even less universal. 23 million people of working age are currently accruing S2P benefits (or contracted-out equivalents), but 12 million are not³. Additional reasons for not accruing S2P, even if BSP is being accrued, include being self-employed, unemployed, or not working while caring for children above primary school age⁴.

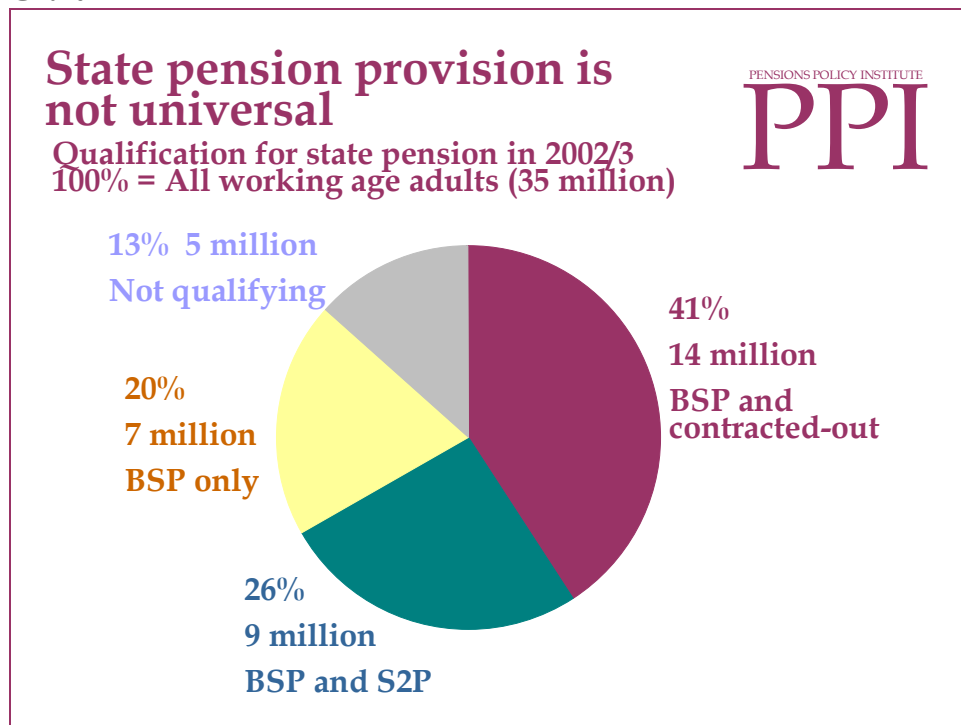
¹ Disabled people and men aged 60-64 not seeking work will get credits for BSP. Home Responsibilities Protection, which reduces the number of years of contributions needed for full BSP, is awarded to a non-working carer of a child up to the age of 18, or of an older or disabled person.

² GAD (2003) Table 7.2

³ PPI estimates based on analysis of the Family Resources Survey 2002/3 and DWP (2003 STPP)

⁴ Credits are given for S2P for a full year of caring for a child under 6 or a disabled person

This means that two-thirds of working age people are accruing rights to a both the BSP and either S2P or its contracted-out equivalent. Of the remaining one-third, nearly half are not accruing any state pension. **There will continue to be significant differences in the amounts of state pension pensioners have.**

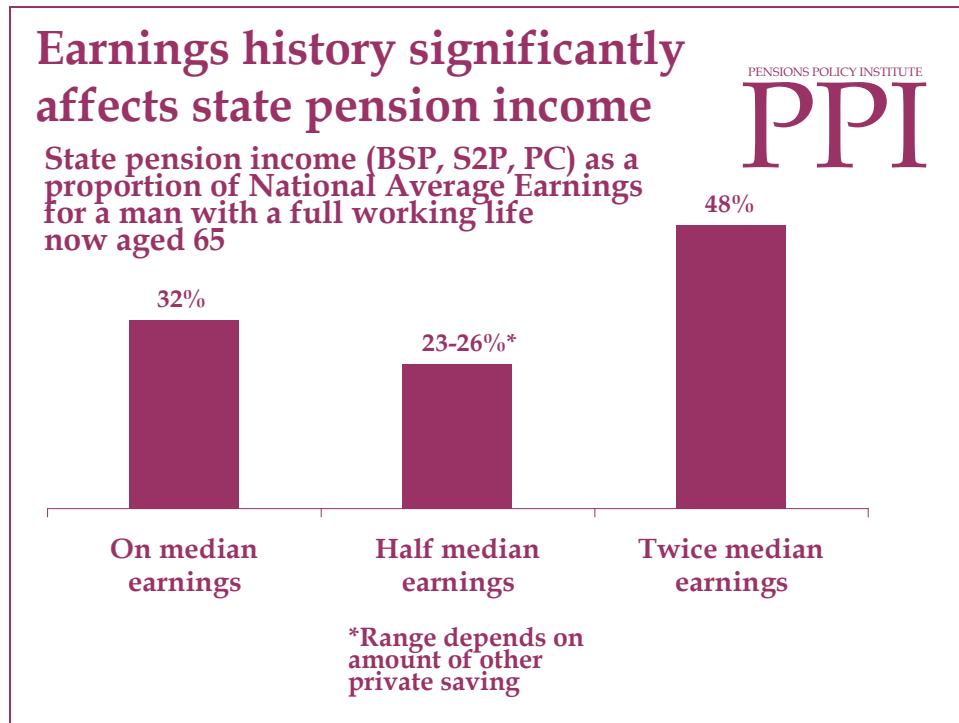
Chart 1⁵

⁵ PPI estimates based on analysis of the Family Resources Survey 2002/3 and DWP (2003 STPP)

As well as contribution-related differences in the levels of entitlement to state pension being accrued, there are earnings-related differences.

The benefit level of S2P (and its predecessor SERPS) goes up for people who had higher levels of earnings while working. **This means that there are quite significant differences in the level of total state pension benefit received by pensioners depending on the level of their earnings while working (Chart 2).**

Chart 2⁶



⁶ PPI calculations from the PPI's Individual Model. Each example is based on the 'policy stereotype', who works for a full 44-year career; with earnings at each age either median, half median or twice median. 'State pension' here includes Basic State Pension with other benefits such as Winter Fuel Allowance; State Second Pension, SERPS and Graduated Pension; and Pension Credit, including both Guarantee Credit and Savings Credit element.

Myth Number 2: The state pension will be minimal in future

The perception, especially thought to hold among young people, that there will be no state pension in future was quoted several times.

It is true that the real level of the basic state pension is declining. The full BSP for a single pensioner will fall from 16% of national average earnings (NAE) in 2003 to just under 10% of NAE by 2028⁷.

The real level of S2P benefit is also falling. Someone reaching state pension age now with a full contracted-in National Insurance contribution record, who was on median earnings throughout his or her working life, will receive a state pension from BSP plus S2P of 32% of NAE. By 2028, the equivalent person then reaching age 65 will receive 23% of NAE from BSP and S2P.

For someone with a more interrupted working life (which is more typical) the equivalent figures might be in the order of 28% NAE now and 21% NAE in 2028.

Pension Credit tops up a pensioner's total income to at least 22% of NAE, and further depending on the amount saved over and above the BSP⁸. So by 2028, the pensioner who would otherwise receive full state pension of 23% NAE could actually be eligible for a total income of up to 29% NAE from the state (Chart 3). Someone with a more typical career could receive up to 28% of NAE in total in future.

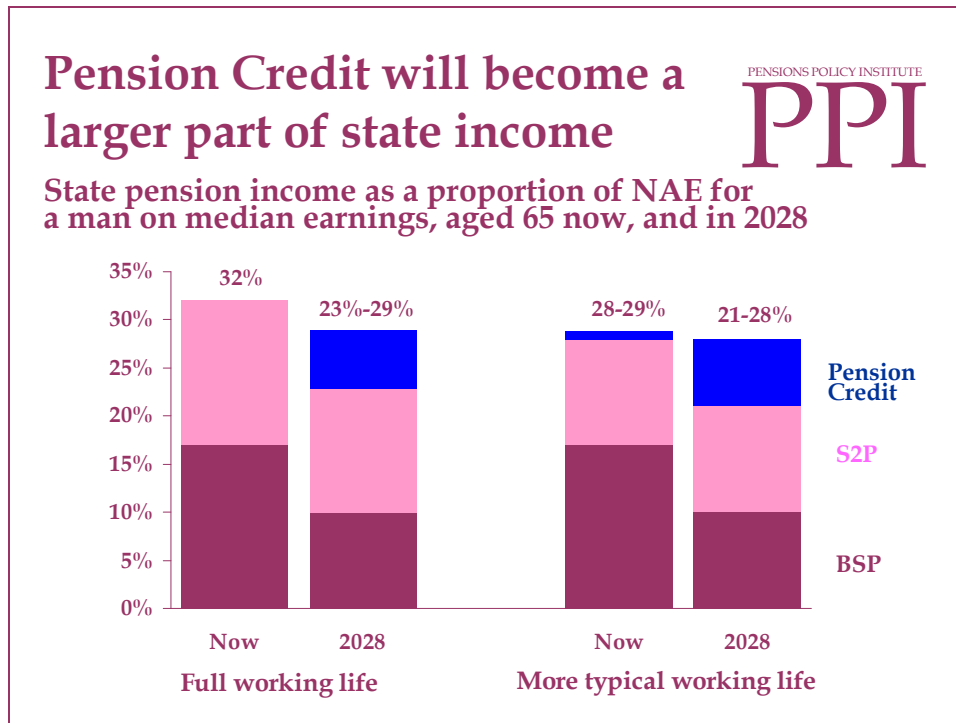
Around 50% of pensioners are currently entitled to claim the Pension Credit, and that could rise to around 70% of pensioners by 2028⁹. **Pension Credit will form a larger share of total state pension benefits. This means that the state, instead of taking a minimal role in pension provision, will in fact set income levels for most pensioners.**

⁷ Curry & O'Connell (2003) p. 27

⁸ 22% NAE is the level of the Guarantee Credit. It should stay at this level as it is indexed to earnings. Savings Credit adds further benefit depending on the level of savings (including S2P). The maximum level of Savings Credit grows faster than NAE under current policy.

⁹ Curry & O'Connell (2003) p. 30

Chart 3¹⁰



The Pension Credit benefit is ‘minimal’ in the sense that most people would aspire to live on more than the income it guarantees: £105.45 per week¹¹.

Many of the pensioners entitled to Pension Credit will not take up their benefit. Between one-quarter to one-third did not claim its predecessor (MIG), and figures for the Pension Credit are still awaited. Current estimates are that while around 2.5 million pensioners are receiving Pension Credit, 4.9 million pensioners are eligible. The target is for 3.7 million to be in receipt by 2006¹².

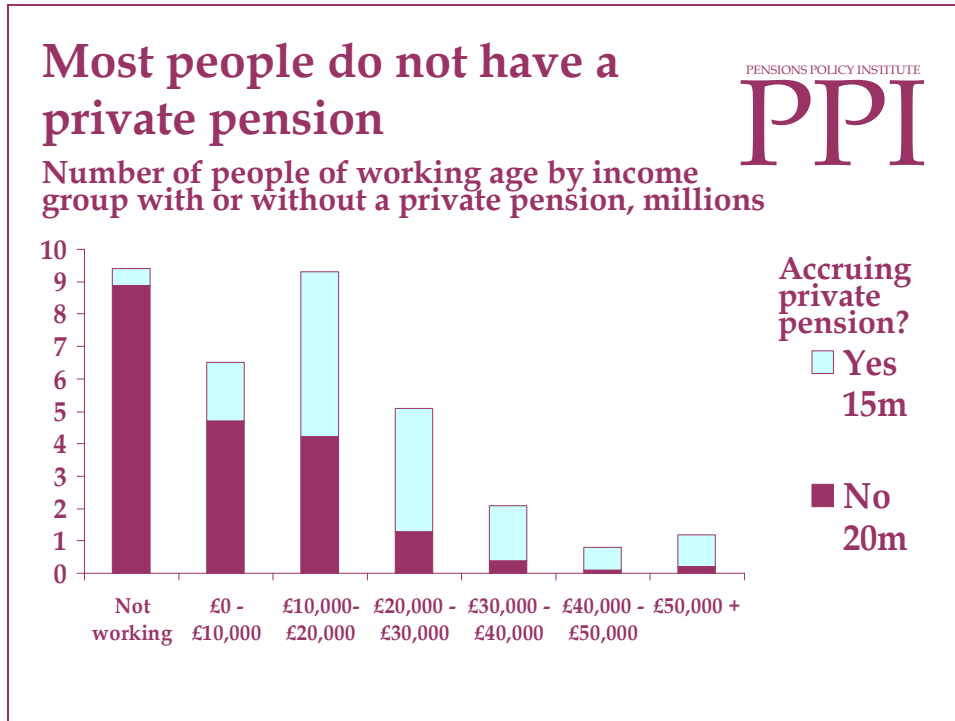
¹⁰ PPI calculations from the PPI’s Individual Model; person on median earnings throughout a full or more typical interrupted career

¹¹ From April 2004

¹² Parliamentary Question Lord Taylor of Warwick *Hansard*, 26 January 2004, Column WA11

Myth Number 3: Everyone has some private pension

Many people assume that having a private pension (occupational or personal) is the norm. **But in fact most people of working age are not accruing a private pension** (Chart 4).

Chart 4¹³

Some of those people accruing a private pension are only accruing enough to replace the state second pension (S2P). It is not known exactly for how many people this is the case, but it could be up to 2.7 million¹⁴. The contracted-out portion would be expected to provide at least as good a benefit as S2P, but it may do better or worse depending on investment performance. However, these people are not accruing a 'third tier' of benefits beyond that which the state system would provide.

Some people assume that people who do not have a private pension 'should' have one. But for many, it would be unnecessary, as Pension Credit would provide a similar income without having to save. For some people it would be impossible or very difficult to have one, because they do not have an employer to provide an occupational scheme and/or little money for personal saving.

¹³ PPI estimates based on analysis of the Family Resources Survey 2002/3

¹⁴ In the period April 2002 - January 2003. Table T7.4 Inland Revenue Statistics. 2.7m is an over-estimate as some of these people may have other private pension arrangements.

2. Feedback on the current pensions problems

The problems in the pension system were summarised as in Chart 5.

Chart 5¹⁵



There was widespread agreement on all the problems identified with the current UK pension system. The issues that had most consensus were

- That the system is too **complex**, and
- That state pensions are getting worse, because of the increasing extent of **means-testing**

¹⁵ See *A Guide to State Pension Reform* pp. 10-43

The other issues where there was general agreement were:

- **The impact the state system has on private pensions.** The concern is that someone who had saved (or had an employer who provided an occupational pension) could end up in the same position as a person who did not save – because the saved pension did not turn out to be big enough to take the saver above the Pension Credit limit.

The introduction of the Savings Credit may have been designed to overcome this ‘**disincentive to save**’ problem, and there is debate as to whether it has achieved this. However, it introduced another problem. It has increased complexity so much that it is impossible to know what someone can expect to receive from the state as a pensioner.

This makes it **impossible for an adviser to advise positively on pension saving, or for an employer to know that providing an occupational pension will be worthwhile** for all but a minority of people who are clearly going to be free of Pension Credit throughout their retirement.

- **The way the current system looks after older pensioners** less well than it does younger pensioners, so that the odds of having to claim means-tested benefits increase with age.
- That it seems unlikely that the headline figure of **state pension expenditure** (5% of GDP) would – or should – be kept level in future as the number of pensioners increases by 40%¹⁶.

¹⁶ See PPI Briefing Note Number 3

Some of the stated problems with the current system were questioned. The following comments were made by few rather than many people, and sometimes reflected a lack of evidence or debate rather than a disagreement.

- **As recent reforms have directed more money to the poorest pensioners, is it the case that pensioner poverty still exists?**
Pensioner poverty has improved since 1997, but it still exists. 22% of pensioners are in poverty according to the government's official measure¹⁷.
- **Do pensioners really need more income as they get older, as their costs should go down, not up?**
Discretionary spend for pensioners might decrease with age (one holiday a year instead of many when first retired, for example) but basic living costs may increase, for example, needing to do food shopping at local shops if mobility becomes a problem. As disability increases with age the costs of care would be expected to increase. More research on this issue would be welcome.
- **Are women really disadvantaged, once their husband's income is taken into account?**
The women who are the poorest are widowed or divorced with incomes on average 15% lower than that of never-married women pensioners, and only just over half that of married pensioners¹⁸.
- **Although the UK spends less than other European countries on pensions, is the UK not in a better state than some of those countries who cannot afford their system?**
Although the UK does not have an affordability problem, as many of the other European countries do, there remain all the other problems for the UK, as discussed.

¹⁷ Income below 60% of contemporary median income (after housing costs) from DWP (2003 OFA)

¹⁸ Curry (2003 TUP W)

3. Feedback on the criteria to test reform models

The criteria on which the PPI proposed testing the proposed pension reform models were summarised as in Chart 6.

Chart 6¹⁹

Testing possible state pension reform models

PENSIONS POLICY INSTITUTE


1. Sustainability	6. Fairness
2. Poverty risk	7. Simplicity
3. Short-term cost	8. Easy for oldest
4. Long-term cost	9. Enables saving
5. Robust to life trends	10. Transition

The most important for most of the audience were

- **Sustainability**, as people wish there were political consensus to sustain a stable environment for pension planning and provision, and
- **Simplicity**, as people want pension provision to be understood and pension planning able to be done with confidence.

No criteria were disagreed with. The other criteria receiving some agreement were:

- **Poverty risk**, as it was thought that pensioner poverty should be no higher than that in other vulnerable groups such as children or lone parents, and
- **Transition**. There has as yet been little consideration given to transition for any of the models being considered. There was some concern that any change might have some 'losers', which would make it more difficult to find the political will for change.

¹⁹ See *A Guide to State Pension Reform* pp. 44-47

The criterion of **fairness** provoked some debate. While in the PPI analysis 'fair' was used to discuss equity between different groups, views in the seminars seemed polarised around the 'fairness' of a contributory system. The two extremes can be described as follows, although it was not expressed this starkly. Some thought 'fair' should mean the state provides everyone with the same pension, which avoids making value judgements on whether it is better that an individual spent a lifetime working at a full-time job, or caring for a family. Others thought 'fair' meant what someone got out of the state system should reflect what he or she put in, so that a contributory system is appropriate.

Some of the discussion was about how the criteria should be ranked, or how the way in which the reform models stand up to the criteria should be scored. The PPI exercise will aim instead to give as much information as possible on how the reform models stand on each criterion (qualitative and quantitative). It will then be up to the reader to make his or her own trade-offs to decide which model best fits the right balance of criteria.

4. Feedback on the potential reform models

The reform models that the PPI planned to test were summarised as in Chart 7.

Chart 7²⁰

State pension models to be tested

PENSIONS POLICY INSTITUTE
PPI

1. **Status quo:** tinker with BSP, S2P and PC
2. **Reform S2P:** flat-rate, more generous especially for lower earners
3. **Much higher BSP, scrap S2P**
4. **Citizen's Pension:** simplest, most radical, based on residency, ensures minimal means-testing
5. **Age additions:** higher benefit for the oldest

The consultation exercise was a very preliminary trial of opinion on the reform models, as a full analysis of the pros and cons of each was not presented.

There was no widespread support for Options 1 and 2, primarily because they implied some continuance of the problems of the current system, particularly means-testing and the complexity of having many components.

The most widespread support was for Option 3 or 4, with Option 4 being most often preferred. One reason given for choosing Option 4, the Citizen's Pension, was simplicity. It is the simplest system. Preference for Option 3 tended to be because it is less radical than a Citizen's Pension – it continues part of the current system rather than making a wholesale change.

The other point of difference seemed to be what concept of 'fairness' people implicitly assumed, as described in the last section. Those who preferred a Citizen's Pension thought the potential for disadvantage in the current contributory system was wrong. Those who preferred Option 3 supported the contributory principle.

²⁰ A Guide to State Pension Reform pp.48-53

However, most people recognised that in practice the contributory system is not a strong incentive to work, and that the current system is faulty as credits are not consistently applied²¹. A Citizen's Pension at the level of the means-tested pension benefit gives a similar outcome as the current system, where the majority of pensioners are means-tested anyway. And a Citizen's Pension should be a more efficient system without take-up problems.

The next favourite model was Option 5, age additions. Many people agreed that the oldest pensioners should be protected from increasing poverty. This option was also liked as it is very simple, albeit rather arbitrary. There was concern that someone struggling to cope at age 73 would have to wait to the 75th birthday for an increase in income.

There **were pockets of support for an improvement of the current system**, namely boost BSP and retain the earnings-related nature of S2P. An argument for this is the potential for S2P to give an alternative to occupational provision. However, this does not help those who do not have access to occupational provision, either via S2P or an employer's scheme.

There was some discussion of how to pay for improvements to state pensions, although not enough to draw any conclusions. This was not an area of focus for the seminars, although it will be part of the analysis²². Many people suggested that raising state pension age would have to be considered as part of a new package, with opinion divided on whether that was appropriate or not²³.

²¹ Fawcett Society and Age Concern (2003)

²² See *A Guide to State Pension Reform* p. 50

²³ See O'Connell (2003b) for more detail on this policy option

Refining the models

Refinements to the proposed models were suggested, and these will be incorporated into the PPI analysis:

Refinements to Option 1 (status quo)

- **Boost BSP, retain S2P.** As discussed, this model was suggested so that state pensions are overall improved, while retaining an earnings-related pension in S2P. The boost to BSP could be through a one-off increase and/or indexing to earnings instead of prices. The S2P element could be the status quo, or reformed as in Option 2.
- A level of **compulsory occupational pension** could also be added here.

Refinements to Option 4 (Citizen's Pension)

- **Citizen's Pension, retain S2P.** This model would replace the BSP with a Citizen's Pension at a similar level. The aim would be to combine the fairness advantages of the Citizen's Pension at a low level with a higher pension earned through contributions. Means-testing would continue for those without full S2P or private savings.
- **Citizen's Pension, starting at age 75 or 80.** This model was suggested as a way of transitioning to a more generous Citizen's Pension, set at around the level available from Pension Credit (as in Option 4). Over time the age of first eligibility could be decreased until the pension system was entirely replaced by a Citizen's Pension.
- **Universal Pension at age 80.** This model pays a Citizen's Pension (Option 4) only at a high age, say, 80, keeping the current system below 80. It is called 'universal' as it would be paid to everyone aged 80 and over, regardless of residency requirements. Its purpose would be to guarantee that all of the oldest pensioners would not need to go through a means-testing process.

Acknowledgements and contact details

Thanks to all those who have contributed feedback in discussions and by written notes. Thanks also to all participants of the eight events held, which ranged in size from 8 to 90 people. Particular thanks to the chairmen and hosts:

Laurie Edmans	Association of British Insurers
David Yeandle	Engineering Employers' Federation
Harvie Brown	Faculty of Actuaries
Michael Pomery	Hewitt Bacon & Woodrow
David Lewis	Institute of Actuaries
Christine Farnish	National Association of Pension Funds
Jeannie Drake	Trades Union Congress

The author, Alison O'Connell, takes responsibility for the final version of this paper and any remaining errors and omissions.

© Pensions Policy Institute, 2004

The PPI's Individual Model is being developed as part of a wider project funded by the Nuffield Foundation.

The Pensions Policy Institute is an educational charity promoting the study of retirement provision through research, analysis, discussion and publication. The PPI takes an independent view across the entire pensions system.

The PPI is funded by donations and benefits-in-kind from a range of organisations. To learn more about the PPI, see www.pensionspolicyinstitute.org.uk

To contact the PPI please call, email or write to
Alison O'Connell, Director
Pensions Policy Institute
King's College
Waterloo Bridge Wing, Franklin Wilkins Building
Waterloo Road
London, SE1 9NN

Tel no. 020 7848 3751
Email alison@pensionspolicyinstitute.org.uk

References

Curry C, O'Connell A. (2003) *The Pensions Landscape* London: Pensions Policy Institute
www.pensionspolicyinstitute.org.uk

Curry C. (2003 TUP W) *The Under-pensioned: Women* London: Pensions Policy Institute
www.pensionspolicyinstitute.org.uk

Department for Work and Pensions (DWP) (2003 STPP) *Second Tier Pension Provision*
www.dwp.gov.uk

Department for Work and Pensions (DWP) (2003 OFA) *Opportunity for All: Fifth Annual Report 2003* www.dwp.gov.uk

Fawcett Society and Age Concern (2003) *One in Four* Published by Age Concern England www.ace.org.uk

Government's Actuary Department (GAD) (2003) *Government Actuary's Quinquennial Review of the National Insurance Fund as at April 2000*, www.gad.gov.uk

Inland Revenue Statistics T7.4 - *Personal pensions for employees and the self employed*
www.inlandrevenue.gov.uk

O'Connell A. (2003) *A Guide to State Pension Reform* London: Pensions Policy Institute
www.pensionspolicyinstitute.org.uk

O'Connell A. (2003b) *Raising State Pension Age: An Update* London: Pensions Policy Institute
www.pensionspolicyinstitute.org.uk

Office for National Statistics *Family Resources Survey 2002/3*
www.statistics.gov.uk