Should the state provide an earnings-related pension?

Introduction
Many recent reform proposals have suggested strengthening the flat-rate 'foundation pension' and abolishing the State Second Pension[1]. This would mean that the state no longer provides an earnings-related pension, that is, where the state gives a higher pension to higher earners compared to lower earners. This Briefing Note looks specifically at whether the rationale that led to the introduction of an earnings-related scheme in 1978 is still relevant, and what issues are relevant today.

Table 1: Rationale for the state earnings-related pension

Rationale	Did rationale apply? 1955 when debate started, to 1978, when SERPS was introduced	Now (2005)	How reform could change the current situation
1. Inadequate Basic State Pension (BSP)	Yes in 1955: below 20% NAE and increased ad hoc No by 1978: 25% NAE and indexed to earnings	Yes: 16% NAE and falling, as indexed to prices Safety-net of Pension Credit compromised by <100% take-up rate: indexation uncertain	Widespread support for BSP to reach at least 22% NAE (£109 a week) and be indexed to earnings (whether contributory or citizenship based)
2. Unequal/low access to occupational pensions	Yes in 1955: 35% of employees in a scheme Less so by 1978: 49%	Less so: 55% of employees are in an occupational or personal scheme	Widespread support for enhancing voluntary employer provision; some call for compulsion

The PPI is continuing work on this issue and would welcome feedback.

Background to state provision
Concerns grew in the 1950s regarding both the inadequacy of the single, flat-rate, basic state pension (BSP) and the low coverage of occupational pensions.

In 1961 the Graduated Retirement Scheme (GRS) was introduced for those without access to occupational pensions. With earnings-related contributions, the scheme gave more to higher earners and was also intended to raise more revenue for the state.

The limited GRS was succeeded by the State Earnings Related Pension Scheme (SERPS) in 1978. Through SERPS, the state aimed to provide an additional 25% of National Average Earnings (NAE) on average to people with the maximum of 20 years accrual. People on lower earnings would get less, and higher earners would get more.

However, by 1978, the two main reasons for introducing a state earnings-related scheme had been largely mitigated (Table 1). BSP was higher than it was in the 1950's so, with SERPS, total state pension was heading towards 50% NAE on average. Further, occupational pension schemes covered half the working population.

Earnings-related provision proved to be expensive
SERPS's generosity was cut back (1986, 1995) and the adequacy of the BSP was reduced when it became indexed to prices (1980). Despite cutbacks, higher earners could gain significantly more through SERPS than moderate and low earners. The maximum amount of SERPS payable in 2001/2 was £131 per week compared to £85 for someone on average earnings[2].

SERPS was replaced in 2002 by the State Second Pension (S2P), intended to provide a more generous pension for low to moderate earners and people not earning. An extra 4 million people gained coverage in 2002/3[3].

S2P is less earnings-related than SERPS was and is becoming even flatter (Chart 1). By 2051 there will be essentially two flat rate state pensions (BSP and S2P), each with different contributory and eligibility rules[3].

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Does the rationale for the state to provide an earnings-related pension still exist?

The BSP is now lower than ever, currently standing at 16% NAE. Price indexation means that this level is set to decline further. The increasing generosity of the S2P only partially makes up for this.

SERPS never managed to top up the BSP to an average of 50% NAE and the current system will not. Only a high earner with a full contribution record on SERPS, S2P and BSP receives state benefits of 40% NAE in total[4]. On average, men receive 21% NAE and women 14% NAE[5].

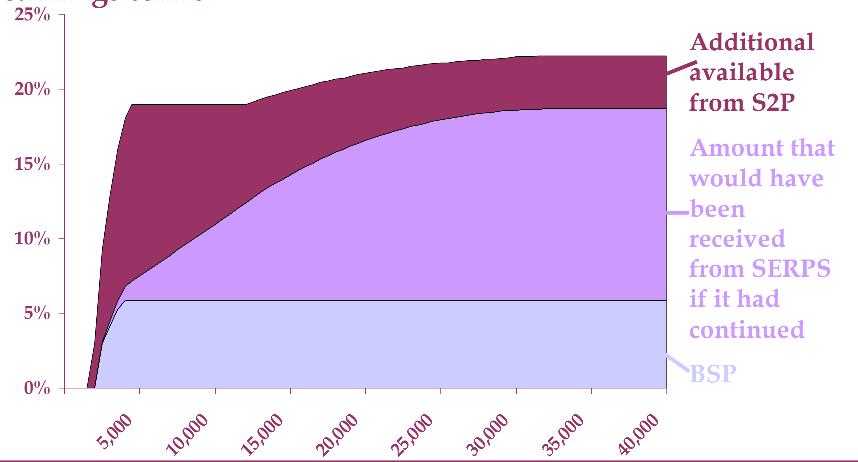
The need to resolve the second issue, to deliver a state alternative to occupational pension schemes, has been diminished by greater coverage of occupational and personal pensions. Over half of employees now have such a pension, compared to only one-third in the 1950s[6].

Issues now

The UK has now to decide how best to spend its state resources for people over state pension age, given an ageing population. The history of SERPS cutbacks, and future long-term spending plans, suggest a political economy that is only willing to afford a total state pension of around 20-25% NAE on average.

Chart 1: The State system will be less earnings related in future

Pension entitlement on reaching SPA in 2054/5 as a proportion of NAE by constant annual earnings in 2005/6 earnings terms



This means that it will be difficult enough to find the resources to improve the BSP, let alone add an earnings-related tier on top.

Even if additional resources are available, prioritising a better flat foundation tier is likely to be better for low earners than prioritising an earnings-related tier on top of a poor first tier[7]. A one off hike to the BSP and subsequent indexation to earnings would mitigate to some extent the rationale for an earnings-related second tier. Continuing with price indexation and/or a low BSP inevitably means that part of any second tier makes up for an inadequate first tier rather than contributes new pension resources.

While coverage of private pensions among workers might be better than it was, there are now two main issues focussing on extending coverage further. Firstly, increasing take-up and the level of contributions to occupational pensions. Proposed solutions include, for example, automatic enrolment for occupational pensions. The second issue is how to include non-earners, such as carers. A credit to an additional state pension could be used for specific non-earning circumstances such as caring.

A state second tier can provide solutions for today's issues, but it need not be earnings-related.

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[1] Pensions Policy Institute (PPI) (2005) Briefing Note 18 *Pension Reform: An update*
[2] Department for Work and Pensions (DWP) (2004) Second Tier Pension Provision 1978/79 to 2003/04
[3] See PPI (2004) *The Pension Primer* p.33
[4] PPI analysis
[5] DWP (2004) *State Pension Summary of Statistics*
[6] DWP (2004) *Family Resources Survey 2004/5*
[7] See PPI (2004) Response to the Pensions Commission First Report