After Turner: creating a sustainable pensions settlement

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Introduction

On November 30th, the Pensions Commission, headed by Adair Turner, will publish its final report three years after it was first set up following a Government Green Paper in December 2002. The Government has promised a formal response in the spring of 2006. A wide range of stakeholders are hoping that the analysis and recommendations in the Pensions Commission report will allow the Government to forge a consensus on pensions reform, however difficult that will be.

The first report of the Pensions Commission published in October 2004 proved influential in part because of the stark choices it put forward[1]. The problems that the current pensions systems will pose for future generations of retirees in the context of an increasing proportion of the population aged over 65 led the Commission to pose four options, which are set out in box 1.

Box 1: The Pensions Commission's four options

1. Pensioners will become poorer relative to the rest of society; or
2. Taxes/national insurance contributions devoted to pensions must rise; or
3. The savings rate must rise; or
4. Average retirement ages must rise.

Source: Pensions Commission (2004)

On November 24th, the Secretary of State for Work and Pensions announced five key Tests that any lasting pensions settlement would need to meet, at an event held by ippr[2]. These Tests are set out in box 2.

Box 2: The Government's five tests for the pensions settlement

1. Does it promote personal responsibility, giving everyone the opportunity to build a decent retirement income?
2. Is it fair, to women and carers and to those who have saved, and does it protect the poorest?
3. Is it affordable to taxpayers and the economy as a whole?
4. Is it simple, clearly setting out what the state will do and what is expected of citizens themselves?
5. Is it sustainable, with the reform package forming the basis of an enduring national consensus?

Source: Speech by the Rt Hon John Hutton MP, 24/11/05

ippr believes there are six key questions that need to be addressed to secure a sustainable pensions settlement, that is one based on making difficult choices and trade-offs. These questions are set out in box 3.

These lists of options, tests and questions might look a little confusing set alongside one another. However, together they frame the parameters of the pensions debate. The Government's five tests effectively set out the *objectives* of reform, about which there is widespread consensus. The Pensions Commission's four options set out in the starkest terms the broad choices that we face in meeting

[1] Pensions Commission (2004) Pensions: challenges and choices. The first report of the Pensions Commission. The Stationery Office.
[2] These Tests appear to subsume the six principles for pensions reform announed in February 2005 in Department for Work and Pensions (2005a) Principles for Reform: the national pensions debate. DWP

those objectives. ippr's six questions force us to think about the details of policy that will need to be thrashed through in order to meet these objectives.

Box 3: The six key questions for achieving a 'hard' pensions consensus

1. Should the Basic State Pension (BSP) be increased to the level of the Guarantee Credit and indexed to earnings? How would this be paid for over the short and long term?
2. Should the State Second Pension (S2P) and its associated contracting out rebates be retained or abolished?
3. Should the State Pension Age (SPA) be increased?
4. How should tax incentives for pensions and other forms of saving be reformed?
5. Should there be compulsory contributions by employees and/or employers into a funded second pension?
6. How should women and carers be enabled to claim a more generous state pension in their own right, through a revised contributory pension or through the introduction of a residence based pension?

Many different organisations have put forward proposals that seek to meet the pensions challenge. All of them contain answers to some or all of the six questions we pose. The purpose of this short pamphlet is to set out for each of these questions:

- What we think the final report of the Pensions Commission report is likely to say,
- What we think the Government's reaction might be, or more accurately the reaction of different parts of the Government,
- How different stakeholders are likely to respond; and
- What ippr thinks should happen.

Should the Basic State Pension (BSP) be increased to the level of the Guarantee Credit and indexed to earnings? How would this be paid for over the short and long term?

What the final report of the Pensions Commission is likely to say
This is the most important issue in the pensions policy debate. The Commission is likely to argue for an increase over time in the value of the BSP (currently £82.05 per week) towards the level of the Guarantee Credit (currently £109 per week) and its indexation in line with earnings (paid for in part by increasing the State Pension Age – see below). The Commission has clearly been impressed that this is the one solid area of consensus that has developed amongst a wide range of stakeholders, following ippr originally putting forward this proposal in 2002[3]. However, there are two key questions of detail the Commission report will have to address. The most important is how this increase in the BSP would be paid for over the short and long term. The second issue is how the transition to a higher BSP would be managed over time.

How the Government will react
No. 10 and the Department for Work and Pensions have always seemed likely to be warm to this proposal. They too have been impressed by the consensus that exists on this issue and No. 10 in particular seems anxious to reduce the proportion of future pensioners likely to be receiving a means tested pension top-up (which could amount to around three-quarters of pensioners by 2050). However, the Treasury is worried by the significant cost of this proposal and is concerned that it will give 'windfall gains' to better off pensioners. This is one area where the first step will need to be establishing a consensus *within* government.

How stakeholders will react
This will be widely welcomed. Most pension reform proposals have at their heart increasing the generosity of the Basic State Pension, thought not all say how this would be paid for.

What ippr thinks should happen
ippr was the first to advocate this as the heart of any pensions settlement. It would give most people a basic level of income above the poverty line, without a means test, on which they could then plan their own additional provision for retirement. It could be largely paid for in the short term by phasing out the rebates associated with the State Second Pension (S2P), phasing out the Pension Credit and reducing the cost of the various tax incentives for pensions and savings, and over the longer term by phasing out S2P altogether and raising the State Pension Age (see below). All this would allow for a significant simplification of the pensions system, creating a system that people would better understand. It is the one change that would most effectively meet all the Government's tests, including affordability.

Should the State Second Pension and its associated contracting out rebates be retained or abolished?

What the final report of the Pensions Commission is likely to say
This is one of the issues the Commission has been deliberating over. One argument is for retaining a flat rate S2P and for it and the BSP together to reach the level of the Guarantee Credit. On the other hand this would mean losing the best chance of simplifying the state pensions system and making it more understandable. The decision about whether to contract in or out of S2P is the one bit of the system that no-one can currently understand without an actuarial qualification. It is for this reason that abolishing S2P and instead paying one flat rate state pension is the other option the Commission has been considering.

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[3] Brooks R, Regan S and Robinson P (2002) *A new contract for retirement* ippr

How the Government will react
The current Government introduced S2P, so one might think it would be reluctant to get rid of it. On the other hand Whitehall has come more and more to comprehend how far a wide range of stakeholders are crying out for simplification. In this context it is hard to see how S2P and especially contracting out can survive and the Government still claim that it had met its objective of establishing a simple system.

How stakeholders will react
There is far less consensus on this issue. Some industry bodies have seen the writing on the wall for contracted out rebates and have taken a mature decision to sacrifice them if that is the price to be paid for a wholesale reform that will deliver simplicity. Some providers cling on to the rebates because they are a source of funds that they can manage. Some worry about the effect on occupational pension schemes if the rebates go. Some would like the state to continue to provide an earnings related pension. Any decision on this will not please everyone.

What ippr thinks should happen
The State Second Pension and contracting out rebates should be abolished. This is at the heart of the objective of having a simple system that people can understand. Without the abolition of contracting out, the pensions system will remain excessively complex. Moreover, the rebates cost 0.9% of GDP in 2004-05, and their abolition could make a significant contribution to making affordable a higher BSP.

Should the State Pension Age (SPA) be increased?

What the final report of the Pensions Commission is likely to say
The Commission will argue for an increase in the SPA, probably to 67 by around 2030, with the SPA steadily increasing in each subsequent decade, as life expectancy improves. Although the Commission will have been pondering over this in the light of the Government's controversial decision on the normal pension age for public sector workers, it understands there is no better signal to send about the desirability of working longer as the key option for making the pensions system affordable.

How the Government will react
A few weeks ago one could have been confident that the Government was thinking seriously about taking this politically difficult step. It is clear that the decision to keep a normal pension age of 60 for all existing public sector workers was taken without any appreciation of the knock on effect on the rest of the pensions agenda. The Government has thus boxed itself in on this issue and will struggle to find a way out.

How stakeholders will react
Many stakeholders also recognise that an increase in the SPA at some point after 2020 is imperative, as a signal of the desirability of working longer and as a means of making a more generous BSP sustainable over the long run. The main exception to this is the trade union movement, which will oppose any increase in the SPA. All stakeholders are sensitive to the argument that there are significant differences in life expectancy between manual and non-manual workers (and men and women)[4], but the answers lie with health and social policy more broadly.

What ippr thinks should happen
The SPA will have to increase to reflect rising life expectancy and to make any significant increase in the BSP affordable. In 2002, ippr advocated increasing the SPA to 67 by 2030, arguing that this would make the overall pensions reform package affordable. Subsequent analysis suggests that a SPA of about 69 by 2050 would keep government spending on pensions broadly stable as a proportion of GDP, even with a much more generous BSP. Thus raising the SPA initially by two years and then by

[4] In the late 1990s the gap in life expectancy at age 65 between manual and non-manual workers was about two-and-a-half years and three years between men and women.

one year in each subsequent decade would make sense and still leave someone retiring at 69 in 2050 with an average of about 20 years or so of retirement (and around 10 years of 'healthy' retirement). There would be 'no working until you drop' and of course people could retire earlier if they made their own provision and were not relying solely on the state pension.

How should tax incentives for pensions and other forms of saving be reformed?

What the final report of the Pensions Commission is likely to say
This is one area where it is unclear what the Commission will say, despite its remit to look at the incentives for private saving into pensions. What is clear is that there is a widespread consensus that the current system of incentives is opaque, ineffective and highly regressive. Moreover, they are immensely costly: the OECD estimates that the net fiscal costs of subsidising private pension contributions amount to about 1.25% of GDP currently and could increase to between 2 and 2.5% of GDP between 2020 and 2050[5].

How the Government will react
Despite the consensus that the current system of incentives is wholly unsatisfactory, the government could be wary of change in case they are seen to be tampering with the part of the system that disproportionately benefits the "middle classes". More generally the government has found itself in a terrible pickle over its whole approach to savings policy. For example, it now has one tax favoured instrument, equity-based Individual Savings Accounts (ISAs), where the advantages only accrue to higher rate taxpayers and those with a capital gains tax liability and do not benefit basic rate taxpayers at all.

How stakeholders will react
Although everyone accepts the current system is opaque, ineffective, regressive and costly, few want to voluntarily give up their tax advantages and indeed some bodies have been lobbying for more taxpayers money to be used to support their own proposals for enhanced incentives. The critical trick will be to show what the reform process will gain if different groups are prepared to sacrifice some of their favoured incentives.

What ippr thinks should happen
Simplifying the whole tax treatment of pensions and savings would potentially free up huge resources for pensions reform and could make the system significantly more progressive and easier to understand. A starting point would be abolish schemes like equity-based ISAs and make it clear that the government will only subsidise saving into a pension and a 'rainy-day' pot such as a cash ISA. It could also reduce the age allowances in the income tax system for the over 65s which would temper the 'windfall' gains to richer pensioners from increasing the BSP. Overall, there is a very rich agenda for policy here. Although it might seem strange to recommend it, there may be scope for another fundamental review of savings policy to make up for past missed opportunities to sort this issue out, especially if the Pensions Commission is light on recommendations in this area.

Should there be compulsory contributions by employees and/or employers into a funded second pension?

What the final report of the Pensions Commission is likely to say
This has been the theme the Commission has spent most time deliberating over, not least because it is one very close to its original remit. The idea of compulsory contributions by both employees and employers into a pensions pot that could be invested in equities and bonds was floated by Adair Turner earlier in the year and attracted widespread criticism, including within government. The Commission is now likely to advocate that employees would be required to make contributions of 3-4% of salary to a personal pension savings account unless they explicitly opt out; but if they opt in,

[5] OECD Economic Surveys 2005 United Kingdom OECD

employers would also be compelled to make matching contributions of 3% of salary (with possibly a nominal contribution by the taxpayer too). These contributions would be collected through the PAYE system and invested in funds with low charges.

How the Government will react
The Government will be reticent about supporting even this form of 'soft compulsion', because of the likely fierce opposition of employers, for the reasons set out below.

How stakeholders will react
This is likely to be a deal-breaker. Many employers will almost certainly fiercely oppose it, even more so following the Government's decisions in relation to public sector pensions. This is not just because they are angry that the unions 'won'. They will deploy the equity argument: why should workers and their employers in the private sector be compelled to make contributions to a private pensions pot, when public sector workers will not be required to because they have access to such good salary related pensions paid for by the taxpayer? The Trade Unions are of course in favour of compulsion, but arguably they have used up all their political capital defending the pensions of their public sector members. Very importantly, the Conservatives and the Liberal Democrats have also said they will oppose any such form of compulsion. It is highly unlikely there will be a consensus on this issue.

What ippr thinks should happen
If you simplify the state pensions system and make the BSP more generous, it is unclear why you should go further on compulsion. If nearly everyone got a state pension that lifted them above the poverty line, it would then be up to them to decide what additional provision they want to make to secure a more generous income in retirement, supported by a transparent system of savings incentives. The issue of employer contributions is a bit of a red herring: in a competitive labour market they would in the long run be paid for by lower wages. If this central idea of the Pensions Commission is in fact a deal-breaker, it is worth sacrificing, though it will be interesting to see how the debate develops after the Commission reports and whether Turner will be able to win employers round.

How should women and carers be enabled to claim a more generous state pension in their own right, through a revised contributory pension or through the introduction of a residence based pension?

What the final report of the Pensions Commission is likely to say
The Commission seems likely to stick to a contributory state pension, but with some suggestions as to how it could be made more generous for women and careers (see below). Because the state pension is now the main benefit 'paid for' through national insurance contributions, shifting to a pension based simply on a period of residence in the country would require re-thinking the whole system of national insurance. There may be a number of good reasons for doing precisely this, but the political risks are very high for the reasons set out below.

How the Government will react
The Government will be very happy if the Commission comes up with a compelling case for continuing with a revised contributory pension. One argument it will deploy is that the current generation of women under the age of 45 appear to accumulating rights to the BSP at a similar rate to men[6]. The problem then of women and careers getting a poorer deal from the state pensions system is one that applies to older women. The government probably sees the political advantages of sticking with a contributory principle that may still be quite popular with and well understood by the population at large, when so many other difficult changes are being mooted.

[6] Department for Work and Pensions (2005b) Women and pensions: The evidence DWP

How stakeholders will react
An impressive degree of support has been expressed by a wide range of organisations (including the Liberal Democrats) for a residence based (or citizen's) pension, which would pay a pension to anyone over the SPA who had been resident in the country for a certain period of time. More people (and especially more women and carers) could obtain a more generous state pension in this way, depending on the conditions that were set. These organisations will undoubtedly be very upset if the government goes for a more generous contributory pension instead, but many could probably live with it, if the benefits of the wider reform package were clear and changes were made to the contributory pension. Again the probable trump card here is that the Conservatives have signalled that they want to stick to the contributory principle and if the Government wants a consensus it is more likely to get one around a more generous BSP based on contributions. The Conservatives have outlined the changes they would support, such as ensuring more of the lowest paid workers gained state pension rights and abolishing the rule which says that you have to make 10 years of national insurance contributions before you can claim any BSP[7]. Around these kinds of changes you could construct a consensus, provided the Treasury was willing to foot the bill.

What ippr thinks should happen
If you want a widespread consensus it will be around a revised contributory principle that would help more women and careers gain access to a significantly more generous BSP.

The chances of a sustainable settlement

There is one great irony in the national pensions debate. It is possible to see the outlines of a pensions settlement that would be signed up to by a wide range of stakeholders and importantly by the Conservatives and the Liberal Democrats, even though it would involve some difficult trade-offs. This would consist of:

- Raising the Basic State Pension to the level of the Guarantee Credit and indexing it to earnings, and paying for it by:
    - Abolishing the State Second Pension and its associated contracting out rebates
    - Increasing the State Pension Age to 67 by around 2030 and by a year each decade after, and
    - Simplifying and making less costly tax incentives for savings and pensions.
- There would *not* be compulsory contributions by employees or employers into a funded second pension
- The contributory pension would be retained but made more generous to women and carers

It is to be hoped that the Pensions Commission comes up with a reform package that encompasses many of these features.

The key problem is securing consensus *within* the Government on all of this and then selling it to a sceptical, if not hostile, general public.

[7] Willets D (2004) Modernising the Welfare State: Pensions, Poverty and Property. A speech by David Willets MP to the ippr December 2004