A NEW CONTRACT FOR RETIREMENT

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Summary

Since the 1997 election, Labour has devoted much time and effort to pensions and long-term care reform. Both areas have generated significant legislation and the commitment of new public resources. The government has characterised its reforms as a new contract for retirement: a settlement for the long term.

IPPR has great sympathy with the Government's central objective of eliminating pensioner poverty. However, this report has been prompted by concerns about the Government's reform package. Retirement policy has not proved to be a source of political capital for Labour. It has been difficult for Labour to win public support for its complex mix of pensions policies, despite significant increases in public spending on pensioners. Similarly with regard to long-term care, the Government disappointed many by their rejection of the Royal Commission's recommendation that personal care should be free to the individual.

There are several different objectives that pensions and long-term care policies need to address. These include: securing adequacy, maintaining affordability, delivering clarity and simplicity, protecting incentives, and promoting equity. We do not regard changing the balance between public and private funding as a first order goal of policy. Not all the objectives can be satisfied at the same time, and trade-offs between them are inevitable. By exploring alternative policy options, we have investigated whether the Government's current settlement should continue to be pursued or whether a change of direction is necessary.

Labour's pension reforms: a new contract for retirement?

The Government has made significant reforms to the pensions environment since 1997. The transition from SERPS to the new State Second Pension will begin in April 2002 and Stakeholder Pensions have been on sale since April 2001. The introduction of the Minimum Income Guarantee (MIG), effectively a big increase in Income Support for pensioners, was a good short-term mechanism for directing help to the poorest pensioners. The Pension Credit, which is now set to subsume the MIG, also has many positive features: it represents significant new public funding for lower income pensioners and it was designed to stop penalising people with small pensions savings. However, it will require an increase of over one per cent of GDP in pensions spending by 2050. Thus the objective set out in the Prime-Minister's foreword to the 1998 Green Paper, that public spending on pensions as a proportion of GDP would fall, will now not be realised. This raises a very important question: had it been known in 1998 that such an increase in spending was possible would we have chosen a different means of delivering the other objectives for the pensions system?

A number of problems remain in the current settlement:

- With low take-up of the MIG, and take-up certain to be an issue for the Pension Credit, pensioner poverty is still a key problem.
- Incentive problems remain acute. The Pension Credit does not resolve the incentive problems of the MIG: instead it spreads them out over a much larger group. In 2003 around half of all pensioners are expected, according to government estimates, to be eligible for means-tested support. By 2050 up to 70 per cent of pensioners will be eligible.
- The long-term purpose of the State Second Pension is unclear. By 2050 anyone with income only from the Basic State Pension and the State Second Pension will retire with an income which is already below the MIG at 65. Someone who works all their life and makes contributions to the State Second Pension will not have a non-means tested income in retirement that will lift them above the poverty line.
- Planning is very difficult for individuals. The pensions environment has become much more complicated since 1997, and the new policy instruments both increase the need for good quality advice and make such advice more difficult to provide.
- Public support for the pensions settlement is low. Many individuals feel that means testing retirement benefits is unfair: the settlement is not seen by the public to be equitable.

Pensions reform: options and recommendations

We have compared four sets of pension reform options:

- The government's current strategy;
- Making the State Second Pension more generous;
- Raising the Basic State Pension to the level of the MIG, and indexing it in line with earnings, for those aged over 75;
- Raising the Basic State Pension to the level of the MIG, and indexing it in line with earnings, for everyone.

Raising the Basic State Pension to the level of the MIG, and indexing it in line with earnings, for everyone – together with the phasing out of state second pension provision and a modest raising of the official retirement age to 67 by 2030 – best satisfies the key objectives we have set.

Setting the Basic State Pension at £100 in 2003-04 prices will (along with the Winter Fuel Payments and other supplements to the Basic Pension) give all those with a full contributions record a non-means tested income at around the 'low cost but acceptable' benchmark for the incomes of the elderly. It will be just above the quasi-official poverty line of 60 per cent of median household income after housing costs. It will satisfy the objective of securing adequacy, albeit at a level of income few will regard as overly generous. With nearly everyone automatically receiving a full non-means tested minimum pension at the age of retirement, we get round the problem of inadequate take-up of the MIG and thus deliver a significant boost in income to the very poorest pensioners.

Importantly, it will do this without the complexities of the existing policy regime. With the Basic State Pension raised to a level that would be somewhat higher than the Government's planned level for the combined Basic State Pension and State Second Pension, the opportunity would arise of simply phasing out the latter altogether. The overall pensions system will be significantly simpler, assuring adequacy without involving significant means-testing or a complex and ill-understood state second pension. The proposed increase in the state retirement age to 67 would occur in the decade after the official retirement age for women has increased from 60 to 65, which should make the reform easier for people to comprehend. It thus scores highly in terms of the clarity and transparency of the overall pension settlement. The proposed new settlement would significantly reduce the need for potentially costly pensions advice.

The overall reform package favoured here passes the affordability test as well as the Government's pensions settlement, as we have tried to make the package broadly revenue neutral. Raising the retirement age to 67 combined with ending state second pension provision and with it the system of National Insurance rebates achieves this goal. The overall costs to the exchequer rise to around 6 per cent of GDP by 2050, but this is the same as the projected costs of the Government's settlement including the Pension Credit. Under that settlement the Government is confident that 'Over the longer term, the forecast spending on pensions remains affordable and sustainable' (DWP, November 2001). The reform package suggested here is likewise affordable and sustainable.

Raising the official retirement age needs to be justified on more than just the grounds of improving the affordability of the state pensions system. Average life expectancy has been rising for many years, and for those who will reach 65 in 2030 is now in the middle to late 80s for both men and women. So retiring at 67 would still leave an average of around 20 years of retirement for most men and women. There is evidence that raising the official retirement age has a positive impact on labour force participation rates, achieving one of the goals that everyone recognises as desirable.

Our favoured reform package might raise concerns about the 'windfall' gains that will go to many of today's better off pensioners that do not strictly 'need' the extra income from the enhanced BSP. The distributional consequences of these reforms could be offset through changes to the current tax treatment of pensions and other forms of saving. The tax system could be made more progressive by abolishing equity ISAs that will from 2004 only be benefiting higher rate taxpayers and by scaling back the age related income tax allowances.

In terms of the impact of the proposed reform package on incentives, the greater clarity and transparency of the system and the reduction in the prevalence of means-testing should give clearer incentives for people to save for their own retirement. However, offsetting this, the more generous BSP might result in some people saving less given the extra income guaranteed to them by the state. As the BSP would still be set at a very modest level and most people would want to retire on a significantly higher income, those with the means would still face a clear incentive to save in a second tier pension vehicle. The proposed pensions settlement may work without additional compulsion, though it is likely that policy makers would want to keep this issue under review.

Labour's long-term care settlement: a fair deal for older people?

Labour inherited a flawed system of funding long-term care in 1997, with numerous boundaries obstructing the provision of the best quality care on the most equitable basis. The fundamental boundary between the individual's responsibility to pay for their own care and the state's responsibility to fund on the basis of need had become arbitrary, often inconsistent, and difficult for people to understand. Much care was means tested, although the basis for these tests varied depending on the setting in which care was delivered. The regime governing assistance with residential care costs generated particularly strong resentment, as it effectively required older people to become impoverished before the state would offer significant help.

As in the pensions arena, IPPR agrees that the Government has made great improvements in long-term care policy since 1997. The Government has rightly focused on improving the standard of care received by the elderly through establishing the National Care Commission and the National Service Framework for Older People and significantly increasing funding for older people's services. Some of the old boundary issues relating to the location of care have also been addressed. However:

- The funding distinction between acute health care and long-term health care, and thus the difference in consequences for the individual of developing cancer or heart disease versus Alzheimer's or Motor Neurone Disease is still starkly inequitable.
- The distinction between nursing and personal care has introduced new problems for the delivery of appropriate care. Nurses will in effect become the

gatekeepers to free as opposed to means tested care, and this may create perverse incentives for them to perform tasks which could be more efficiently carried out by a less highly qualified care worker. In many cases it will not be possible to draw a line between 'pure' nursing care and 'pure' personal care.

- The operation of the means test is widely perceived by the public to be unfair, particularly in its treatment of housing equity.
- The issue of free personal care has not gone away simply as a result of government determination to stick to its policy of means testing. Many have questioned the logic of establishing a Royal Commission only to ignore its key recommendation, and the proposed Scottish arrangements may put increasing pressure on the English settlement.

Long-term care: options and recommendations

Our central policy question has concerned whether personal care, in addition to nursing care, should be delivered free. Our analysis and modelling has allowed us to understand the relative significance of the different drivers of long-term care costs. Plausible variations in the unit costs of care, largely reflecting labour costs, have a much greater impact on total costs than variations in other factors such as life expectancy, dependency and the provision of informal care.

Making personal care free to the individual on the basis of need would address our key objective of equity. We do not believe it is fair to draw the current distinction between nursing care needs and personal care needs: both are forms of health care. Providing personal care free would thus mean that the health care needs caused by the diseases of old age would be treated in a consistent way to those which are caused by acute illness. This would be both fair and seen to be fair: older people would no longer be subject to funding their own health care needs.

The equity arguments in favour of providing free personal care are strong, but they would not necessarily be conclusive if they generated unacceptable problems with affordability. A better understanding of the likely costs of long-term care now allows us to re-examine this issue. The modelling work projects the additional cost of making personal care free at some 0.3 per cent of GDP by 2050. This is a significant sum, but in no sense strictly unaffordable. Abolishing equity-based ISAs, reducing the value of the age related allowances, and aligning the upper limit on NICs to the higher rate of income tax would generate more than enough revenue to pay for the introduction of free personal care and would be progressive.

The costs of making personal care free represent a significant shift of funding from private to public sources, but the key issue is the total cost of care, which is driven principally by unit costs. If making personal care free increases demand there will be a small additional increase in the total costs of care. Such increases will be limited, however, by the provision of free care on the basis of need rather than request. Our conclusion is that the balance between equity and affordability is best struck by making personal care free: the affordability arguments do not trump the requirement to treat health care fairly and consistently, by providing it free on the basis of need.

Adequacy, or the provision of a uniformly high standard of care on the basis of need, is a key objective of long-term care policy. As this report focuses on funding there are many key issues around provision which we have not addressed. Making personal care free does not in itself inject new resources into the system. It may, however, improve the standard of care for a number of other reasons. The boundary between nursing and personal care is likely to generate significant practical difficulties, particularly for the nurses and care staff who will be required to implement it on a case by case basis. It is possible that the whole cost base of the sector is unsustainably low and that increased funding will indeed be required simply to ensure that an adequate supply of provision is maintained. If there is new demand for personal care as a result of making it free, then this may in part be welcome. Carers, particularly spouse carers, are often themselves frail and in need of improved support services. If frail carers are able to substitute some of their care for formal help then this may both improve their own quality of life and extend their ability to provide care to their partner at home.

Removing the funding boundary between nursing and personal care would be consistent with our goal of delivering clarity and simplicity. It will make it easier for individuals to understand the system and their own responsibilities. It would be a popular policy, because the fairness arguments discussed throughout this report are strong and are intuitively appreciated by many people. If personal care were free then Government could make a clear case for its long-term care policy: the state will meet older people's health care costs, regardless of where such care is delivered, regardless of the cause of need, and regardless of who delivers the care. Current policy cannot be defended like this.

Overall conclusions

We have investigated whether the Government's current settlement should continue to be pursued or whether a change of direction is necessary. We have firmly concluded the latter.

On pensions, the evidence is clear-cut. Our analysis reveals that a policy framework which relies heavily on means-testing retirement benefits is flawed. This perhaps feels an uncomfortable conclusion for IPPR, a centre-left organisation, to have reached. Surely, as progressives, we support directing limited resources to those most in need? Although we are supportive of the Government's aims and its primary focus on tackling pensioner poverty, we part company on how best to achieve those aims. If a means-tested approach was working for poor pensioners and working for people planning for retirement, then we would be in accord with the Government. But it is not working, and people perceive means testing in retirement to be different from means testing benefits during working life. Even if a reinvigorated campaign saw take-up of the MIG/Pension Credit improve, many pensioners would still be reliant solely on the Basic State Pension, which if price indexed will fall further and further below the poverty line. The introduction of the Pension Credit, complexity aside, creates incentive problems that cannot be resolved. In theory, the Government's strategy has merit. In practice, it falls short of eliminating pensioner poverty and providing an environment whereby people can understand their entitlements, save and be rewarded for doing so.

The centrepiece of our suggested reforms – to increase the Basic State Pension to the level of the MIG and ensure it retains its value in relation to earnings in the future – is the only way to guarantee all pensioners escape poverty. Moreover, it allows a radical simplification of the system – the Pension Credit becomes redundant and SERPS/ State Second Pension can be closed – creating a framework which people can understand. This policy reform delivers for both current pensioners and people currently planning for retirement. It delivers for people in poverty and it delivers for the working poor who will no longer be penalised for their thrift. We also believe it delivers for Government: with the closing of SERPS/State Second Pension and a modest increase in the official retirement age to 67 it is affordable, and the political rewards of what would be a highly popular reform would be significant.

On long-term care, our analysis leads to less clear conclusions. The adoption of free personal care in Scotland has allowed us to assess what benefits it might bring if introduced in England. It clearly illustrates that difficulties persist. Moreover, the future costs of different policy options are highly uncertain and sensitive to factors which are very difficult to predict. On balance we have concluded, with fairness being the pivotal issue, that personal care should be provided free. This does imply higher costs to the Exchequer, but we have shown how these could be offset by other policy changes.

Ensuring the security of all citizens in retirement is a key element of social justice. If the elderly in our society are in poverty or receiving inadequate care, we are failing to make progress. We hope our recommendations describe a contract which will ensure better provision of pensions and long-term care for millions of older people. We also hope it will contribute to a renewal of trust in the Government and support for the welfare state. The political rewards are indeed great.

1. Introduction

Since the 1997 election, Labour has devoted much time and effort to pensions and long-term care reform. Both areas have generated significant legislation and the commitment of new public resources. The Government has characterised its reforms as a new contract for retirement: a settlement for the long term.

In the pensions arena, stakeholder pensions have been available since April 2001, the transition from SERPS to the new State Second Pension will begin in April 2002, and the Minimum Income Guarantee is due to be subsumed into the Pension Credit in 2003. With regard to long-term care, the NHS plan was approaching its second birthday in 2002, free nursing care is being introduced across England and Wales, and alternative proposals for free nursing and personal care have been published by the Scottish Executive. With the major policy instruments out in the open, the time is ripe to reflect on Labour's reforms and ask whether they represent the best response to their inherited problems. An analysis at this point can represent a more considered and comprehensive review than has been possible as details of policies have emerged piecemeal over the period since 1997.

However, this report has also been prompted by concerns about the Government's package of reforms. It should be stressed that IPPR has great sympathy with the Government's central objective of eliminating pensioner poverty. However, retirement policy has not proved to be a source of political capital for Labour. In fact, negative reaction in 2000 to the 75p rise in the Basic State Pension was one of the public relations low points of Labour's last term. It has been difficult for Labour to win public support for its complex mix of pensions policies, despite significant increases in the generosity of public spending on pensioners. Similarly with regard to long-term care, the Government disappointed many by their rejection of the Royal Commission's recommendation that personal care should be free, despite significantly increasing health care spending which disproportionately benefits the elderly. One of the questions we seek to answer is whether continued criticism from pensioners and their representative groups is well founded, or whether the Government should press ahead, vigorously making the case for its chosen policies.

Specific concerns have been raised by the financial services industry with regard to the complexity of the current pensions environment and the attendant difficulty of providing advice to savers. There is also a great deal of speculation over the likely success of the stakeholder pensions initiative, and the question of extending the degree of compulsion on individuals and employers is currently enjoying one of its periodic revivals. In difficult policy areas it is sometimes an indicator of success that all participants are complaining equally. We will examine whether this is so in relation to pensions.

Long-term care policy has burnt with a slow fuse since 1997. The Government has come under sustained criticism for its decision not to introduce free personal care as recommended by the Royal Commission – an enquiry that it established in part to consider this very question. Any hopes that the argument would die away were dashed by the Scottish Executive's exercise of its devolved power to disagree with Westminster. As a result, different policies are likely to run parallel in different parts of the UK, guaranteeing the persistence of debate for the foreseeable future. Public criticism of the English settlement has been reinforced by professional criticism from those who will have to implement the distinction between nursing and personal care on a case by case basis.

In this report our starting point will be to assess some of the assumptions which inform and misinform current policy debates. Chapter 2 examines demographic and labour market changes; health expectancy and family trends; and some issues around public and private funding. Individuals do not consciously experience discrete retirement policy areas, so throughout this report we try to draw parallels and think consistently across pensions and long-term care.

Policy often proceeds on the basis of pressure for solutions to particular historical problems. In order to take a broader view, Chapter 3 identifies the underlying objectives of pensions and long-term care policy with a discussion of adequacy, affordability, the protection of incentives, equity, clarity and simplicity, choice and community. We discuss the necessary tensions between some of these objectives, examine the Government's priorities and propose our own ordering.

Chapters 4 and 5 describe the evolution of pensions and long-term care policy in the UK, and assess the reforms introduced since 1997. Many of Labour's policies can be seen as a well motivated response to the problems they inherited. However, we highlight various ways in which the current settlement fails to meet the more fundamental objectives we have identified.

A series of alternatives which might better meet these objectives are then set out and evaluated in Chapters 6 and 7. This part of the report draws extensively on work commissioned by IPPR from external partners at PricewaterhouseCoopers, SAGE at the London School of Economics, the Personal Social Services Research Unit at the London School of Economics, and the Nuffield Community Care Studies Unit at the University of Leicester. It should be noted that IPPR's policy conclusions are not the responsibility of these external partners. Chapter 8 summarises our conclusions and suggests a way forward for Government.

Throughout the report our focus is on funding rather than provision. Thus we are concerned centrally with the various responsibilities of individuals, employers and the state to pay for pensions and long-term care. Whilst these issues have significant implications for provision, for example by shaping the market for private products, we do not directly discuss questions such as the regulation of the financial services industry or the delivery of social care services for the elderly.

It would be wrong to assert that there was ever a golden age of retirement policy. But it is undeniable that public pension provision has become less generous and more complicated over the last 20 years. Over the same period long-term care has become a more significant issue as expectations have risen and the number of those requiring care has increased. Many older people feel that successive governments have broken an implicit contract between the individual and the state, in which a high standard of care and support was the quid pro quo for a lifetime of paying taxes and National Insurance Contributions. After the abandonment of the earnings link and the devaluation of SERPS during the 1980s, the Government needs to establish a new contract for retirement with the public.

A new contract implies rights and responsibilities which are clear to citizens, the financial services industry and government. It implies a degree of permanence which allows individuals, advisors and providers to plan with confidence for the long-term. This means a settlement which is robust to changes of government because it is workable, sustainable and publicly supported. It means a settlement which is both fair and seen to be fair. The prize is not just superior provision of pensions and long-term care for millions of older people, but potentially a renewal of trust in the Government and support for the welfare state. The political rewards could not be greater.

2. The myths underlying policy

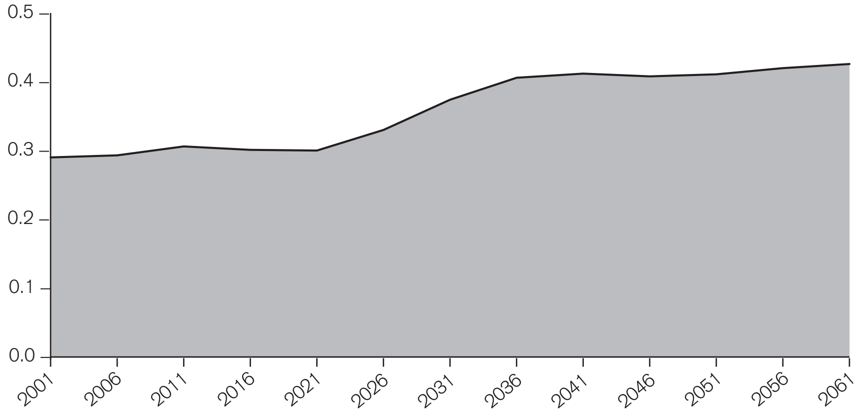
Policy debates in pensions and long-term care proceed on the basis of a set of assumptions that need to be constantly reassessed. Unfortunately, many opinions are supported by popular myths about issues such as demographic change; labour market evolution; changes in future health trends; social and family change; the sustainability of public pensions spending; and the merits of private versus public funding. An informed and constructive debate must start from questioning the received wisdom on a number of issues.

Demographic changes

The consequences of the well-documented ageing of the population are sometimes presented in almost apocalyptic terms as a threatening 'demographic time bomb'. Changes in the age structure of the UK population will come about for two reasons. Firstly, large cohorts of individuals born during the post-war and 1960s 'baby booms' will be reaching retirement age between 2010 and 2030. Secondly, these individuals are projected to have greater life expectancy than earlier cohorts. For example, in 1951 the expectation of remaining life at 60 was 14.8 years for a man and 17.8 years for a woman. By 2031 comparable individuals are projected to have life expectancy at 60 of 22.5 years for a man and 25.7 years for a woman.[1]

A rising dependency ratio, in this case the ratio of the number of people over the official retirement age to the working age population, does pose dilemmas, other things being equal.

Figure 2.1 UK dependency ratio: pension age individuals per person of working age



Source: Government Actuary's Department 2000 based population projections

However, other things are not equal. The *official* retirement age is not fixed in stone and need not remain rigid: the official retirement age for women is already set to rise from 60 to 65 (into line with the existing age for men) between 2010 and 2020. This measure of the support ratio does not tell the whole story about the balance between the working and non-working population. A critical variable is the proportion of the working age population in employment.

Labour market changes

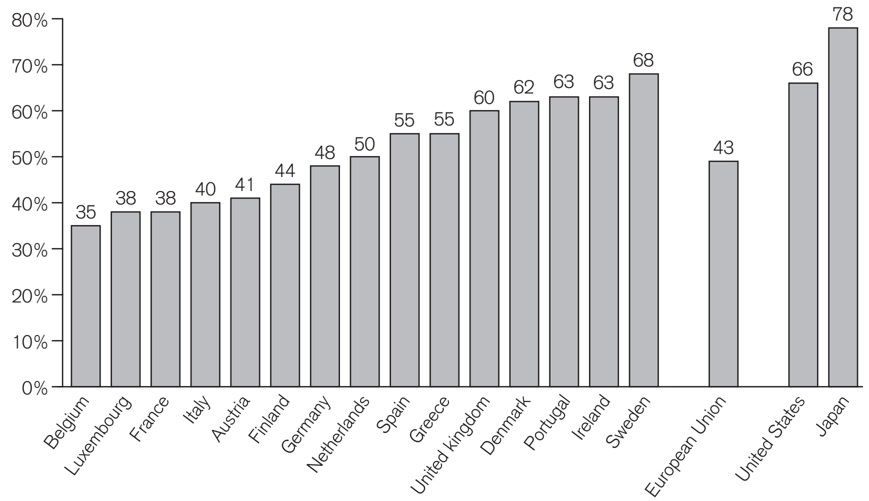
During the 1980s early exit from the labour market reduced the *effective* retirement age, and it would be an important step to increase this effective retirement age nearer to the current official retirement age. This is particularly so because a high proportion of retirement saving often occurs in the latter part of working life once the major expenses of setting up a home and raising children have abated. In addition, the stability of employment has significant implications for the ease of pension provision through the workplace. Increasing the effective retirement age is likely to increase the size of individual savings, decrease individual demand for public pension payments, and contribute to economic output. Whilst voluntary early retirement can be an attractive choice for those who are well off, for many lower earners it is both involuntary and unattractive: the beginning of a long period of low income and dependency on state benefits.

Despite all the hype about the end of 'jobs for life', people between the ages of 25 and 50 now typically have three or four jobs, exactly as they did in the 1970s (Meadows 2001, Pension Provision Group 2001b). Young people aged under 25 do now move around the labour market much more, but this is not the age at which people tend to be saving for their retirement. We should not be worried about the mythical passing of a golden age of lifetime employment, but rather the low income self employed, women earning below the national insurance threshold, those locked in the 'low-pay no-pay cycle' and above all low participation rates amongst the over-50s.

Participation and employment rates for the older workforce in the UK are relatively good compared to those demonstrated by most EU countries, but some European countries, as well as the US and Japan, demonstrate significantly better performance.

In 1979, 84 per cent of men over 50 were employed. This figure fell rapidly during the early 1980s recession and continued to fall until the late years of that decade. During this period the employment rate for the over 50s fell further and faster than comparable rates for men between 25 and 49 years old. Since 1993 the picture has been improving: each year has seen an increase in employment rates for men over 50. Much of this is attributable to cyclical recovery, but the rate of increase has been faster than that for men in the younger age category. From 1993-2001 the employment rate for men between 25 and 49 years old increased by 4.4 percentage

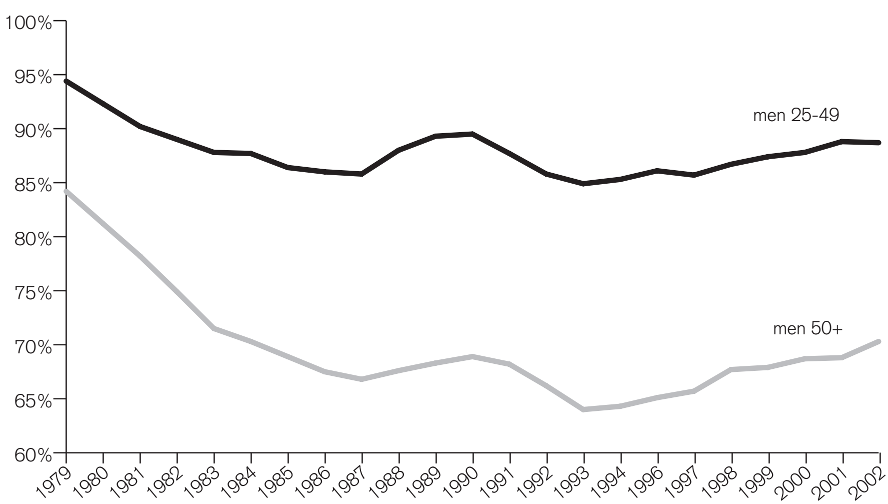
Figure 2.2 Employment rate of 55-64 year old men, 2000



Source: OECD Employment Outlook June 2001

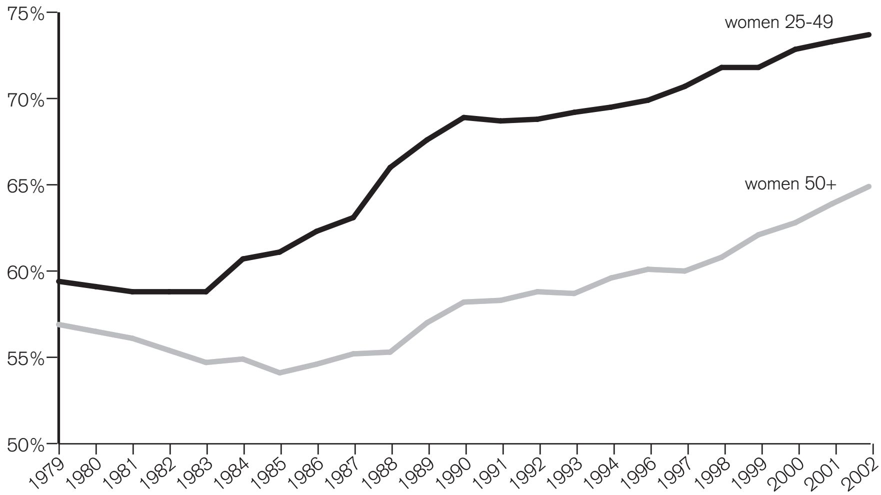
points, whilst the comparable increase for those older than 50 was 6.1 percentage points. Despite this relative improvement, absolute employment rates remain some 20 percentage points lower for older male workers and this gap is still far larger than it was at the end of the 1970s.

Figure 2.3 Employment rates among men 1979-2001



Source: Labour Force Survey

Figure 2.4 Employment rates among women, 1979-2001



Source: Labour Force Survey

The picture is somewhat different for women, who did not suffer a great fall in employment in the early 1980s. However, from the mid 1980s to early 1990s employment grew faster among younger women than among older women, opening up a significant gap between the two groups. Since the beginning of the 1990s this gap has narrowed modestly. Older women's employment rates are currently 10 per cent lower than for the 25-49 age group, a much smaller difference than between older and younger men. The younger female age group now exhibits an employment rate some 15 per cent below that for men of comparable age, whilst employment among the older female group is just five per cent below the rate for older men.

Some of the processes which have historically encouraged early retirement in the UK may now be abating or reversing, improving the prospects for future cohorts of older workers.

- Structural changes in the economy, and in particular the shift away from manufacturing employment, have slowed down. Whilst manufacturing employment continues its secular decline across Europe, and we still occasionally see large scale job losses, manufacturing now represents only 14 per cent of UK employment compared to 26 per cent in 1979.

- Firms wishing to restructure and reduce their workforce have sometimes provided enhanced occupational pensions as part of 'voluntary redundancy' packages. However, as fund surpluses have run down companies no longer have the same leeway to use pensions to subsidise early retirement. In addition, the generous terms available through some public and private sector defined benefit schemes have in the past made early retirement an attractive option to workers. The move towards more defined contribution schemes, and a generally more cautious attitude on the part of employers towards the generosity of defined pension benefits, should reduce some of these incentives to early retirement.

- Public policy during the 1980s was not effectively directed at increasing employment among older workers. For example, the Job Release Scheme which operated from 1977 to 1988 encouraged older workers to stand aside for younger individuals, and the Performance and Innovation Unit (2001) indicated that at this time older unemployed people were not given the same job search help and encouragement that was provided to younger individuals. The Labour Government has now explicitly identified work and community activity among older people as an area for special attention, and new government initiatives to promote employment amongst the over-50s include a New Deal aimed at reconnecting older adults to the labour market.
- In some areas of the UK a tighter labour market is likely to alter the attitudes of employers to the over 50s, and will make discriminatory practices harder to sustain. More generally, public policies aimed at countering age discrimination should continue to assist this process and age discrimination is now high on the list of issues with which trades unions concern themselves.

Social and family change

Families are increasingly complex and household units more diverse. Relationship breakdown and reformation can create severe demands on individuals' income presenting challenges in terms of the need for flexibility in pension planning and provision. The increase in single-person households will have significant implications for the supply of informal care to the elderly.

The social conditions that gave birth to the post-war welfare state clearly no longer exist. Welfare policy, with retirement policy no exception, has been slow to move forward from its reliance on a model of social and family structures circa 1945. The most dramatic social trend has been the increasing numbers of women entering the workforce. This social revolution in women's life-chances demands that labour market policy and family policy be looked at together (Commission on Social Justice 1994). We would be mistaken in thinking that because female participation is now high (although still below men's) that we somehow have gender equality in relation to the ability of individuals to plan for retirement. More women are working but there is still a significant gender pay gap, and this clearly affects women's ability to build up pensions. Women are also more likely to take extended leave from work to care for children or elderly relatives, and thereby have disrupted contribution records.

More fundamentally, we need to reappraise the respective roles of men and women as both employees and as carers. Public policy has yet to get much involved in this debate, essentially accepting that the majority of care responsibilities are still undertaken by women.

The changing nature of relationships and family life is another key challenge. The trend to increased relationship breakdown and reformation can create severe demands on individuals' income. Provision for pension planning needs to be more flexible to meet this challenge. The Government has responded by introducing greater flexibility through stakeholder pensions. This is a welcome reform enabling people to stop and start contributions without penalty. There is a however a broader debate around how people can better balance work with other responsibilities, learning opportunities and leisure throughout their life. Planning for retirement should be compatible with this pursuit of a better work-life balance across the lifecycle. Public policy on pensions and long-term care should not inhibit it from being so.

Society and relationships have undergone significant change, but this should not however lead to a pessimistic account of the demise of family responsibilities and little desire by family members to support and care for their relatives. IPPR's qualitative research, *Age Old Attitudes?* (Edwards *et al* 2001) published as a companion volume to this report, shows this is largely unfounded. A consensus seems to exist across generations that caring for your relatives is a profoundly good thing, and that people still feel a duty to care for their partners or close relatives when in need. Because the older population will increase over the next thirty years, the *number* of dependant people over the age of 65 who live alone is set to rise by 45 per cent over the same period. However, one of the surprising findings of recent research in this area is that at the same time the *proportion* of dependant elderly people living alone is expected to fall, from 43 per cent in 1996 to 38 per cent in 2031. This is likely to occur both because among women currently aged 40-65 the proportion who have married is higher than for older cohorts, and because improvements in elderly male mortality are expected to reduce the number of elderly single women (Pickard *et al* 2000).

Health status

There are considerable uncertainties about future trends in health and disability, the demand for care and the supply of informal care and the costs of health and care provision. However, while demand and cost pressures are important and make trade-offs inevitable, they should not be allowed to become the driving force behind policy development.

There are two broad competing theses about the future of health in old age. The first, a 'medicalisation' thesis, foresees increased life expectancy coupled with increased disability and increased care needs (Wiener *et al* 1994). The second, a 'compression' thesis, sees the costs of care compressed into a short period at the end of an increasingly lengthy healthy life. It has been suggested that improving health status could act as a counter balance to demographic changes (Metz 2001). There is already evidence that after middle age the acute care costs associated with death decrease as the age of death increases, in other words that people who die old, die at relatively low cost to hospital services (Normand *et al* 2002). This is partly because these older individuals are not generally dying of conditions like cancer and heart disease which are very expensive to treat.

At present, cross sectional data from the EU indicate that individuals in countries with longer life expectancies also tend to experience a higher proportion of those lives with some level of disability (Robine *et al* 1998). However, this data does not allow us to project the future with any confidence. Much long-term care is needed because of debilitating diseases such as dementia, and these may eventually become treatable. Improved data on the risks of requiring long-term care is certainly required, and some longitudinal research would provide more reliable information.

The sustainability of public funding

Projecting the costs of long-term care varies significantly from projecting the future cost of pension spending. This is because long-term care is a demand led activity rather than a matter of redistributing income across time and between individuals. The demand for long-term care is driven by a set of factors including the age structure of the population, the health status of different age cohorts, the supply of informal care by relatives and friends, the unit costs of providing formal care, and patterns of formal care demand and supply (for example, domestic or residential care). The division between public and private spending is then significantly affected by policy, especially the extent to which individuals are charged for the care they receive and the extent to which such care is paid for by the state.

IPPR has commissioned original research from the Personal Social Services Research Unit and the Nuffield Community Care Studies Unit to project the future costs of the long-term care in the UK. A description of the PSSRU / NCCSU models and the full account of their research for IPPR is published in the companion volume to this report *A new contract for retirement: modelling policy options to 2050*. Using these models together provides projections of long-term care costs and their division between public sources and private individuals. Table 2.1 summarises the base case cost projections, whilst Chapter 7 discusses the assumptions and sensitivities of the model.

Table 2.1 Public and private spending on long-term care in the UK 2000-2051, % of GDP

	2000	*2005*	*2010*	*2020*	*2031*	*2041*	*2051*
% GDP public	0.94	0.92	0.88	0.91	1.03	1.08	1.06
% GDP private	0.44	0.43	0.45	0.47	0.52	0.55	0.55
% GDP total	1.39	1.35	1.33	1.38	1.56	1.63	1.61

Source: PSSRU/NCCSU model projections

These projections indicate stable total costs at just below 1.4 per cent of GDP until 2020, growth of about 0.25 per cent of GDP between 2020 and 2040 and then a levelling out at just over 1.6 per cent of GDP from 2041 to 2051. Public costs and private costs indicate a very similar pattern of stability to 2020, growth to 2040 and levelling off thereafter at just over one per cent and just over half of one per cent of GDP respectively. Chapter 7 discusses the derivation of these projections and sensitivities around this base case. For the moment we can observe that these projections represent significant but limited medium term to long-term increases in long-care costs. They do not spiral inexorably upwards but rather reflect the growth in the elderly population caused by the ageing of the baby boomer birth cohorts. When compared to gross domestic product or total government spending the increases are more modest: the change in public expenditure from trough to peak across these 50 years is about 0.2 per cent of GDP.

Table 2.2 Public pension expenditure projections 2000-50, % of GDP

	2000	*2005*	*2010*	*2020*	*2030*	*2040*	*2050*	*Change 2000-peak*
Belgium	9.3	8.7	9.0	10.4	12.5	13.0	12.6	3.7
Denmark	10.2	11.3	12.7	14.0	14.7	13.9	13.2	4.5
Germany	10.3	9.8	9.5	10.6	13.2	14.4	14.6	4.3
Greece	12.6	12.4	12.6	15.4	19.6	23.8	24.8	12.2
Spain	9.4	9.2	9.3	10.2	12.9	16.3	17.7	8.3
France	12.1	12.2	13.1	15.0	16.0	15.8	na	3.9
Ireland	4.6	4.5	5.0	6.7	7.6	8.3	9.0	4.4
Italy	14.2	14.1	14.3	14.9	15.9	15.7	13.9	1.7
Luxembourg	7.4	7.4	7.5	8.2	9.2	9.5	9.3	2.2
Netherlands	7.9	8.3	9.1	11.1	13.1	14.1	13.6	6.2
Austria	14.5	14.4	14.8	15.7	17.6	17.0	15.1	3.1
Portugal	9.8	10.8	12.0	14.4	16.0	15.8	14.2	6.2
Finland	11.3	10.9	11.6	14.0	15.7	16.0	16.0	4.7
Sweden	9.0	8.8	9.2	10.2	10.7	10.7	10.0	1.7
UK	5.1	4.9	4.7	4.4	4.7	4.4	3.9	-1.2

Source: European Economy – Public Finances in EMU 2001

Pensions policy has also often been influenced by fears of an escalating cost to the state. However in 2000 the UK devoted a lower share of GDP to public pensions expenditure than any other EU state, and prior to the Labour Government's recent reforms it was also the only EU state where such expenditure was forecast to fall. Even allowing for increased public spending as a result of the new Pension Credit, there is no crisis of affordability in public pensions funding in the UK.

The figures for the UK in Table 2.2 do not include income support and Pension Credit payments to pensioners, and do include some non-pension spending on other benefits which are funded from the National Insurance Fund: these factors somewhat exaggerate the downward trend over time. However, even when these items are corrected the peak level of UK public pension spending is projected to be only six per cent of GDP in 2040 (Hawksworth 2002). This still represents the lowest peak in the EU, and the smallest change from present to peak expenditure. There are more fundamental reasons, however, why we should not be focused narrowly on reducing public pension expenditure.

The inherent superiority of private funding?

There is no overriding reason to believe that in the UK a further switch from public pay-as-you-go to privately funded pensions would raise national income. As all pensions have to be paid out of today's national income, any reform that does not increase national output or income does not make the financing of pensions any easier (Barr 2001). Sometimes a simple story is told that because funded pensions involve saving now, this will result in an increase in national savings, which will result in an increase in productive investment, which will then lead to a higher national output in the future, so allowing more generous pensions to be paid.

However, this story can break down at any point. If saving into pensions is encouraged there may be substitution away from other forms of saving and total national saving may not go up. A lot also depends on how the Government responds in terms of its own contribution to national savings, that is whether it continues to run a budget surplus (which adds to national saving) or a budget deficit (which subtracts from national saving). There is no automatic way that extra savings can be translated into extra productive investment and higher national output.

The one sure way to increase national output is to increase labour force participation rates, which is one of the reasons this is discussed in such detail above. This is where efforts should be concentrated in an advanced industrial economy like the UK that already has well- developed capital markets and a mixed economy in its pensions system. The debates about developing a funded pensions system are more relevant to those developing countries where such a reform can foster the development of capital markets and provide a lever for governments to reform their own fiscal regimes. They might also be relevant to developed countries that currently have all their pension eggs in the same pay-as-you-go basket (Holzmann 2001).

If it is accepted that pension reform in the UK will not directly affect the size of the cake by having an impact on national savings, but only in so far as it affects labour force participation rates, it becomes clear that pensions policy is all about *redistributing* income. This redistribution can be between the current generation of workers and the current generation of pensioners and/or within the current generation of workers or the current generation of pensioners. Even if we did think that a further shift to funding would increase national saving, this implies a redistribution from the current workforce who by definition would have to consume less now, to the retired population in the future.

There is a parallel to these long-standing debates in pension policy in the debates over long-term care. What ultimately matters in long-term care is the total claim on the national income from the public and private funding of the care that people need. The division of this between public and private funding is in some senses of second order importance. What matters are the incentives that people are faced with given the overall care regime that is in place and the quality of the care they receive. In strict efficiency terms, a regime that gave people an acceptable standard of care and cost the State 1.5 per cent of GDP and private individuals nothing would be preferable to a regime that delivered the same standard of care with the State and individuals both paying one per cent of GDP each. The first system is clearly more efficient in terms of its use of the nation's resources. It immediately follows that the objective of putting a cap on public expenditure on long-term care could never in itself lead to the optimal policy outcome.

The balance between state, employer and individual provision

There are effectively three ways of paying for pensions and long-term care. The state can pay, but to do so it must raise revenues through taxes (or National Insurance Contributions), the costs of which are all eventually borne by individuals. Alternatively employers can pay, as they do now through NICs or employer contributions to occupational schemes. In modestly efficient labour markets such payments will eventually be factored into the gross wages received by individuals. Finally, individuals can pay directly through purchases of services and insurance arrangements, and through their own savings. It is often forgotten that all provision for retirement is in the end funded by individuals. The balance to be struck is between individuals paying for their own provision directly or individuals paying collectively for the provision of tax funded pensions and care. The political and practical dimensions of different funding routes, however, make for a more complicated picture.

It would be naïve to imagine that increases in National Insurance Contributions to fund more generous public pension or long-term care provision would be significantly less politically sensitive than tax rises required to fund other public spending. The link between contribution and entitlement has been repeatedly broken through numerous welfare and public pension reforms, particularly by the devaluation of the Basic State Pension and SERPS during the 1980s,[2] and NICs are increasingly seen by the public as similar to other forms of taxation (Commission on Taxation and Citizenship 2000). The storm of speculation during the 2001 general election campaign over possible changes to the NICs regime was good evidence of this.

Party political debates over tax and spend have, however, developed significantly in the last five years. At the 2001 general election the Tories found themselves forced on to the defensive over accusations that they would cut public funding for health and education: a dramatic reversal from earlier years when Labour was forced to defend itself against accusations of planned tax increases. At the same time the well-organised pro-business lobby will continue to push for a simple, stable system minimising risk and administrative costs for employers.

There is a pressing need for clarity over the rights and responsibilities, as well as the risks and rewards, implied by public, individual, and employer funding of pensions and long-term care. Since 1988 and the introduction of personal pensions, the UK has arguably been moving towards a greater emphasis on individual responsibility in pension provision. Much long-term care has always been provided on the basis of sharing costs between the individual and the state, but the drive to move individuals from hospital care (NHS funded) to residential care beds (means tested) has placed extra responsibilities on the individuals affected. It is too easy to say that increased personal responsibility automatically equates to improved freedom, choice, and ultimately better outcomes. Individual decisions involved in long-term financial planning are often very complex, especially for those on low to moderate incomes, and good quality advice is frequently expensive. Some markets, such as that for long-term care insurance, are in their early infancy and may always face difficulties in achieving efficiency. There is increasing evidence that planning for the distant and sometimes unattractive eventualities of retirement and long-term disability is not an activity which individuals are at all keen to undertake (Rowlingson 2000; Edwards 2001).

In the case of pensions a particularly strong current is the shift from defined benefit schemes, including SERPS as well as occupational arrangements, to defined contribution schemes including company and stakeholder pensions. This shift transfers capital market and longevity risk from companies and the state onto individuals. In such an environment two factors increase in importance: firstly, it is vital that individuals understand the risks that they face and are able to plan accordingly. Secondly, if individuals do face increasing risks it becomes more important that the state provides an acceptable basic minimum. Since the end of the long equity bull market in 1999 there has been a much clearer perception of the risks and realistic long-run returns from equity funded pensions. A decent guaranteed basic minimum pension may appear a more attractive safety net now than in the heady days of 1997-98 when UK equity returns were dramatically higher.

One of the most important aspects of the balance between state, company and individual provision is that each must be clear about the role of the other. Without this planning becomes impossible. Whilst this is a common issue in public policy, it is particularly severe in the realm of retirement issues because of the time scales involved. At present individuals, financial service providers and other companies are frequently confused about the present arrangements and unconvinced that they are robust to future policy change.

3. Objectives

The IPPR is supportive of the Government's overall objectives for its social policy agenda. The core overarching value for the centre left is a commitment to *social justice*. Priorities need to be determined by a constant reference to whether the outcomes are socially just. Although this encompasses a moral attachment to equality and a decent minimum for everyone, it is also much broader. It incorporates an increased emphasis on equal access to opportunity and a more ambitious notion of a better quality of life. There is a pressing need for older age to be re-considered, not as a time of inactivity and dependency, but as a more flexible time of life which involves progressively less formal paid work, more community involvement, and a broad range of opportunities for personal development and fulfilment.

Social justice in relation to retirement has distinctive features, in particular with regard to intergenerational issues and the relationships between the actions individuals take earlier in their lives and the outcomes they experience later. Under almost any conceivable pension and benefits system the working population will directly fund some current pensioners' income, and many people strongly support this aspect of the 'intergenerational contract'. In the area of long-term care the vast bulk of funding is through current taxation, and most care in the home is provided on an informal basis by relatives and in-laws. A further intergenerational link is provided by inheritance: most wealth not consumed by older people's living and care arrangements currently passes to their legatees. Changes to the balance between the responsibilities of different generations need to consider all of these issues.

Changes to policies with the long time horizons of pensions and long-term care pose special challenges. This is not just because the effects of change are felt in the far distant future. It is also because people may have been planning for many years on the basis of assumptions which are suddenly changed. To take the most extreme example, there is little that a pensioner can do in terms of additional financial planning when their state entitlements are unexpectedly altered. Changes also pose a particularly difficult political problem because upheavals and costs may be felt immediately, whilst advantages may take decades to become appreciated. It is difficult for governments to make much political capital out of such long-term benefits.

Government policy often seems to be shaped predominantly in relation to overall funding constraints. In pensions it has been an implicit aim of policy to reduce public spending on pensions as a proportion of GDP (DSS 1998, Prime Minister's Introduction). In long-term care the capping of public spending has been a more implicit objective. However, although overall affordability is vital in any sustainable settlement, it should not be the predominant consideration driving policy. There are several different objectives that pensions and long-term care policies need to address. Not all can be satisfied at the same time, and some trade-offs between the objectives are inevitable.

Adequacy

The state must ensure that all receive an income in retirement at least adequate to lift them over the poverty line. This must be the primary objective of pensions policy. An appropriate minimum adequate income would take into account the individual's physical, psychological and social needs: safety, shelter and other material requirements are necessary but not sufficient. An acceptable income must allow for social integration and the avoidance of chronic stress as well.

There are two broad methods of determining what such a level would be in monetary terms. The first is to consider the minimum level as a proportion of the relevant average incomes, the usual definition of the poverty line being 50 per cent of the mean or 60 per cent of median income. In monetary terms, 60 per cent of median weekly income net of tax and housing costs was £81 in 1999-2000 (Households Below Average Income series). Uprating this figure by 4.5 per cent nominal earnings growth per year gives a figure for 2003 of approximately £97 per week.

Table 3.1 Percentage of pensioners living in households with relative low incomes

	Before housing costs				*After housing costs*			
	96/97	*97/98*	*98/99*	*99/00*	*96/97*	*97/98*	*98/99*	*99/00*
Below 50% of mean	22	23	25	23	28	29	30	28
Below 60% of median	21	22	23	22	27	27	27	26

Source: Households Below Average Income series, as reported in *Opportunity for all*, Department for Work and Pensions Third Annual Report 2001

Table 3.1, drawn from the Third Annual Report of the Department for Work and Pensions, indicates no significant improvement in relative pensioner poverty levels over the first three years of the last Parliament. In defence of government policy, it must be noted that only the last of these years would have seen the impact of any major changes since 1997: the Minimum Income Guarantee, for example, was not introduced until April 1999. Other aspects of government pension policy will take many years, or even many decades, to draw up the incomes of the poor. However, some, such as the MIG, should have a very rapid effect and an absence of any significant improvement in relative poverty rates by the end of the current Parliament would represent a real failure. It has been estimated by the DSS that in the first year of the MIG between a fifth and a third of pensioners failed to claim the payments that they were entitled to. The Department for Work and Pensions is now working to improve take up, particularly through simplifying the application procedure for the MIG and establishing the pensioner service.

The second way of determining a monetary level of sufficiency is to construct the budget needed to support the expenditure implied by a particular standard of living.

The Family Budget Unit carry out these exercises using two useful standards: low cost but acceptable (LCA) and modest but adequate (MBA). Both of these standards are implicitly relative: goods and services are included in the LCA standard if they are consumed by more than 80 per cent of comparable households, and in the MBA budgets if they are consumed by more than 50 per cent of comparable households (Parker 1997 and 2000). LCA represents a level of income below which people are likely to suffer social exclusion, and should thus represent the floor below which no individual falls. In April 2003 terms[3] a weekly LCA budget (net of any tax and after housing costs) for a single homeowner pensioner would be approximately £107, with the comparable individual needing £164 to reach the MBA standard. The LCA level is thus similar to the proposed MIG rate of £100 for 2003 plus the weekly equivalent of £4 for the Winter Fuel Allowance. Free television licences for the over 75s also increase the generosity of public provision for those who qualify.

Table 3.2 Monetary adequacy levels, weekly amounts net of tax and housing costs
April 2003 terms

	Single homeowner pensioner
60% of median income	£97
Low Cost but Acceptable standard	£107
Modest but Adequate standard	£164
MIG (plus weekly equivalent of Winter Fuel Allowance)	£104

Source: Parker 1997 & 2000; Department of Social Security 2000

Government policy is aimed at reducing the proportion of pensioners with low relative incomes, reducing the proportion of pensioners living in poverty measured in an absolute sense, and also reducing the proportion of pensioners with persistently low incomes (Department of Work and Pensions 2001). In fact, under most circumstances, achieving one of these aims will lead to the others. If relative poverty is decreasing and average incomes are rising then the number of those in absolute poverty is almost certainly decreasing. Similarly, if the absolute incomes of the poorest rise faster than average incomes, then relative inequality will be falling. Success on either score is likely to improve the situation of at least some of the long-term poor, particularly through measures like the MIG.

The standard of adequacy for long-term care is that everyone should receive appropriate care on the basis of their need. Medical care standards are central, but there are many other elements of care required to ensure that individuals continue to lead the fullest possible lives. It is much more difficult to define an appropriate minimum standard for long-term care than for pensioner incomes, but in general we should expect that it will be relatively high. Care must be of a high standard and tailored to personal need if it is to promote the independence and dignity of the individual, and these are goals as important in many cases as narrowly defined medical status.

There is a significant difference between pensions and long-term care in the distribution of outcomes that we should be prepared to accept. Whilst reducing income inequality is a key goal for policy, we are still rightly prepared to accept differences in pensioner incomes that reflect individual work effort, consumption and savings behaviour in earlier life: some variations are necessary to maintain incentives to work and save. In the case of long-term care we should require both a high minimum standard and a much narrower range of outcomes across pensioners because the need for care is not the result of any individual actions and it is difficult for many individuals to make their own provision for care.

Affordability

Affordability is a highly contested term. In the context of government policy it concerns the evaluation of competing priorities and public willingness to fund government spending as well as technical questions about the likely cost of particular policies. Policy should not set up future costs for the State that are unaffordable in the sense that they imply a sharp and ongoing rise in spending as a proportion of GDP. However, the State should not make an obsession of capping or reducing spending as a proportion of GDP. As noted above, the UK currently devotes a relatively small proportion of GDP to public pension provision compared to our European neighbours, and this comparison is set to become progressively more flattering to the UK over the next fifty years. Public and private long-term care costs are set to remain stable for the next twenty years before rising with an ageing population. The public costs of long-term care are currently around one fifth of the size of public pension costs.

In the case of both pensions and long-term care, the Government has rejected popular policies on the ground of cost. Widespread demands to restore the earnings link for the Basic State Pension were rejected even before the 1997 election victory (Labour Party 1997). The Royal Commission on Long Term Care's recommendation that personal care should be free, which was widely supported by campaigning organisations, was rejected in the NHS Plan (Department of Health 2000). In neither case was the Government's argument simply that the policy was too expensive. Rather, in both cases the argument was firstly that in the short term the same amount of money could be better targeted on those pensioners in the greatest need, and secondly in the longer term the rejected policies would set up unsustainable spending commitments.

There is clearly something strange about this two-stage argument. On the one hand it seems to suggest that the government proposal is as generous as the rejected alternative. On the other hand it suggests that the rejected proposal is unaffordable.

This example of the desire to both have the cake (generosity) and not eat it (prudence) can only be consistent if longer term spending is in fact less generous under the Government's proposals. In addition, the argument that spending on other items for the target group will add up to the total implied by the rejected policy is often specious. For example, the Government argued that it would rather allocate extra resources to intermediate care instead of making personal care free. However, those who advocated making personal care free were not suggesting that intermediate care should be starved of resources: their argument was that the resources for personal care should be additional to other expenditure on services necessary for older people.

Just as affordability is a complex issue for the Government, it is not always straightforward for individuals either. Whilst many people never earn large enough incomes to support their own retirement, there is increasing evidence that others could be saving more but instead choose higher current consumption for a variety of reasons (Oliver, Wyman & Company 2001). In some areas the issue of affordability is more straightforward, for example those without significant liquid assets at the beginning of their retirement are unlikely to be able to afford long-term care insurance. There are also areas where changes in markets and policies may make new options affordable for individuals, for example the development of a larger market in equity release schemes may enable more people to fund long-term care insurance from a portion of the value of their home.

Protecting incentives

People must be rewarded and adequately incentivised for saving or insuring themselves, especially given the increased emphasis on personal responsibility. It is also important that the tax, benefit and care regimes do not interact in such a way as to undermine the incentives to make such provision. Means testing benefits, whilst intended to target help on those most in need, almost always creates incentive problems: the familiar 'poverty trap' where incremental provision by the individual reduces entitlement to state assistance.

In some cases, people may respond to such disincentives by reducing their own level of provision. However, many will not be able to understand the complex incentives they face. This damages trust in the pensions system and is likely to reduce the effectiveness of certain policy instruments. For example, if the Pension Credit is supposed to act as an incentive to save, it needs to be understood by people for them to respond accordingly. Incentive problems also lead to perceptions of unfairness. Original research by IPPR shows that many people feel means testing is unfair: they feel penalised for acting prudently when this leaves them only slightly better off. (Edwards *et al* 2001)

There is a significant difference between pensions and long-term care with regard to the type of incentive problems in the two areas. In the pensions arena, policy should seek to actively incentivise retirement saving relative to other forms of saving and eliminate disincentives to save generally. The UK has a history of using tax incentives to favour pensions because of the long-term and illiquid nature of such savings. It will be important to maintain this advantage if people are to be encouraged to make sufficient provision for an adequate income in retirement. The situation is somewhat different with regard to long-term care: it is not possible to incentivise people to make their own provision against needing long-term care in the same way that it is possible to incentivise them to make their own provision against being poor. It may be possible to incentivise people to make their own provision against the cost of long-term care, but where the incentive issue really bites is in the perceived unfairness of the means test for long-term care.

Equity

A common interpretation of equity is that relevantly similar cases should be treated in the same way: this is sometimes called horizontal equity. In health and social care provision according to need and not ability to pay has long been held up as a vital principle and is motivated by considerations of horizontal equity. Another interpretation of equity holds that relevantly different cases should be treated differently, and in particular that those with fewer opportunities (for example lower incomes) should be assisted through redistributive measures. Means tested benefits and other targeted measures attempt to promote vertical equity. Some parts of the UK system reflect both considerations, for example the Basic State Pension is flat rate in payment but is funded by progressive taxation.

The *perception* of equity or fairness is vital, as this is required for broad political support. In practice, this is not always easy to achieve. Different individuals may perceive fairness differently, and there are cases where different applications of the principle of fairness can pull policy in two ways: targeted versus universal benefits are the classic example. In pensions there needs to be an equal opportunity to build up pension entitlements, an issue which raises significant gender issues.

Questions of equity are central to the debate over long-term care. Those who are dissatisfied with current policy often point to the contrast between individuals who fall sick from cancer and those who fall sick from Alzheimer's disease. In the first case medical expenses are fully met by the state, whilst in the case of dementia payment for the large amounts of personal care required by the individual are shared on the basis of a means test. There is widespread public resentment at the means testing of long-term care, and IPPR's qualitative research brings out very clearly that it is not simply that individuals do not like means testing: they feel that it is unfair, and that it penalises those who have worked, saved or bought their own house. This situation may be exacerbated by the fact that the means test for long-term care is more like an affluence test, or a negative means test: it is perceived as taking from those who are relatively well off, rather than assisting those who are in particular need (Edwards *et al* 2001).

With regard to public pensions, our research found that 'everyone getting the same' was far more clearly identified as fair than 'those who need more getting more'. Other attitudinal research (Jowell *et al* 1999) supports this finding.

Clarity and simplicity

It is important to distinguish clarity and simplicity from an administrative and from an individual point of view. Any policy must be workable and administratively efficient. However, in the area of pensions policy it is clarity and simplicity from the individual's perspective that is particularly important. This is because individuals make their own retirement arrangements: Government cannot micro-manage the delivery of pensions in anything like the way it can deliver education or healthcare services. In the language of *Savings and Assets for All* (HM Treasury 2001b), welfare policies need to be simple to provide and also simple to use.

Some degree of complexity is inevitable in a pension system. This is partly because the problem of redistributing income over time and between individuals is inherently complex. Complexity can also be the result of complex need and circumstance, and can arise from a respectable desire to treat different cases differently. However, complexity has costs and these also need to be considered.

First, excessive complexity makes it difficult for people to plan effectively. This is likely to result in under-provision if people are reluctant to make significant financial commitments in an environment they do not understand. The Government should try where possible to make the difficult business of financial planning easier and less intimidating. This will help increase the number of people who successfully make their own provision.

Second, complexity and the attendant difficulty of individual planning increases the importance of good quality advice. However, complexity also makes it more difficult for advisors and financial service providers to give advice and encouragement to save, particularly to clients on low to middle incomes. This is because complexity both increases the cost of providing advice, and makes it more difficult to give unambiguous recommendations.[4] The pensions industry has fresh scars from the personal pensions mis-selling episode, and is now wary of accusations that people have been allowed to 'mis-buy' financial products such as stakeholder pensions.

Third, confusion about public provision erodes political support. On the one hand, if the Government wants to make political capital out of its pension policies then these policies need to be comprehensible. On the other hand, where pension rights are not valued then they are hostage to political fortune. The Conservative Governments of the 1980s were able to massively devalue SERPS in large part because these rights were not well understood. IPPR's research (Edwards *et al* 2001) shows that whilst younger people are confused about their rights to public pensions, few expect such rights to be of significant value in their own retirement.

Fourth, retirement planning is a long-term business, but because the current high degree of complexity cries out for rationalisation, there is little faith that the present arrangements are likely to prove durable. Similar considerations apply if policies are not considered robust to political change. Individuals, firms and financial service providers all need confidence about the environment for which they are planning.

In the area of long-term care clarity is important for two key reasons. Firstly, if individuals are expected to contribute to the costs of their own care then they must be able to plan for this in a comprehensible environment. Secondly, individuals with growing care needs may be particularly vulnerable and should not be faced with excessive and stressful complexity at this time. It is important that policy does not introduce artificial boundaries between different locations and types of care, or via complex assessment and financial support mechanisms.

Choice

In private product markets for both pensions and long-term care products we expect choice to drive competition, improving quality and price. In relation to retirement issues choice has another important dimension: it should promote independence and therefore the dignity of the individual. For example individuals requiring care should have a good level of control over their own arrangements.

As noted above, the desire to provide choice generates a degree of necessary complexity. However, excessive complexity makes it difficult to exercise informed choice. Well-informed choice may imply people having access not only to information but also to good quality advice.

Balancing the objectives

There are inevitably trade-offs between the different aims outlined above, and policy makers have to be clear that they cannot always simultaneously achieve all of them. For example, a high level of universal (non means-tested) state provision takes care of the adequacy and incentive problems, but at a high cost to public funds. Strictly means-testing entitlements reduces costs and can provide adequacy for those in receipt of benefits, but is very likely to cause incentive problems. We can infer from the 1998 green paper *Partnership in Pensions* that Labour's priorities in the pensions arena have been, in order: adequacy, affordability, and the maintenance of incentives, with clarity and simplicity in a poor last place.

The balance to be struck between the various objectives will be strongly influenced by political colour: for the left, adequacy must be the overriding goal. We agree with the Government that abolishing pensioner poverty should be the central aim of pension policy, and that ensuring all receive adequate provision for long-term care is the fundamental principle of policy in that area. For those on the right, the overriding goals are likely to be different, with the protection of incentives and affordability likely to be given more importance than a high minimum standard. Equity can be considered a mechanism by which these objectives are balanced rather than as a separable end in itself. An effective balance between the various elements will generate broad political support, in turn creating the long-term stability that is so important in this area.

We believe that a reduction of the complexity in the existing pensions system will be a vital part of any reform. In some areas of policy, clarity and simplicity are seen as less important, second order goals. This must no longer be the case for UK pensions policy. It is crucial that individuals are able to plan with confidence, firms are able to provide the appropriate occupational pensions for their employees, and financial services companies are able to develop and offer the right products with confidence.

IPPR's first priority is therefore the same as the Government's: adequacy. But we believe that transparency must be a first order goal of any reform, and disagree with the priority the Government has attached to cost control in relation to an already highly affordable pensions settlement. We are also mindful of the importance to maintain strong and clear incentives to save. Therefore our priorities for pensions policy are, in order: adequacy, clarity and simplicity, incentives and affordability. We do not regard changing the balance between public and private funding as a first order goal of UK pensions policy.

In its response to the Royal Commission on Long Term Care, the Government appeared to adopt the priorities of affordability, then adequacy and then equity. As noted above, the issues of clarity and simplicity are not so acute in this area, and incentive issues are more about equity than influencing individuals' behaviour during their working life.

As in the area of pensions, the balance to be struck between affordability, adequacy and equity will be influenced by political colour. However, whilst those on the right are usually comfortable with a very wide distribution of incomes, they are often less comfortable with a wide distribution of care outcomes. Whilst there will probably be differences at the margin, there is likely to be more agreement across the political spectrum for a good minimum standard of care in old age than for a good minimum standard of income in retirement.

Where political choices are likely to become more apparent is in the balance between affordability and equity. When defending its policies on long-term care, the

Government does not argue explicitly for a trade off between these two objectives. Instead they argue that it is more equitable to focus the available resources on those who cannot afford to contribute towards their own provision, and thus within the bounds of affordability their settlement represents the most equitable solution. Many areas of government policy have followed the path of targeting support on the disadvantaged, and IPPR strongly supports the drive to level up opportunities in this way. However, targeting does not necessarily imply means testing, and targeting itself may be more appropriate in some circumstances than in others.

There are clear in principle equity arguments against means testing for personal care, foremost among them its similarity to other health care. In addition, public resistance to the current policy of means testing for care is clearly based on the perception of inequity. However, these considerations do not simply trump all questions of cost. It is a political reality that governments have to make difficult trade-offs between spending alternatives. The future costs of long-term care are significantly uncertain, and policy may alter those costs in ways which are also hard to predict. Because of these issues, a proper analysis of the relationship between affordability and equity will have to wait for a fuller discussion of the existing settlement in Chapter 5 and an investigation of the likely future costs of long-term care in Chapter 7.

4. The pensions settlement and its problems

The UK pensions system has been built up around three key tiers or pillars:

- The first tier of state provision was designed to provide everyone with a basic income in retirement and in the UK prior to 1998 consisted of a non-means tested but contributory Basic State Pension and means tested income support, both financed on a pay-as-you go basis.
- The second tier consisted of the three *compulsory* options for people to build up their own second pension entitlements. These options were the State Earnings Related Pensions Scheme (SERPS), Occupational Pensions and Personal Pensions.
- The third *voluntary* tier enabled people to make additional savings into their occupational pensions through Additional Voluntary Contributions (AVCs) and Free Standing Additional Voluntary Contributions (FSAVCs).

Thus prior to 1998 the UK pensions system had seven key elements as laid out in Table 4.1. The 1998 Green Paper introduced a further two new elements: the State Second Pension to eventually supplant SERPS and stakeholder pensions to complement Personal Pensions (and perhaps eventually supplant FSAVCs). It also re-named income support for pensioners the Minimum Income Guarantee (MIG). By 2000 the Government had announced another element to be added to the pensions system: the Pension Credit, which will subsume the MIG and add a new savings credit element. Potentially therefore the pensions system would move from having seven elements prior to 1998 to having ten after the Government's reforms, at least during the very long transition to the new system.

Table 4.1 Elements of the UK pensions system

Pre-1998	*Post-1998*
First tier state provision	
Basic State Pension	Basic State Pension
Income Support	**Minimum Income Guarantee**
	Pension Credit (MIG plus savings credit)
Second tier compulsory options	
SERPS	SERPS
	State Second Pension
Occupational Pensions	Occupational Pensions
Personal Pensions	Personal Pensions
	Stakeholder Pensions
Third tier voluntary options	
Additional Voluntary Contributions (AVCs)	Additional Voluntary Contributions
Free-standing AVCs	Free-standing AVCs

One important point to clarify about this pensions system is that there is already a strong element of compulsion in it. Some commentators talk about the need to 'introduce' compulsion without making it explicit what they mean by this. Every employee earning above the lower earnings limit (of £72 per week in 2001-02) must make a contribution to a second pension: either by building entitlements to the pay-as-you-go SERPS, or building entitlements within – largely funded – occupational pension schemes or by paying into their own funded personal or, since April 2001, stakeholder pension. There is no opting out for employees from saving in at least one of these three second tier pension vehicles (unlike the self-employed).[5] When commentators talk then of 'introducing' or 'extending' compulsion it seems they usually mean employees being required to pay a certain proportion of their salary into a *funded* second pension rather than simply being allowed to build up entitlements to SERPS or the new State Second Pension. That is the sense in which this report will address the issue of compulsion for employees.

Employers are *not* required to pay into any of their employee's pension vehicles though in practice the UK's historically strong occupational pensions system has involved often quite significant employer contributions.[6] However, there is now accumulating evidence of the decline of traditional salary-related or 'defined benefit' occupational pensions, discussed below. The pension arrangements that might replace traditional occupational pensions almost always involve a smaller employer contribution and sometimes no contribution at all. This then raises a second issue of compulsion: should *employers* be required to contribute to the funded second pension vehicles of their employees, a requirement that has never formally been there in the UK pensions system? Of course, as already pointed out, the actual incidence of such contributions will fall on employees in the form of lower gross wages, but in presentational terms is there a case for compulsion on employers? In addition, notwithstanding the possible impact on voluntary savings, further consideration could be given to making membership of occupational schemes compulsory once again unless people consciously opt for other provision.

Out of a working population of some 28 million in the mid to late 1990s, around 22.4 million people were paying National Insurance Contributions and were therefore building up entitlements to the Basic State Pension and also to some compulsory second tier pension provision. Of these people, around half had occupational pensions, a third were contributing to SERPS, and a fifth had a personal pension (Pension Reform Group 2001).[7]

The pensions settlement before 1998

Pension policies cast a long shadow. Not only do they generate long-term claims and entitlements, they also generate long lasting patterns of expectation and behaviour. No UK government can start with a blank sheet of paper and design the perfect pension system from scratch, so before examining Labour's recent reforms it is necessary to understand the situation they faced on entering government. Many of their reforms can be seen as well motivated responses to the problems they inherited.

The Basic State Pension

The BSP has long been the foundation of state pension provision. It is a contributory benefit paid at a flat rate to men aged over 65 and women over 60, as long as they have paid enough years of National Insurance Contributions.

Box 4.1 The Basic State Pension

The full weekly rate of the Basic State Pension for 2001-02 is £72.50 for a single person and £115.90 for a couple, equivalent to around 15 per cent of full time male average earnings for a single pensioner and 25 per cent for a couple.[8]

To qualify for the full rate, men need to have made NICs for 44 years, women for 39 years. Fewer years of contributions mean that the individual receives less than the full rate, although there are arrangements for those who are not contributing because they are providing care for others, or because they are unemployed, sick or disabled. Where both partners have a full contribution record they both receive the full single persons rate. The married couple's rate applies where only one partner has the necessary record, and is 1.6 times the single rate. From 2010 the women's retirement age and contribution requirement will gradually rise until they are the same as those for men in 2020.

Rights to the BSP accrue to individuals once they earn more than the Lower Earnings Limit, which is £72 per week in 2001-02. NICs are then payable on earnings between the Primary Threshold, set at £87 per week, up to the Upper Earnings Limit of £575 per week (all in 2001-02). Employees pay 10 per cent on this band, employers pay 11.9 per cent on all earnings above the Primary Threshold. These are the rates where the employee and employer are contracted in to SERPs, whilst lower rates apply for those who have contracted out. The self employed make a small flat rate contribution.

The BSP was introduced in 1948, and grew from slightly less than 15 per cent of average earnings then to nearly 20 per cent by the beginning of the 1980s. However, since 1981 until last year increases have been in line only with inflation. This has led to a decline in its relative value from 19.6 per cent of average male earnings in 1982 back to 15 per cent in 2001. Assuming the BSP continues to grow only in line with prices and that long-term average real earnings growth is 1.5 per cent per annum, it will be worth just seven per cent of average earnings by 2050.

Income Support, Housing Benefit and Council Tax Benefit

Income Support is a means tested benefit for those with low incomes, and was paid to pensioners before April 1999 when it was replaced by the Minimum Income Guarantee. Income support in the UK is not designed to cover housing costs: there is a separate Housing Benefit, which operates in a similar manner to income support and is paid to those on low incomes who rent their home. It is paid whether or not the claimant is in full time work or not, and can be paid alongside other benefits or on its own. Council Tax Benefit is similarly paid to those on sufficiently low incomes who have a council tax liability.

Box 4.2 Income Support, Housing Benefit and Council Tax Benefit

Income support is not paid to single people working 16 hours or more per week, or to couples if the claimant works 16 hours or more per week or their partner works 24 hours or more per week. It is not paid to those with capital holdings in excess of a threshold level. Since April 1999, Income Support for pensioners has been replaced by the Minimum Income Guarantee, which is very similar in structure and is discussed below.

Housing Benefit (HB) and Council Tax Benefit (CTB) are calculated in relation to a defined 'eligible' rent and council tax, which is usually the actual rent and council tax paid by the individual. The eligible rent may be lower if the rent paid is unusually high in relation to other properties in the local area, or if there are non-dependants living in the same property, who are assumed to be making a contribution towards the rent and council tax. The maximum level of HB and CTB is the full eligible rent and council tax. Under the old system of Income Support for pensioners, entitlement to HB and CTB was progressively withdrawn as income rose above the Income Support level. The situation under the Minimum Income Guarantee is described in detail below.

State Earnings-Related Pension Scheme

SERPS began operation in 1978 as an earnings related pension primarily for those without access to an occupational scheme. It was intended to top up the BSP with amounts depending on the individual's earning history. As indicated below, SERPS will close to new contributions from 2002 and will be replaced by the new State Second Pension. However, millions of individuals will retain the rights they have already accrued for many decades to come.

Box 4.3 SERPS

The rules governing SERPS are complex and have changed significantly over the last 20 years, usually to reduce the value of the scheme to its members. Broadly, for each year of membership of the scheme, earnings between the Lower and Upper Earnings Limits are taken into consideration. These are revalued in line with earnings, and the original scheme was specified to add together the individual's best 20 years of revalued earnings and divide by 80 to give a pension of 25 per cent of earnings between those limits.

Over the course of its relatively short history SERPS has been made progressively less generous. Firstly, the calculation of entitlements was changed in 1986 from 25 per cent of the individual's best 20 years of earnings to 20 per cent of the individuals average earnings calculated over their entire working lifetime. The change from 25 to 20 per cent was delayed to 2000 and the change from the best 20 years to working lifetime average will be phased in between 2000 and 2028. The same Act of Parliament halved the rights of widows to inherit their partner's SERPS pension. This change has now been delayed until October 2002 subject to age related transitional provisions. In the longer term the relative value of SERPS payments will also fall because of the way in which the earnings limits are indexed: they move in line with prices. Thus as incomes rise faster than prices a successively larger proportion of earnings will fall above the Upper Earnings Limit.

Table 4.2 shows earnings in the first year of retirement for individuals who have remained contracted in to SERPS whilst earning the average wage for their gender in each year of their adult life. A man retiring now in this situation will receive a total pension of 36 per cent of average earnings. By 2050 this will have fallen to just 20 per cent, which was the level of the BSP alone at the beginning of the 1980s.

Table 4.2 Basic State Pension and SERPS awards as a percentage of average earnings, for men and women with a lifetime of average earnings

	Men			*Women*		
	BSP	*SERPS*	*Total*	*BSP*	*SERPS*	*Total*
2000	15	21	36	21	18	39
2010	13	18	31	19	16	35
2020	11	17	28	16	16	32
2030	10	16	26	14	16	30
2040	9	15	24	12	16	28
2050	7	13	20	10	16	26

Source: Government Actuary's Department, from Pension Provision Group 1998 Notes: Assumes price indexation of earnings limits, individuals have average earnings in every year of their working lives, earnings grow faster than prices by 1.5 per cent per annum.

The other key aspect of SERPS is the facility for individuals to opt out (known as contracting out) into a private sector alternative. This was originally intended to apply to defined benefit occupational schemes, but changes in 1988 meant that defined contribution occupational schemes and personal pensions also became eligible. Contracting out into an occupational pension involves a reduction in NICs payable, whilst opting out into a personal pension means that the same NICs are payable but the Government pays a rebate to the individual's scheme. By the early 1990s around three quarters of those eligible for SERPS had contracted out (Dilnot *et al* 1994), including 80 per cent of all those with an occupational scheme (Government Actuary's Department 2001). The Governments of the day provided clear incentives for individuals to follow this course in the form of actuarially favourable rebates.

Occupational Pensions

An occupational pension scheme is an arrangement made by an employer to provide retirement and death benefits for employees and their families. Employers do not have to offer occupational schemes, nor (since 1988) do employees have to be members of their employer's scheme. Rules and benefits can vary significantly, with contributions coming from employers and often employees as well, although we would expect employer contributions to be reflected in gross wages. Two important categories of arrangement are defined benefit and defined contribution schemes.

Box 4.4 Defined Benefit and Defined Contribution schemes

Defined Benefit (DB) schemes have benefits which are specified independently of both the contributions payable and the investments of the scheme. A typical scheme might pay a proportion of final salary on the basis of duration of employment, for example one sixtieth of final salary for each year of service. Following the Pensions Act 1995 all DB schemes are required to offer limited price indexation up to a maximum of five per cent per annum on rights accrued after April 1997, and most public pension schemes index benefits to RPI. Just under half of private sector DB schemes operate a 'clawback' mechanism which makes an adjustment to payments to take account of the value of the BSP (Government Actuary's Department, 2001a).

Defined Contribution (DC) schemes have predetermined contributions, with benefit levels dependent upon total contributions achieved, investment returns within the fund, and annuity rates at the time the individual's fund is converted into a pension. Each individual has an account, usually funded, which builds up in value until retirement when it is used to buy an annuity.

To the individual, the advantages of DB schemes are commonly understood as increased predictability of benefits and insurance from investment risk, which lies in the first instance with the employer offering the benefits. However, DB schemes often suffer from a lack of portability between jobs, as such schemes are frequently designed to improve workforce retention in the first place. In addition, workers face the risks of premature employment termination which can significantly reduce the value of benefits based on final salary values. DC schemes are generally more portable, but usually expose the individual to significant investment and annuity rate risk. Some companies operate hybrid schemes with both DB and DC elements.

Approximately 46 per cent of all employees, including part timers, were in occupational schemes in 1995. This figure comprised 52 per cent of male employees and 39 per cent of women (Government Actuary's Department 2001a). Historically, coverage for men remained above 60 per cent from the early 1960s to the early 1980s before declining to the 1995 level. Coverage amongst female employees has risen slowly from around 20 per cent in 1963 to its present level. Of the 6.1 million members of private sector occupational schemes, three quarters were in DB schemes, 18 per cent were in DC schemes and the balance were in hybrid arrangements in 1995. Virtually all public sector schemes have defined benefits.

Many reports have identified a drift away from defined benefit final salary schemes to defined contribution money purchase schemes in the UK, with a number of employers closing their final salary schemes to new employees (for example, NAPF).

This trend has already gone much further in the US, with a decline in defined benefit plans that has been described as 'quite dramatic' (Disney and Johnson 2001). It is important to be clear why this trend has occurred and what its consequences are.

Some people erroneously correlate the decline of final salary schemes with changes in the labour market that have ended 'jobs for life', but we have emphasised that the evidence does not support the assertion of such significant changes. A range of other factors have persuaded some employers to close final salary schemes:

- it is often overlooked that the very factors such as an ageing workforce that pose questions about the affordability of public pension provision also threaten the continued viability of occupational pensions;
- changed expectations about the future returns on equity investment have brought home to employers their actuaries' long-standing concerns about the viability of their future pension commitments (and have resulted in some firms switching to investing in bonds);
- changes to accounting standards have made these future pension liabilities more transparent;
- Defined Benefit schemes can impose uncertain and fluctuating contribution requirements on employers, in contrast to Defined Contribution schemes;
- finally, the Government's changes to the treatment of pensions in the Advanced Corporation Tax regime in 1997 will have helped bring the issue to a head in some companies.

Many people are worried that the switch from final salary to money purchase schemes has led to a reduction in the contribution of employers to their employees' pensions. It is important to disentangle cause and effect here. The range of factors described above has caused firms to lower the contributions that they are willing to make to any individual employee's 'pot'. The switch to a defined contribution scheme may be the *means* by which this lowering of contributions has been achieved, but it is not the underlying cause. Regardless of the pensions vehicles utilised by employers, they will not be able to be as generous in the future to their employees as they were during the golden age of the final salary scheme. The trends seen in the US may well predict the future in the UK.

Additional Voluntary Contributions (AVCs) and Free Standing AVCs

AVCs are additional contributions which a member of an occupational scheme may choose to make in addition to their required contribution. The total of tax approved ordinary contributions plus AVCs is 15 per cent of the individual's earnings over the tax year subject to an earnings cap. Whilst AVCs cannot be used directly to buy a larger tax free lump sum, they may increase the lump sum that can be produced by the individual's main scheme. An FSAVC is a contribution which an individual can make to a pension plan other than their occupational scheme. FSAVC do qualify for tax relief subject to a limit on total tax approved ordinary contributions, AVCs and FSAVCs of 15 per cent of the individual's earnings over the tax year subject to an earnings cap.

Personal Pensions

Personal pensions began in 1988 and largely replaced retirement annuities, which were a form of private pension product sold before that date. Personal pensions allow individuals to privately save for their retirement in a tax-favoured way outside occupational and state administered pension schemes.

Box 4.5 Appropriate Personal Pensions and Group Personal Pension schemes

Two key types of personal pensions are Appropriate Personal Pensions and Group Personal Pension schemes. Group personal pensions are simply personal pensions arranged by an employer through a pension provider for their employees. In contrast to an occupational pension the employer does not administer the scheme. Approved Personal Pensions are personal pensions which individuals may use to contract out of SERPS. Personal pensions offer flexibility to the individual to specify how they wish their funds to be invested and they are highly portable between jobs. Employers may contribute to an individual's personal pension but they are under no obligation to do so.

In 1988, the same year that personal pensions were introduced, membership of an occupational pension scheme became voluntary: employers were no longer allowed to contractually require membership of their workers. Employees were required by law to make some secondary pension provision, but they were able to choose between staying in SERPS or contracting out into either their occupational scheme or a personal pension. However, those who opted out of an occupational scheme into a personal pension nearly always lost their employer's contribution. Hundreds of thousands of people were advised to take this step, and the episode became known as the pensions mis-selling scandal. The pensions industry is still in the process of compensating those affected, with total pay outs expected to reach £12 billion and with lasting damage to public confidence in the financial services industry.

Labour's reforms: a new contract for retirement?

The Labour Government came to power in 1997 promising to continue the trend of mixed public and private pension provision. The manifesto had recognised the key problems of growing pensioner poverty and inequality, and promised to examine means of improving income support for the poorest pensioners. However, the key demand of the trades unions and pensioner representative groups to restore the earnings link for the Basic State Pension was rejected. The manifesto instead promised that it would be uprated 'at least in line with prices'. For those on low to modest incomes with changing patterns of employment a better value, more flexible personal pension – the stakeholder pension – was promised. Soon after the election the Pension Provision Group was formed as part of the Government's pensions review, and the area was clearly marked as a priority for legislation.

The Pension Provision Group was not asked to look at new policy options, but to analyse the likely effects of a continuation of the existing regime. They reported in mid-1998 and among their key conclusions were: that those on low life time incomes would not be able to provide for themselves, so the state would have to continue to provide for them; that the BSP would not provide an adequate retirement income in itself if it remained linked to prices, and thus that means tested benefits would need to fill the gap; and that, absent an appropriate policy response, a rise in pensioner poverty and inequality was very likely.

Later in the same year, the 1998 Pensions Green Paper laid out the Government's priorities clearly: an adequate retirement income for everybody, the protection of incentives to work and save, and a falling proportion of national income to be spent on public pension provision. As we have stated earlier, we agree that the first two of these are the right priorities, and that in addition any system has to be affordable. As we also stated earlier, it is also necessary to make trade-offs between these goals: they are in natural tension.

The Government adopted a strategy of targeting expenditure on the poorest pensioners with heavy weighting given to increases in means tested benefits.

- They attempted to tackle existing pensioner poverty with the means tested Minimum Income Guarantee (MIG), which was more generous than the previous income support arrangements.
- For the current workforce, the introduction of the State Second Pension involved a recognition that the lowest paid could not be expected to save for their own retirement.
- Stakeholder pensions were designed to be a flexible cheap funded pension for people on moderate incomes.
- The stakeholder pension and the State Second Pension were together meant to reduce the proportion of people facing a means tested retirement in the future.
- The policy package collectively was meant to reduce public spending on pensions as a proportion of GDP, eventually leading to a shift from 60 per cent of pensions being publicly funded and 40 per cent private, to 60 per cent private and 40 per cent public.

Although the Government has maintained that the policy settlement they have carefully devised is politically sustainable, increasing doubts have been raised. From a situation where the financial services industry, some academics and the media were broadly supportive, there was from 2000 a notable increase in the critical tone of debate (Actuarial Profession 2001b; Rake and Falkingham 2001; Pension Provision Group 2001). The obvious *political* high point of criticism came in the autumn of 2000 in the wake of the 75p rise in the Basic State Pension (BSP).

The Minimum Income Guarantee

In April 1999 MIG replaced Income Support for people who are over 60. Like Income Support, MIG is a means tested entitlement. People qualify on the basis of having low income and small savings, but the value of their home is not taken into account. In the 1998 Green Paper the Government stated its long-term ambition, but made no commitment, to raise the MIG in line with earnings (DSS 1998).

Box 4.6 The Minimum Income Guarantee

The full weekly MIG rate in 2001 is £92.15 for a single person and £140.55 for a couple, equivalent to just under 20 per cent of average male full time earnings or just under 30 per cent for a couple. The income and savings of a couple are added together for the means test. Most income is fully set off against any entitlement, so a single person with a full BSP of £72.50 and no other income or savings would be entitled to £19.65 from the MIG, bringing their total income up to £92.15 per week. Savings of up to £6,000 are not taken into account in the means test. People with savings of between £6,000 and £12,000 receive less help the more savings they have, and individuals or couples with over £12,000 of savings do not qualify for any MIG payment.

The MIG is currently at the level which the BSP would have attained if the earnings link had not been broken in 1981. The MIG will be raised to £100 a week for a single person by April 2003 (HMT 2000), and the Chancellor stated that the MIG would rise in line with earnings for the duration of the current Parliament (PBR 2001). The MIG would thus be just above the quasi-official poverty line[9] from 2003, so effectively abolishing pensioner poverty if there were 100 per cent take-up.

Table 4.3 details the Department of Social Security's own estimates of take up for Income Support (Minimum Income Guarantee), Housing Benefit and Council Tax Benefit among pensioner households (Department of Social Security 2001).[10]

As the table indicates, between optimistically one in five and pessimistically one in three pensioner households did not claim the Minimum Income Guarantee payments they were entitled to in 1999/00.[11] Whilst some of these people would have been missing out on very small amounts, the median and average weekly amounts unclaimed are significant: £12.80 and £20.00 respectively. What makes these take-up

Table 4.3 Income-related benefits take-up among pensioner households

	Pensioner households entitled but not receiving benefit	*Median weekly amounts unclaimed*	*Mean weekly amounts unclaimed*
Income support			
1998/99	19-32%	£10.60	£19.00
1999/00 (MIG)	22-36%	£12.80	£20.00
Housing Benefit			
1998/99	4-11%	£22.30	£22.60
1999/00	7-15%	£23.80	£24.40
Council Tax Benefit			
1998/99	26-32%	£5.90	£6.30
1999/00	30-36%	£6.60	£6.80

Source: Department of Social Security, Income Related Benefits Estimates of Take-up in 1999/00

figures so important is that all those entitled but not receiving this benefit are, by definition, living in poverty.

It is notable that pensioner take up of Housing Benefit is much better than take up of the Minimum Income Guarantee. This may be because many pensioners claiming HB were already claiming before they became pensioners: non pensioners and pensioners have similar take up rates for HB, whilst take up of MIG is much worse than take up of Income Support for younger households.

The credibility of the Government's means testing approach depends crucially on take-up. The Government should publish as quickly as possible the results of its attempts to increase take-up of the MIG, and if it is to continue with the focus on targeting benefits, it must develop innovative and robust proposals to increase take-up further.

Attitudes to means testing

IPPR has conducted its own research into people's attitudes towards means testing with a series of focus groups and interviews with a spectrum of age and income groups. The results reveal a complex and sometimes contradictory picture (Edwards, 2001). Firstly, few people instinctively see means testing as a way of targeting help on those who are most in need. Instead, the first reaction of many is to see means testing as a way of penalising those who have been hard working and prudent. There is a great deal of resentment towards a perceived group of the 'undeserving poor' who are felt to receive help they do not deserve. The concept of the undeserving poor is also mirrored by a perception of the 'deserving rich': those people who have worked hard and deserve their relative wealth.

However, when talking about these undeserving poor our interviewees were rarely referring to people they knew. People who 'abuse the system' and get 'handouts they don't deserve' are most often an unknown quantity and more likely to be shaped by stories in the media than by individual experience. When means-testing is related to known individuals such as friends, family, and neighbours, people are often far more willing to make the arguments in favour and to recognise a genuine need. Our research revealed a real concern for pensioners struggling to get by on very limited resources.

In some cases the same people who object to the 'undeserving poor' receiving special help, simultaneously object to what they perceive as the stigma attached to means testing, the difficulty of claiming entitlements, and the intrusion of privacy implied by the process. Another area of particularly stark contradiction was the conflict between people's desire for the flat rate benefits and rewards according to contribution. Some responses suggested that this contradiction could be resolved by a decent flat rate pension for all with additional provision being on a contribution related basis. Others expressed the view that people should 'get out what they put in', and few recognised that the state should have an essentially redistributive role.

People often feel particularly negative towards means-testing when it relates to older people rather than those of working age. At the broadest level there is an argument that older people are more vulnerable, the implication being that older generations are a homogenous group who are collectively in need of support. Other, perhaps more fundamental, arguments are made around the notion that the wealth and assets accrued in retirement have been built up over the course of a life. There is a perception that retirement wealth is the result of years of hard work, saving and good money management. Many therefore resent these assets being 'held against' people as it suggests penalising them for the effort they have put in over the years. In general our interviewees found it much more natural to consider as 'fair' treating retired people alike than recognising inequalities and responding to them by treating people differently.

Incentive problems

Concerns quickly arose that the Minimum Income Guarantee might undermine incentives as people who worked and accumulated pension entitlements found themselves with an income in retirement little higher than the MIG. The MIG effectively operates a 100 per cent rate of benefit withdrawal as original income rises up to its level, and this has been felt most acutely by those with small second pensions. For example, a single pensioner with a full BSP plus a weekly pension of £15 would be no better off than a pensioner with only the BSP and no additional income, assuming both claimed their full MIG allowance. The saved income of £15 would be fully set off against MIG entitlement. This problem was given real bite by the large number of pensioners in this situation: £15 was in fact the average SERPS payment to men aged 65 to 69 in 1998,[12] and the figure was just £8 for women in the same age group. Around a third of all pensioner benefit units received less than £5 a week from private sources in 1995-96 (Emmerson and Johnson 2001).

In addition to the incentive problems, the very high withdrawal rate operated by the MIG generated public resentment over the perceived unfairness of the system. It was clear that both the incentive and fairness problems would become progressively more acute if the BSP were to grow in line with prices and the MIG with earnings. The response to this problem was the Pension Credit announced in the autumn of 2000.

Pension Credit

The Pension Credit has been proposed for introduction in 2003, and will subsume the Minimum Income Guarantee. Those on low or modest incomes will have their income raised to a guaranteed minimum, and will then receive a further 'savings credit' on any other income they have in excess of the level of the Basic State Pension up to a ceiling. The savings credit then reduces in value as the individual's original income increases to a second ceiling, above which no credit is payable. The guaranteed minimum can be considered the replacement for the MIG. The savings credit is the element which is intended to deal with the incentive problem of the MIG and reward those with small retirement incomes additional to the BSP. The guarantee element operates for men

Box 4.7 The Pension Credit

At the time of introduction in 2003 the guaranteed minimum income is expected to be £100 per week for a single pensioner and the Basic State Pension £77 per week. Income excluding any Pension Credit, called original income, between £77 and £100 will attract a credit of 60 pence per £1. Thus an individual with a full BSP plus £10 of second pension would have an original income of £87 and would receive £100-£87 = £13 in guaranteed income top up plus £10 x 0.60 = £6 as savings credit. The maximum savings credit payable would thus be £23 x 0.60 = £13.80 for someone with an original income of £100. The savings credit is then tapered off at the rate of 40 pence per £1 of additional original income, so an individual with original income of £101 receives £13.40 of savings credit, an individual with original income of £102 receives £13.00 of savings credit, and someone with £135 of original income receives no Pension Credit. Analagous arrangements will operate for couples.

The Pension Credit will also treat savings more generously than the MIG. As with the MIG, savings of up to £6,000 are not taken into account in the means test for the Pension Credit. However, the upper savings limit of £12,000, above which people are not entitled to the MIG, will not apply for the Pension Credit. Instead, savings above £6,000 will attract notional interest at 10 per cent which will be taken into account as if it were income. This notional interest rate is half that assumed under the MIG.

An additional improvement to the MIG is that entitlements to Pension Credit payments will be reassessed relatively infrequently: initially at retirement, then at 65, then only once every five years.

and women over the age of 60, and the savings credit for all pensioners over the age of 65. The future uprating of both the guarantee element and the lower savings credit threshold are crucial aspects of the future development of the Pension Credit. Whilst the Government has announced that the guarantee element is set to rise in line with earnings at least until the end of this Parliament, there is no commitment beyond that date (Department for Work and Pensions 2001b).

The most obvious way of considering the Pension Credit is as a straightforward means tested benefit with a long taper. The maximum benefit for an individual with a full state pension is £23 if they have no additional income. For each £1 that their income rises above this level, the £23 is reduced by 40 pence, a taper which runs up to those earning (£77 + £23/0.4) = £134.5. The problem with the MIG was that it had a 100 per cent withdrawal rate up to a ceiling of £100 (in 2003 terms). The problem with the Pension Credit is that it has a withdrawal rate of 40 per cent up to a much higher ceiling of £135, therefore affecting a much greater number of people.

Incentive problems again

The Pension Credit will generate other incentive problems. The first is that those with entitlements to less than the full level of the BSP will face a 100 per cent withdrawal rate on any additional earnings up to the full BSP level. As noted above, over ten per cent of men were in this position in 1997 (Pension Provision Group 1998). Individuals in this position will have no incentive to save if the expected weekly income from their saving will not take them over the level of the BSP.

The second incentive problem arises because of the gap between entitlement to the guarantee element of the Pension Credit at the age of 60, and entitlement to the savings credit at the age of 65. Women pensioners between the ages of 60 and 65 will thus remain in the same position as under the MIG with respect to benefit withdrawal as a result of small second pension incomes. Poorer female pensioners may see no benefit from saving for small second pensions until they reach the age of 65.

The third incentive problem is that those with original incomes between £77 and £100 face new and conflicting incentives. Their withdrawal rate has fallen from 100 per cent to 40 per cent, improving their incentives to save. On the other hand the effect of this is to increase their total income, which may reduce their need to save. The net effect of these changes is not easily predictable. However, the 100 per cent withdrawal rate in this income band was clearly politically unacceptable, and its removal helps to address the popular concern that the MIG was actually unfair.

The fourth incentive problem is that original income in the range of £100 to £135 now faces an increased withdrawal rate. Under the MIG these individuals suffered 100 per cent withdrawal on income below £100 and zero withdrawal above that level. They would now face 40 per cent withdrawal rates between £77 and £135, reducing their incentive to save into the £100 to £135 bracket. In addition, the Pension Credit will increase their total incomes, reducing the need to save. The Pension Provision Group noted in their response to the consultation paper that 'it seems likely that saving which would result in income in this range [£100 to £135] would fall' (Pension Provision Group 2001a).

The fifth incentive problem concerns the interaction of the Pension Credit with Housing Benefit and Council Tax Benefit. All those receiving MIG are currently entitled to the maximum HB and CTB. Income above MIG level reduces entitlement to HB by 65 pence per £1, and entitlement to CTB by 20 pence per £1: a maximum 85 per cent withdrawal rate. Under the Pension Credit income up to the level of the guaranteed minimum plus the maximum savings credit (£113.80) is likely to be disregarded when calculating entitlement to HB and CTB.[13] This would mean that each £1 of additional income above £113.80 would incur 40 pence per £1 withdrawal of Pension Credit plus £0.60 x (0.65+0.20) = 51 pence per £1 withdrawal of HB and CTB. It is hard to identify any treatment of the three benefits which does not impose very high withdrawal rates at some point in the income distribution. On the other hand it should be remembered that under the existing system people claiming HB and CTB already face 85 per cent benefit withdrawal rates on some of their income above the MIG level.

Finally, incentives need to be understood to be effective. The foregoing discussion should make it clear that the Pension Credit is a highly opaque means of generating the right incentives: it is extremely difficult for individuals to know what to expect from it, especially over the long time periods relevant to retirement planning. This problem does not just affect the individual planning for their own retirement: professional advisers are in a similar position in respect of their clients.

It would be very hard to argue that the Pension Credit has been designed to generate incentives for current workers to save. Rather, it has been designed to ameliorate the penalties imposed by the MIG on current pensioners with small second pensions. The only way in which the Pension Credit represents an incentive to save is the degree to which it reduces the penalties for future savers relative to the previous regime. The story of the Pension Credit highlights one of the fundamental problems of pensions policy: the requirement to meet the needs of both current and future pensioners.

Costs

The proposals before Parliament at the beginning of 2002 indicated short term costs of £2 billion for 2004/05, including £460 million for consequent increases in Housing Benefit and Council Tax Benefit payments. It has been independently estimated that the Pension Credit will increase public spending on pensions alone by about 1.2 per cent of GDP by 2050 (Hawksworth 2002).[14] The Department for Work and Pensions produced its own long-term estimates for the cost of the Pension Credit in late January 2002 and these indicate similar incremental expenditure of 1.3 per cent of GDP by 2050[15] (Department for Work and Pensions 2002).[16] On the basis of the independent modelling, total government spending on pensions and related income support is thus set to rise from just under five per cent of GDP to six per cent by 2050, in contrast to all previous projections which had public spending falling as a proportion of GDP. One of the key aims of the 1998 Green Paper would appear to no longer apply.

It has been estimated that the Pension Credit will increase the proportion of people being means tested to approximately 65 per cent of single pensioners and 51 per cent of couples by 2025 (ABI 2001). The Department for Work and Pensions also estimates that coverage will be 65 per cent of pensioner benefit units by 2040 if the guarantee element is uprated in line with average earnings whilst the savings credit threshold rises in line with prices (Department for Work and Pensions 2002). The significant increase in means testing to cover the *majority* of the retired population appears to undermine one of the other main aims of the 1998 Green Paper. It is possible that developments in other areas of public policy, particularly in-work family benefits and tax credits will mean that future cohorts may increasingly be used to receiving means tested benefits. However, it remains a challenge to ensure maximum take up and minimum effects on work and saving incentives. However, there are significant differences in which in work benefits are perceived compared to benefits in retirement. New benefits such as the Working Families' Tax Credit are received thorough the pay packet and are effectively seen as a supplement rather as an entitlement. IPPR's qualitative work brings out that the public do see means testing in retirement as different from means testing in-work benefits: whilst those receiving benefits in work may be getting something 'extra', those who 'fail the means test' in retirement are often seen as being punished for their accumulated work and saving (Edwards *et al* 2001).

The Pension Credit raises other questions. Its introduction into an already complex system of provision will add to the lack of transparency, making it harder still for individuals to understand that system. In the long-term, it is not clear that the Pension Credit and the State Second Pension will work together. The ostensible aim of the State Second Pension added to the Basic State Pension is to provide a non-means tested retirement income for those on low lifetime incomes that is clear of the means-tested MIG level. There were already concerns before the introduction of the Pension Credit that the State Second Pension would not achieve this aim without being made significantly more generous (Rake, Falkingham and Evans 1999). With the introduction of the Pension Credit, the State Second Pension and all other forms of second pension provision will have to work much harder to give people a non-means tested retirement (Pension Provision Group 2001).

Not withstanding what has just been said, it is still important to recognise that the Pension Credit represents an improvement on the Minimum Income Guarantee. It undeniably represents significant new public funding for lower income pensioners, and it softens some of the benefit withdrawal problems of the system it replaces. However, it is clear that it is far from a perfect solution, and that we must ask the question whether the very significant resources it will require could be better deployed.

State Second Pension

The State Second Pension is intended to be the replacement for SERPS. But whereas SERPS was strictly earnings related and intended to provide for moderate earners without occupational pensions, the State Second Pension will be redistributive and focused on those with low incomes, including carers. The target group is those with incomes between the Lower Earnings Limit and around £10,500 per annum in 2001-02 terms, which is the lower bound of the target group for stakeholders. State Second Pension will also be targeted on those with severe disabilities and their carers, and those caring for children less than five years old.

SERPS is set to accrue at the rate of 20 per cent on earnings between the Lower Earnings Limit and Upper Earnings Limit. Thus a full SERPS pension will be 20 per cent of the individual's average income between the earnings limits.[17] When it is introduced (currently set for 2002), the State Second Pension will accrue at different rates on different portions of earnings.

Table 4.4 Rates of accrual as a percentage of relevant earnings for the State Second Pension and SERPS

Earnings per annum	*State Second Pension*	*SERPS*
Lower Earnings Limit (£3,744) to £10,500	40%	20%
£10,500 to £24,000	10%	20%
£24,000 to Upper Earnings Limit (£29,900)	20%	20%

Source: DSS

The immediate impact of this structure is to make the State Second Pension twice as generous in accruals for earnings in the lower band, and it is designed so that there are no individual losers under the reform. However, the full benefits will not be felt by the target group for many years until the scheme begins to mature. It is intended that soon after the State Second Pension is established the scheme will become flat rate, treating all earnings (and qualifying non-earners) as if they were at the level of £10,500 income per annum, with this threshold increased in line with earnings. This will further increase the redistributive nature of the State Second Pension and is intended to provide an incentive for those reliably earning more than £10,500 to opt out. It is not entirely clear why the Government has decided to introduce the State Second Pension in two stages rather than one, as this decision further adds to the scheme's already considerable complexity.

Stakeholder Pensions

Stakeholder pensions are tightly regulated defined contribution personal pensions, and were introduced in April 2001. They are intended to address a gap in existing provision for those on low to moderate incomes of £10,500 to around £20,000 per annum without occupational pensions. For people in this income range personal pensions have historically offered relatively poor value, with high charges relative to modest contributions.

Box 4.8 Stakeholder Pensions

To qualify for stakeholder status a pension must meet standards in relation to cost, access and terms, known collectively as CAT standards. The stakeholder CAT standards specify that the provider may levy a maximum charge of 1 per cent per annum of fund value, must accept contributions as small as £20, and must enable contributors to transfer to another scheme without additional charges. Stakeholders benefit from a very similar tax regime to other personal pensions, with tax free contributions, fund accumulation and lump sum withdrawal. Contribution limits start from £3,600 per annum in 2001 and increase with age.

Employers also have to meet certain requirements in relation to stakeholders. Firms with five or more employees[18], who do not offer an occupational pension scheme or pay contributions of three per cent or more into their employees' personal pension, have to make a stakeholder pension available and arrange to pay employees' contributions directly into their funds. Whilst employers are required to offer access to a stakeholder, they are not required to make any contribution to their employees' scheme, nor are employees required to take out a stakeholder pension. It is possible for individuals to contract out of SERPS (and eventually State Second Pension) into a stakeholder.

In many respects stakeholder pensions represent a real improvement on past provision. Increased flexibility and lower charges make them much more attractive to lower earners than earlier personal pensions. The one per cent cap on charges has driven down costs for existing holders of personal pensions and has had a significant impact on private pension provision more broadly (Ritchie 2001). However, stakeholders will also clearly benefit the wealthy, with the financial pages now full of advice on how rich grandparents can open them for their grandchildren.

The largest question mark is over the ability of the stakeholder pension to reach the intended target group: roughly those on between half average and average earnings. As of early 2002 it was still too early to tell whether stakeholders have been a success or a failure in this respect. However, whether stakeholders reach their intended target group needs to be closely monitored and the effectiveness of current incentives assessed. However, there is as yet no indication that the Government will collect the data necessary for this task.

There is disquiet among financial advisors and pension provider companies that many in the target group would be badly advised to opt out of the State Second Pension into a stakeholder (Ritchie 2001). Many providers may not now receive contracted out rebates at the basis for opening stakeholders; though they, as well as the Government, had been banking on this. Whilst firms may be nervous about recommending stakeholders themselves, there are also potentially problems for the Government if it is seen to have encouraged 'mis-buying' of stakeholder pensions.

Given the complexity of making the decision about opting out of state provision, another issue is the availability of advice. While the group being targeted might well need advice, little advice is likely to be available at the point of sale as a result of the one percent cap on charges. It is highly questionable whether decision trees will be a viable substitute.

There are various issues about which individuals may need advice. Tom Ross suggested the following framework at an IPPR seminar in December 2001, and many aspects are also present in *Savings and Assets for All* (HM Treasury 2001b).

- First: should the individual be saving for their own retirement or not? At present this is a real question for those on low incomes who may face very high benefit withdrawal rates as a result of making their own provision.
- Second: how much should the individual save? The answer to this question will depend on the individual's circumstances and expectations, but also involves realistic estimates of returns on savings.
- Third: what vehicle should be used for saving? In particular, is a pension of any kind appropriate, or would the individual be better off with more liquid assets such as an Individual Savings Account?
- Fourth: should a person contract in or out of State Second Pension? Contracting out used to be a fairly straightforward choice. However, with the increased generosity of State Second Pension, this is likely to become a particularly difficult issue for low to middle earners.
- Fifth: who should give advice? In particular, what is the right role for the state and what is the right role for employers?
- Sixth: who should pay for the advice? Lower to middle income groups may not be prepared to pay for their own advice, but under the current arrangements these are the people with the most difficult decisions to make.

Stakeholders and pensions policy more generally also need to be thought of in the context of broader savings policy. Are current incentives to save into different vehicles coherent? It has been suggested, for example, that low-income groups will find it more attractive to keep savings liquid in an ISA rather than to lock them away in a pension (FSA 2000). The Savings Gateway (HM Treasury 2001b) also needs to be considered. It will provide accounts targeted specifically at lower-income households with strong incentives to save in the form of matched contributions from the Government. After a given time period people would be able to reinvest the accumulated funds, with one option being a stakeholder pension.

The proposed Savings Gateway was announced together with the Child Trust Fund as part of a strategy to extend the benefits of saving and asset-ownership to everyone. In particular, it aims to support more people on low incomes to save. This new emphasis has been coined *asset-based welfare*: an emerging area of study exploring the welfare benefits of saving and asset-holding and the integration of saving policy with welfare policy.

The innovative aspect of the Savings Gateway is that it does not rely on tax relief as the central saving incentive, recognising people on lower incomes have less to gain from a tax-based incentive. The Savings Gateway introduces the concept of matching, whereby the Government would match £1 for £1 individuals' saving up to a pre-determined limit (a concept developed and operating in the United States with Individual Development Accounts). The Child Trust Fund is a radical new universal policy whereby all children have an account opened for them at birth into which government endowments are deposited at birth and with top-ups at five, 11 and 16. The key aims of the Child Trust Fund is to ensure all young adults have a pot of assets at coming of age to invest in their future.

The advent of asset-based welfare has clear implications for pensions policy. The Saving Gateway has a direct implication in that it can be designed to act as a feeder into a stakeholder pension. It could kick-start a saving habit and encourage people to thing about longer-term goals and needs. More fundamentally, asset-based welfare brings with it new and powerful means of incentivising saving. An individual has to decide where to invest limited resources and government incentives influence that investment choice. What is more important, parents saving for their children's education or parents saving for their own retirement? We are in the terrain of difficult value judgements. We would suggest though that there is currently no clear rationale for different tax incentive strategies. Research being undertaken by IPPR's Centre for Asset-based Welfare is contributing to the development of a more coherent, and progressive, incentive structure which will help individuals make saving decisions which are best for them.

The tax treatment of pensions and savings

Direct public spending on pensions in 2000-01 totalled five per cent of GDP. This included spending on the Basic State Pension, SERPS and means tested benefits including income support or the MIG and housing and council tax benefit. However, the Government also contributes resources to people's pensions through its treatment of pensions through the tax system and its system of National Insurance rebates for those who contract out of state second pension provision.

Table 4.5 State resources spent on the provision of retirement income *2000-01*

		% of GDP
Direct spending items		
Basic State Pension		3.6
SERPS		0.5
Income Support/MIG		0.4
Other (Winter fuel allowances etc*)		0.5
	Total	**5.0**
'Expenditure' on 'real' tax concessions		
Contracted out NI rebates		0.9
Age-related allowances		0.2
Tax free lump sum		0.2
	Total	**1.3**
	Total expenditure on 'state' support	**6.3**
Other items		
Income tax relief for approved pension schemes		1.3
(Of which: higher rate tax relief		0.2)
Income tax relief on PEPs/ISAs/TESSAs		0.2
Upper earnings limit on NICs		0.6

* Also includes free TV licences for the over 75s, widow's pensions, war pensions and the Christmas bonus.

Sources: HM Treasury 2001, IFS

The system of NI rebates is especially costly: a sum equivalent to 0.9 per cent of GDP was paid into people's pension pots in 2000-01 in return for their giving up their claims to state second pension provision. This was almost twice as much as was paid out in SERPS itself in that year. This system of NI rebates is almost unique to the UK, with only Japan also allowing people to contract out of the state pension system but on a much smaller scale (Disney and Johnson 2001, p25). The introduction of rebates for personal pensions in the late 1980s cost the Government substantial revenues that it will never recoup from lower SERPS payments.

Individual contributions into pension schemes attract income tax relief at an individual's marginal rate. There are limits on the proportion of annual income that can be saved in a pension and these are age-related in the case of personal pensions. Income and capital gains accrued in pension funds are tax-relieved. Pension income is then taxed when it is paid out. This approximates the treatment that would exist under what economists call an expenditure tax regime – income is tax-free on the way in but taxed on the way out (Emmerson and Johnson 2001).

However, other features of the tax treatment of pensions make them especially tax-favoured. Two features stand out that benefit *existing* pensioners. Firstly, income tax allowances are higher for pensioners. In 2001-02 the personal allowance for those aged under 65 was £4,535. It was £5,990 for those aged between 65-74 and £6,260 for those aged 75 and over. Pensioner couples still benefit from a married couple's allowance when this has been abolished for all those under 65. Secondly, a quarter of an individual's pensions pot or 1.5 times final salary in the case of a salary related defined benefit scheme can be taken as a tax-free lump sum.[19] Together these two forms of 'tax expenditure' currently cost the Exchequer about two-fifths of one per cent of GDP. In addition employer contributions to pensions are exempt from NICs and no NICs are paid by individuals when the pension is drawn.

Although the whole cost of the income tax relief allowed for pension contributions should not be counted as an 'expenditure' in that people will be paying tax on their pension income, some pensioners will be better off in that they may get tax relief at the 40 per cent tax rate while in work but attract only the basic rate of tax in retirement. This has made higher rate tax relief a target for revenue raising. Overall the system of tax relief for pensions is highly regressive.

Overall expenditure on the 'real' tax concessions and subsidies in the pensions system totalled about 1.3 per cent of GDP in 2000-01. This needs to be added to the cost of direct public spending on pensions. In total the state devoted 6.3 per cent of GDP to pensions in 2000-01. In looking at the scope for reforms this is the total pot that one would look at if an attempt was being made to make any set of reforms revenue neutral, that is to ensure that the overall costs to the state were similar to those envisaged under the Government's pensions settlement.

There are other features of the tax system relevant to the debates on pensions and long-term care. One anomaly in the tax system that has been the subject of much debate is the upper earnings limit on national insurance contributions. Employees in 2001-02 paid NICs at 10 per cent on income between £87 and £575 per week, but not above this upper limit, producing a dip in the marginal direct tax rate from 32 per cent to 22 per cent until the higher rate of income tax at 40 per cent clicked in at £33, 935. Eliminating this limit entirely would have raised revenue equal to about 0.6 per cent of GDP in 2000-01 and aligning it to the higher income tax rate would have raised 0.1 per cent of GDP.

Pensions are not the only form of saving that is currently tax-favoured. In 2000-01 the tax reliefs attached to PEPs, ISAs and TESSAs cost the Exchequer about 0.2

per cent of GDP. There is a very real question as to why the state feels it should encourage saving through these kinds of vehicles. In the 2001 Budget, the Government outlined three reasons for helping people to save: for independence throughout their lives; for security if things go wrong; and for comfort in old age. Private pensions help secure the first and third of these objectives. Very liquid assets such as cash ISAs are appropriate for security. The proposed asset based welfare vehicles are designed to secure the first objective. What objectives do equity based ISAs meet?

Equity based ISAs also create real incentive problems for people thinking about locking away income for up to 40 years in their pension. Why should one do so when putting income into an ISA attracts somewhat similar tax treatment as saving in a pension, albeit on the basis of income not being tax-free on the way in but tax-free on the way out?

From 2004 the advantages of investing in an equity-based ISA will be zero for a basic rate taxpayer due to the little noticed abolition of the 10 per cent tax credit on dividend income: it will become a vehicle solely of benefit for higher rate taxpayers. This will make the continuation of equity-based ISAs very difficult for a Labour Government to justify. The problem of investment in ISAs competing with investment in pensions would be partially removed if equity-based ISAs were simply abolished and cash-based ISAs retained with a modest limit on total savings to help people shelter some of their 'rainy-day' savings in a tax favoured manner.

Concern has been expressed from many quarters about affluent grandparents using the generous tax treatment attached to pensions to open up stakeholder pensions for their grandchildren. This was clearly never the intention of introducing stakeholders. If and when the Government introduces the Child Trust Fund, the tax treatment of this Fund should make it the main vehicle for adults to contribute to building up the financial assets of children. In this context the loophole in stakeholder pensions should be closed.

Summary of the problems

IPPR agrees that the Government has made great improvements in the pensions policy environment since 1997. The introduction of the MIG, effectively a big increase in Income Support for pensioners, was a good short term mechanism for directing help to the poorest pensioners. Crucially, the goal of abolishing pensioner poverty and ensuring an adequate income for all in retirement is the right objective for a progressive administration. We also recognise that the Government has tried to address incentive issues within the confines of its strategy of means testing. However, if we go back to the objectives of policy we can see that the current pensions settlement does not fully achieve either the Government's or IPPR's goals.

- Pensioner poverty remains a key issue. This is partly because of low take up of the MIG and partly because it remains slightly below the level which provides an acceptable low cost standard of living. Take-up is certain to remain a key issue with the Pension Credit.
- Incentive problems remain acute. The Pension Credit does not resolve the incentive problems of the MIG: instead it spreads them out over a much larger group.
- Planning is very difficult for individuals. The pensions environment has become much more complicated since 1997, and the new policy instruments both increase the need for good quality advice and make such advice more difficult to provide.
- Public support for the pensions settlement is low. Despite well intentioned reforms the public debate has moved on little, with continued calls for increases in the Basic State Pension and its indexation in line with earnings. The settlement is not seen by the public to be equitable.
- The Government appears to have abandoned its Green Paper objective of reducing the proportion of public spending on pensions with the introduction of the Pension Credit. This raises the question of whether the new resources that this policy implies can be better spent.

5. The long-term care settlement and its problems

The growing need for long-term care is the result of a very positive trend: we are more likely to live longer now than we were fifty years ago. This will provide many of us with a longer period after full time work in which to pursue new or neglected interests, to spend time with our families and friends, and hopefully to lead a fulfilling and productive third age.

Increased demand for long-term care is partly driven by these welcome demographic changes. However, as in the pensions area, long-term care policy has often evolved more in reaction to a series of problems and challenges than from consideration of the basic objectives of policy. As a result long-term care suffers from a series of overlapping boundary issues, which have historically confronted the elderly and their carers with a system which has not adequately met their needs. Labour has made significant efforts to improve the standard of care received by elderly people. However, the boundary between individual and collective responsibility for funding such care remains to be drawn in a way which generates public support.

Fundamental boundaries: health care and long-term care

Perhaps the most fundamental boundary is that between ordinary health care and the health care which is categorised as long-term care. At the very beginning of the National Health Service a distinction was made between the sick elderly, for whom the NHS was responsible, and the long-term infirm elderly, for whom local government was responsible. Right from 1948 NHS provision was free to all whilst local government provision of assistance to the elderly was means tested. The distinction between long-term care and other health care thus immediately engendered a new boundary between the two funding sources for the different types of care.

By the 1980s pressure on resources available to both the NHS and Local Authorities, together with a political desire to create a private sector supply of long-term care, led the way to additional funding of long-term care by the Department of Social Security. Supplementary Benefit to pay for residential care became available in 1983 to all who passed an assets and income means test.

There were two particularly notable features of this settlement. Firstly, Supplementary Benefit was not available to pay for places in Local Authority care homes or for domiciliary care in the individual's own home. This provided strong incentives for both Local Authorities and individuals to use the private residential sector, and the number of private sector long-term care places[20] duly rose from around 125,000 in 1983 to some 425,000 in 1993 (Laing 2001). A particularly unwelcome effect of the regime was that many who may have been better served by domiciliary care at home, paid for by the Local Authority, may have been placed in residential care for budgetary reasons. Secondly, Supplementary Benefit was available without the individual having to undergo any test or assessment of need. The result was that expenditure on Supplementary Benefit grew from £350 million in 1985 to £2.5 billion in 1993 (Royal Commission on Long Term Care 1999).

This situation led to a series of reviews, the 1989 White Paper *Caring for People*, and eventually the Community Care Act of 1993. Under the new regime budgetary responsibility was devolved from the DSS to the Local Authority, which was required to carry out an assessment of individual need, arrange care and apply a means test to determine the appropriate financial contribution by the person needing care. The intention was to restore budgetary control, to rebalance the system so that it was better focused on care outcomes, and to revive the role of domiciliary care, thereby enabling people to stay in their own home for longer. The system did indeed remove the most obvious incentive for individuals to enter residential care rather than receive domiciliary care, as Local Authorities were required to bear the cost of either option subject to the individual's means test. However, the reforms failed to remove one important incentive for local authorities to provide care in residential settings because housing wealth was generally included in the means test for residential care but not for domiciliary care. In addition, the new system included an element called Residential Allowance: an additional DSS payment for the housing part of independent home costs, which was not available to those placed in Local Authority homes and therefore maintained an artificial bias against local authority residential provision.

The operation of the means test was a particular area of contention. Under the 1993 Act, Local Authorities were required to make an assessment of the individual's needs, arrange care and pay for that care in the first instance. Where this resulted in the individual entering residential care, the Local Authority was required to determine the appropriate financial contribution which the individual should make on the basis of their income and assets. The operation of this means test was nationally prescribed, and mirrored the rules for Income Support: the aim was that the individual would be left with a small amount of personal spending money after contributing to their living and care costs. Most income, including cash benefits, was taken fully into account. Because the personal allowance was always set below income support this effectively meant that everyone made some contribution towards their care costs. Those whose income exceeded the home fees by more than the level of the personal allowance were expected to pay the full costs out of their income.

Where the means test was most deeply resented was in its treatment of savings and particularly housing equity. The means test effectively required older people to become impoverished before the state would offer significant assistance with their residential care costs. This was not only inequitable, but established strong incentives for avoidance behaviour such as gifting assets to relatives to 'beat the means test'.

Box 5.1 The means test for long-term care before 1997

Those with capital assets of more than £16,000[21], including housing equity, received no help with home fees regardless of their income. Capital of less than £10,000 was ignored by the means test and between these limits each £250 of capital was treated as if it generated £1 of nominal income, thereby reducing entitlement to assistance by £1. One immediately obvious anomaly in this system is that someone with £15,999 of assets would have their Local Authority assistance reduced by £24 per week, whilst someone with £16,000 would have to pay full fees of around £300 per week. The most politically acute problem, however, was the requirement for many people, who owned their houses but had never considered themselves 'well off', to sell their homes to pay for long-term care. It is, however, difficult to determine how many people were actually forced to sell their properties for this reason.

Boundaries between the home, the care home, and the hospital: the location of care

The situation was somewhat different for domiciliary care. Nursing care in the individual's own home was funded through the NHS and was free of charge to the individual. Non-nursing care was arranged by Local Authorities, and there was a wide variety of charging regimes across the UK. Some Authorities applied a variety of means tests for domestic care, others levied small flat rate charges, others charged full costs. This inconsistency further added to the perceived unfairness of the system. Another set of boundaries, this time based on the location of care, became problematic: nursing care received in hospital or in the home was available free of charge on the NHS, whilst nursing care delivered in residential homes was subject to means testing. The fundamental boundary between the individual's responsibility to pay for their own care and the state's responsibility to fund on the basis of need had become arbitrary, often inconsistent, and difficult for people to understand.

This is the system which the Labour Government inherited on coming to power in 1997. Their principal manifesto promise in the area was to establish a Royal Commission 'to work out a fair system for funding long-term care for the elderly'. The party also made commitments on improving the consistency of care and inspection standards.

Boundaries, classifications and assessments: nursing care, personal care, and hotel services

The Royal Commission, chaired by Professor Sir Stewart Sutherland, reported in March 1999 and proposed fundamental reform. It also introduced a range of new distinctions, most importantly between nursing, personal care and living/housing costs (sometimes called 'hotel' costs). Personal care was defined as 'care that directly involves touching a person's body (and therefore incorporates issues of intimacy, personal dignity and confidentiality) and is distinct both from treatment/therapy (a procedure deliberately intended to cure or ameliorate a pathological condition) and from indirect care such as home-help or the provision of meals.' (Royal Commission on Long Term Care, 1999, para 6.43) Nursing care and hotel services were considered to be relatively intuitive given the concept of personal care, which was spelt out with the aid of examples. As will be seen later, these new boundaries have generated many new issues.

The fundamental recommendation of the Royal Commission was that all nursing and personal care, regardless of setting, should be free to the individual. The hotel costs of residential care, and the non-personal care costs of domiciliary help, would continue to be shared between state and individual on the basis of revised means tests. The Royal Commission made many other proposals aimed at increasing the quality and consistency of care, including one for a National Care Commission. The Royal Commission accepted that their key proposal implied real increases in public funding for long-term care as a proportion of GDP, but argued that these costs would not be excessive and were justified by improvements in the fairness and transparency of the system. They estimated the result of their proposal as an immediate increase in public spending on long-term care from 1.0 per cent to 1.2 per cent of GDP, with a peak cost in 2051 of 1.4 per cent of GDP versus a base case of 1.1 per cent of GDP under projections of then current policies.

However, the members of the Royal Commission were not unanimous in their proposals. Two of the members[22] wrote a note of dissent in which they disagreed with the proposal to make personal care free. Their fundamental objections were that this proposal would not improve the quality of care received by anyone, that it would imply significant transfers of public resources to the relatively better off who would have paid for their care under means testing, and that it might result in considerably greater cost increases than those forecast in the main body of the report.

In the summer of 2000 the Government accepted most of the recommendations of the Royal Commission on Long Term Care. However, on the issue on which the Commissioners disagreed – whether personal care should be free – the Government chose to adopt the position of the note of dissent. It decided to provide free nursing care but to means test personal care. The Government decided to concentrate additional expenditure on service provision, predominantly through funding for intermediate care.

The Royal Commission's proposal for a new body to monitor and ensure consistently high care standards was quickly accepted with the announcement of the National Care Standards Commission late in 1999. This non-departmental public body will be responsible for inspecting and regulating almost all domiciliary and residential care in England from April 2002, including such care for older people. In the light of the Commission's Report the Government also made some revisions to the means test: a three-month disregard on the value of the individual's home was introduced to avoid the situation where a potentially short residential stay becomes permanent due to sale of the property. The capital limits applied in the means test were also increased, but only to restore their value to the 1996 level. The resources behind Residential Allowance, which was previously paid by the DSS, were transferred to Local Authorities.

Before the Royal Commission's Report there was no funding based motivation to make a distinction between nursing and personal care, but in the new environment this boundary has assumed high importance. The English settlement has required the Government to produce a definition of nursing care and a procedure for assessing nursing care need. The definition the Government has chosen is 'registered nurse time spent on providing, delegating or supervising nursing care in any setting' (Department of Health 2000b). Payment will be based on assessed level of need, with three bands corresponding to payments of £35, £70 and £110 per week, and exceptional cases above this level being funded directly by the NHS. The average payment is expected to be £85 per week, with 42,000 people benefiting. This system requires an assessment of all those currently in receipt of nursing care, and these people are intended to receive payments backdated to October 2001.

The distinction between nursing and personal care is a high profile issue throughout the caring professions, and the Government's definition of nursing care in particular has been strongly resisted by nursing professionals represented by the Royal College of Nursing. The RCN has argued that care practice is changing so that staff who are not themselves registered nurses are increasingly being trained to take on tasks previously performed by registered nurses. Because the Government's definition does not cover such care, individuals may have to pay for what is effectively nursing health care unless it is actually delivered by a registered nurse.

This may generate both questions over fairness and practical problems in the delivery of care. Nurses will in effect become the gatekeepers to free as opposed to means tested care, and this may create perverse incentives for them to perform tasks which could be more efficiently carried out by a less highly qualified care worker. In many cases it will not be possible to draw a line between 'pure' nursing care and 'pure' personal care: care assistants may often work under the direct supervision of a registered nurse. The appropriate degree of direct supervision, as opposed to delegation, may also change as the care team changes, and not simply as a result of the individual's care need. The RCN wants a wider definition of nursing adopted: 'the care identified by a registered nurse as necessary to meet a nursing need' (Gough 2001). This definition would certainly encompass some assistance which is currently classified as personal care.

These ethical and practical problems arise because of the boundary between nursing and personal care, a boundary which is both difficult to draw and is likely to shift over time as caring practice develops. It is important to realise that this boundary is both motivated by funding considerations and would not be so important if the Government had accepted the Royal Commission's recommendation that both types of care should be free to the individual. Whilst it would still be necessary to assess an individual's various care needs and determine who should deliver the care, there would be no arbitrary distinction between the funding of different types of care.

Pathological boundaries: the cancer/Alzheimer's contrast

There has been widespread disquiet about the Government's response to the Royal Commission. Pensioner representative groups such as Age Concern and Help the Aged have mobilised around the demand for free personal care, questioning the logic of establishing a Royal Commission only to ignore its key recommendation. The Commission's argument was that personal care should be exempted from means testing on the basis of considerations of both equity and efficiency. The efficiency argument is that the cost of personal care is very high to the individual, whilst the risk is uncontrollable and private insurance markets do not sufficiently ameliorate the problem. The equity argument often highlights the contrast between individuals who fall sick from cancer or heart disease and those who fall sick from Alzheimer's. In the first case medical expenses are fully met by the state, whilst in the case of dementia payment for the large amounts of personal care required by the individual are shared on the basis of a means test. The Royal Commission's argument was that personal care is health care, and should be funded consistently with other NHS health care. It is indeed difficult to imagine that any health care system which was designed from scratch would contain quite such a sharp distinction with regard to the funding of the costs arising from two different diseases.

Public attitudes to the settlement

A key priority for government must be to ensure that the settlement it arrives at is perceived to be fair and equitable. IPPR has performed original research into people's attitudes towards the means testing of long-term care. First reactions often indicate an understanding that means testing does take place, and many people spontaneously indicate their belief that many people have to sell their homes to finance long-term care. This is almost always perceived to be unreasonable, and we encountered similar responses to those generated by our investigation of means testing in relation to pensioner incomes: that means testing penalises thrift rather than focusing help on those who need it most.

When these themes are developed, attitudes become more difficult to decipher. Many people accept that it is reasonable for the individual to contribute towards their costs. A number of studies (Parker 1997; Scottish Care Development Group 2001) indicate majorities in favour of some form of cost sharing between the individual and the state on the basis of ability to pay. In the case of the latter study, examining the views of a large sample of older people and carers, 42 per cent thought that the state should pay only for those who couldn't afford such care themselves, 34 per cent were in favour of universal free provision by the state, and 20 per cent had no clear view. At the same time people do question the rationale behind charging for one form of health care and not another, and few distinguish between the different elements of care (nursing, personal, hotel costs) which have become a feature of the professional debate.

The current means test generated particular resentment for a number of reasons. It is perceived as a *negative* means-test, taking away from people who have rather than simply giving more to those who have not. The issue of forced sale of housing is extremely emotional, the home being seen not just as an asset but as a tangible symbol of a lifetime's achievement. Houses were often seen by our interviewees as 'a safe bet' and as 'the working man's investment'. Some were angry that having been encouraged into home ownership, not least by politicians, their assets were now being held against them. However, some of our sample argued for a raising of the means testing threshold rather than for the abolition of means testing.

National boundaries: the Berwick question

The Scottish Executive, in a highly symbolic declaration of its independence from Westminster, announced in January 2001 that it would move towards the introduction of free personal care for older people, and initially set a timetable of April 2002 for its introduction. A Care Development Group was established to advise on how this commitment should be implemented, and its report was released in September 2001.

The heart of their recommendation was that individuals in care homes should be assessed for both nursing and personal care need, then awarded payments of £65 per week if requiring nursing care and up to £90 per week for personal care. These individuals were also expected to receive Attendance Allowance of £55 per week, bringing the total maximum non-means tested assistance for residential nursing and personal care to £210, estimated to be the average cost of such care in Scottish residential care homes (Scottish Care Development Group 2001, para 5.27). All domiciliary personal care was to be made free of charge. The report strongly emphasised the need to improve domiciliary care and support services for informal carers. Individuals in residential care would still be expected to contribute towards their hotel costs on the basis of a means test.

There is no doubt that the report was motivated by the best intentions, and its publication was eagerly awaited by proponents of free personal care in England. The report contained a relatively detailed cost model, the output of which was that the extra resources required in the short term exactly matched the sum previously allocated for this purpose by the Scottish Executive. Forward cost projections extended only to 2020, the beginning of the decade when the ratio of pensioners to the working population worsens most dramatically.

Perhaps most strikingly, the Scottish report made clear just how difficult it is to guarantee that all care is free and that artificial boundaries do not affect service provision. In both England and Scotland the amount of assistance will be capped. Before attendance allowance is taken into consideration the maximum payment in Scotland is £65 for nursing plus £90 for personal care, whilst in England the maximum is £110 for nursing care only. In England exceptional nursing needs above this level are to be met by the NHS: presumably the same will have to apply in Scotland. Will a similar logic apply to those with exceptionally heavy personal care needs, such as those with severe dementia in need of almost constant attention? On the other hand, there has to be a limit to the quantity of domiciliary care paid for by the state, because otherwise many would opt for very expensive individual care in their own home rather than enter a residential establishment. If the total Scottish package is £65 plus £90 plus £55 for Attendance Allowance, and the average cost of personal and nursing care in a Scottish residential home is £210, there will be people in homes with above average costs who may have to pay for some of their care from their own individual resources.

The Scottish proposal assumes the UK Department of Work and Pensions will continue payment of Attendance Allowance to those in Scottish residential homes. This is not a surprising assumption: Attendance Allowance is a non-means tested benefit paid to individuals in need of care, and in England it is effectively paid whether such care is domiciliary or residential.[23] However, the Department for Work and Pensions has said it will not continue Attendance Allowance for Scottish care home residents if they are receiving payments intended to cover the cost of their personal care. They have argued that such people would otherwise benefit twice, because they would receive free personal care from the Scottish Executive and also Attendance Allowance which is meant to cover the cost of personal care.

This argument is clearly faulty. The Scottish proposals only deliver free personal care if Attendance Allowance continues to be paid, otherwise the proposed maximum amounts of £90 for personal care and £65 for nursing care do not add up to the required total of £210. The gap is £55: the weekly rate of Attendance Allowance. Implementation of free personal care has now been delayed until July 2002, but unless the Department for Work and Pensions changes its policy the Scottish Executive will either have to find the extra resources from within its own budget or accept that individuals will have to fill the gap.

The Care Development Group Report proposed a slightly wider definition of nursing care than will be used by the UK government, and a slightly wider definition of personal care than was proposed by the Royal Commission Report. However, it is striking that they retained the problematic nursing/personal care divide at all. It was originally considered one of the problems with the English settlement that this distinction needed to be made. Making personal care free on the Scottish model does not remove the difficulties of assessing individuals for payments to be made on the basis of need.

A very short section of the Care Development Group Report is devoted to the distributional impact of the free personal care policy. This noted that making personal care free removes the anomaly whereby funding responsibility is determined by the type of illness (the cancer / Alzheimer's issue). However, the report noted that 'the direct impact of the policy will typically benefit better off pensioners' who are currently required in virtue of their income or assets to pay for some or all of their own care. In fact, the report went on to note that, '85 per cent of the long-term care provision for older people [in Scotland] is currently free of charge. Therefore making a proportion of the remaining 15 per cent of provision universal must by its nature have a more favourable impact on those currently paying for the service and hence with the greater assets or income' (para 8.14). Scotland does not have the devolved power to change this distributional effect through its tax system.

Regardless of the outstanding questions over its detailed decision, the Scottish Executive's divergence from the Westminster settlement is important. In particular, it raises the Berwick question: Mr Jones in Berwick may have to pay for his personal care while Ms Smith living just north of the border gets it free. This may generate significant political pressure on the London government. More positively, those on both sides of the border have the opportunity to learn from the experience of the other.

There are, however, practical problems with the possibility that people in England will attempt to take advantage of more generous provision north of the border. Would a residency test be required to avoid an exodus of elderly people to Scotland? The authors of the Scottish report noted that they had found no real evidence on which to base a view on whether the policy was likely to cause population inflow, and recommended that only ordinary residency should be required for individuals to qualify for free personal care.

The main arguments used by the Westminster government against the provision of personal care free to all is that it would not represent the best use of resources in the short term, and it would be excessively costly in the longer term. As indicated earlier in this report, the costs of long-term care are driven by many different factors. Chapter 7 of this report explores the way in which different assumptions about these factors affect the projected future costs of long-term care, and the way in which policy decisions affect the allocation of these costs between public and private sources of funding.

Private product solutions?

The need for long-term care is likely to impose new costs on individuals whether or not personal care is funded by the state. Currently, individuals who have savings, investments or housing equity worth over £18,500 are expected to pay for their personal and hotel care from their own resources. The average fee level for a residential care home was £280 per resident in March 2000 (derived from Laing and Buisson in Wittenberg *et al* 2002). This is likely to represent a significant increase in weekly expenses for most pensioners. Even if personal care was funded up to, say £100 per week, the remaining hotel costs would certainly exceed average pensioner incomes. Whilst many of these would receive means tested assistance, home owning pensioners with low incomes would still need to meet their costs.

The Government has sought to protect people's homes through changes to the means test. The value of a resident's home will be disregarded for the first three months after admission to residential care. The upper capital limit has also been raised to £18,500. However, analysis has suggested that the average benefit of the changed capital limits will be relatively insignificant and will predominantly benefit those on moderate incomes (Hancock 2000). In order to benefit those on lower incomes the means test would need to disregard more income.

The note of dissent to the Royal Commission, many financial service providers, and to a limited extent the Government itself have highlighted the way in which private sector products might help individuals address their need to fund care. Two key products are long-term care insurance, and equity release mechanisms.

Insurance products

Various insurance products have been developed to meet long-term care needs. Two broad categories are pre-funded insurance contracts and enhanced needs annuities (sometimes called immediate needs annuities). Pre-funded insurance contracts provide a specified maximum regular benefit when the insured individual requires care, with payment usually triggered by failure of a number of Activities of Daily Living.[24] There are usually various options around the degree and period of disablement required to trigger payment and the up-rating of benefits over time, but most UK policies continue until death or recovery. Policies can be bought either with regular premiums or with a single large payment, and are typically purchased after retirement. Naturally, earlier purchase reduces the payment required for a given level of benefit.

Enhanced needs annuities are usually purchased at the time an individual needs care. In exchange for a single payment, the insurance company provides a defined level of benefit until the individual's death. The cost for a given level of benefit reflects the individual's life expectancy. Table 5.1 describes the growth of the UK market in long-term care insurance and enhanced needs annuities.

Table 5.1 New policy sales of private sector products for long-term care

	Regular premium insurance	*Single premium insurance*	*Enhanced needs annuity*
1995		1,963	135
1996	3,575	4,505	127
1997	2,841	3,740	180
1998	3,040	3,672	280
1999	2,055	2,959	534
2000	1,899	2,053	743

Source: Gulland, 2001, from ABI data

As these figures indicate, whilst the numbers of those who will potentially need long-term care is large, the number of buyers of long-term care insurance has been very small, and the growth of this market has actually slowed in recent years. Sales of enhanced needs annuities have been even fewer, although this market has recently experienced some growth from its very low base. In the words of one practitioner, 'the industry has failed to create a significant market for long-term care insurance' (Gulland 2000). This may be due in part to a lack of consumer awareness about the potential value for money of private insurance, for example the capacity of insurance to protect a spouse's wealth or the value of inheritable assets. Insurance companies may also have been less than proactive in their marketing and development of new products for a number of reasons. Firstly, the recent past has been a turbulent time for the financial services industry, particularly with respect to core business areas like pensions and more liquid personal savings. The development of a new and currently very small market may have been a low priority for many. Secondly, the policy environment has been uncertain with the Royal Commission, then the Government's response, and now the Scottish decision and continued public resistance to charging re-opening issues about free personal care. In order to play a valuable role, the private sector requires clarity about what the state will provide, and it can then provide products which help to address the gaps.

Improving the long-term care market is not necessarily about creating new products. Increased choice and flexibility may benefit sophisticated or well advised consumers, but there are also great benefits to consumers from familiarity and simplicity in the products available to them. There are certain innovations which may significantly increase the level of private insurance, the foremost of which is allowing the sale of pensions with linked long-term care benefits. Such a product would offer a pension in which the payment increased if the policy holder required care. The cost would obviously be a somewhat reduced pension in the period before ill health. The

Inland Revenue currently bars the sale of such products, presumably because pensions attract a more favourable tax regime than long-term care insurance. Some representatives of the pensions industry have also resisted linkage on the basis that individual pension provision is often barely adequate and contributions should not be diverted into long-term care insurance. It is true that with limited net disposable income providing for long-term care insurance reduces the funds available for pension saving. However, pensions and long-term care insurance are in some respects similar mechanisms for spreading the risk of poverty in old age. In addition, pension plus long-term care products would have to sell on their merits in competition with pure pensions: consumers would be able to choose. The currently restrictive Inland Revenue regulations should be revisited, although the Government will rightly have concerns both about the potential cost of changing the tax regime, and about the political implications of tax favouring what is in part a form of health insurance.

Another natural linkage is between ordinary health insurance and long-term care insurance. Most traditional private medical insurance products exclude long-term conditions, but there is no reason why the two could not be insured together. Indeed, there may be benefits from incentivising the insurer to provide early intervention which may delay or prevent the need for more expensive care at a later date.

More fundamental options might require changes to the current funding regime. For example, there might be a partnership between private and state funding, with the former providing cover for a given initial period of need, after which state funding would be drawn on and assets protected (Fox 2001).

Though we think there is merit in exploring the role that might be played by the financial services industry in coming forward with new products, it is important to strike a note of caution. The evidence that has been presented to us suggests that financial service providers are fully occupied with the introduction of stakeholder pensions, demutualisation and the problems of with-profits policies. Whilst some regulatory change seems sensible, the appetite of the private sector to expand their provision of long-term care products should not be taken for granted by policy makers.

There are also significant general problems with private insurance for long-term care which are inherent and not easily surmountable. People find it very difficult to assess the relative merits of different insurance products because of their inherent complexity and the level of uncertainly in estimating the risks of requiring long-term care (Burchardt 1997). Pricing long-term care insurance policies is also very difficult for insurers: as will be discussed later in this paper, the future determinants of care need are very difficult to predict (Barr 2001). The Treasury has hoped that improved regulation involving the use of CAT standards, and the provision of free nursing care may help resolve some of the problems and make insurance cheaper (HM Treasury 2001a). By the same logic, if significant components of personal care were to be delivered free, it might be cheaper and easier for private insurance to provide top-up funding.

Housing equity release

The use of housing equity provides another option for funding care. Many elderly people have significant wealth tied up in their own homes. By head of household, over 60 per cent of 70-80 year olds own their own home outright, and more than half of those over 80, who are the group most likely to need care. Larger proportions of younger cohorts are on their way to homeownership, for example 78 per cent of 45-59 year old household heads either own outright or with a mortgage (General Household Survey, in Le Grys 2001). Equity release mechanisms are designed to allow people to draw down some of the equity in their house, with repayment usually deferred until sale of the property on their or their surviving partner's death. There is often flexibility around transferring a scheme between houses and payment of interest on a rolling or accumulated basis: equity release mechanisms are essentially loans secured against a housing asset.

Private firms are not the only providers of equity release products. Local Authorities also have powers to make interest free loans secured on properties instead of requiring that properties be sold to pay for long-term care costs. New funding is being assured, but with a comparatively small budget of only £85 million over a three year period. It has to be questioned whether hundreds of different Local Authorities are the right entities to administer a complex financial product in this way. Equity release, and long-term care products more generally, require quite sophisticated advice which Local Authorities are likely to be unwilling and unequipped to provide. Authorities may find themselves making loans without adequately establishing the legal status of the property, or they may face claims from individuals who feel they have been misadvised by their authority, for example because of the interaction of equity release and benefit entitlement. A public private partnership might improve delivery of the product and could potentially lever in private sector funds to expand the scheme. A successful partnership between local authorities and financial service providers could also be a way of building confidence in equity release mechanisms more generally.

The cash generated by equity release can be used for any purpose: it is not specifically tied to long-term care, and is often used to carry out housing repairs or adaptations or to generate additional income. Some of these uses might themselves delay the demand for institutional care. Where equity release is used to fund long-term care it could be used to pay for a single premium pre-funded insurance contract, or alternatively to purchase an enhanced needs annuity. This might protect ownership of the home, although interest would often still accrue which would further erode the residual equity value. One problem is that using equity release to buy an insurance product incurs a double set of commissions or charges, and can thus represent poor value for money.

For a number of reasons, many older people are reluctant to use equity release products. Equity release mechanisms received a bad press after mis-selling in the early 1980s, and regulation that might increase consumer confidence is lacking (Le Grys 2001). In addition, people usually see their homes in a quite different way to their savings and other assets. IPPR's qualitative research indicates that people often have difficulty in distinguishing between 'housing equity' and 'their home': they assume that accessing the former effectively means giving up the latter (Edwards *et al* 2001). This should not be dismissed as a simple confusion, but may reflect the sense of ownership and achievement which comes from paying off a mortgage. Our qualitative research also indicated that many people believe equity release schemes charge excessively high interest rates.

The need to pay for long-term care, forced sale of housing and issues around inheritance have become bound together for many people. Our research, and other work such as the Debate of the Age (2000), indicates significant resistance to the use of housing equity to pay for care. However, the picture is not simple, and may change over time. Some homeowners, particularly those from lower income brackets, made the argument to us that government policy had encouraged homeownership, that a home was a 'working man's investment', and that it was wrong to have this held against you in old age. Research by Parker *et al* (1997) has indicated that objections to using housing equity to pay for care are not always as strongly held when related to house values: the more housing wealth the individual had, the less likely respondents in this survey were to think that the state should pay for care.

It has been suggested that attitudes towards inheritance are changing (Actuarial Profession 2001a), although in the Parker *et al* study there was no significant evidence of a relationship between age and attitudes to the use of housing to pay for care. As part of IPPR's qualitative research we explored these issues. Our research looked at attitudes towards inheritance generally, to both receiving and giving, and at what people's appetite was for de-cumulating their wealth throughout their retirement. This has implications for both pensions and long-term care policy: for pensions policy, because people might factor receiving an inheritance into their financial planning or might run down their wealth in retirement to supplement pension income; for long-term care policy, because some people could self-fund their care through their wealth, in particular by accessing housing equity.

There was little evidence that people expected or relied upon receiving an inheritance for their future financial security. The prevailing view was that people should use their assets to improve their own quality of life in retirement, with anything left over being endowed to children or grandchildren. Having said that, most people did feel strongly that they would like to pass on some wealth to future generations, In particular, people often saw their home as a ring-fenced asset to pass on. Attitudes towards running down housing wealth in retirement were consistently strong and negative, even when people understood it did not mean giving up their home. Providers of equity release products will be well aware of this obstacle. For many, owning a house represents everything that they have worked for over the years and has both a symbolic value as well as a financial one. This seemed particularly true for lower income groups who had a greater sense of their transition towards greater financial security and often describe the poverty of their own parents. They therefore place greater importance on ensuring that their relative affluence is maintained for future generations. Whilst this was the prevailing majority view, some respondents did think of their housing equity as part of their financial security in retirement and were prepared to use it flexibly in order to cover the costs of old age.

The qualitative research also explored attitudes towards running down wealth specifically to pay for long-term care. People were resistant to this particularly because long-term care is seen in essence as a health cost and therefore something that, like the rest of the National Health Service, should be free to all. There is a sense of injustice that people may have 'paid into' and relied on the NHS all their lives but are let down when they reach their most vulnerable life stage and are most likely to be dependent on others to care for them.

Summary of the problems

As in the pensions arena, IPPR agrees that the Government has made great improvements in long-term care policy since 1997. The government has rightly focused on improving the standard of care received by the elderly through establishing the National Care Commission and the National Service Framework for Older People and significantly increasing funding for older people's services. However, the crucial issue of equity has not been successfully addressed. There are clear inconsistencies in the treatment of different diseases, and these inconsistencies are widely felt to be unfair. Whilst government reforms have improved some of the old boundary issues relating to the location of care, they have introduced new problems because of the nursing/personal care division. At the same time, the Scottish experience shows just how hard it will be to effectively address these challenges.

- The funding distinction between acute health care and long-term health care, and thus the difference in consequences for the individual of developing cancer or heart disease versus Alzheimer's or Motor Neurone Disease is still starkly inequitable.
- The distinction between nursing and personal care has introduced new problems for the delivery of appropriate care. Nurses will in effect become the gatekeepers to free as opposed to means tested care, and this may create perverse incentives for them to perform tasks which could be more efficiently

carried out by a less highly qualified care worker. In many cases it will not be possible to draw a line between 'pure' nursing care and 'pure' personal care.

- The operation of the means test is widely perceived by the public to be unfair, particularly in its treatment of housing equity.
- The issue of free personal care has not gone away simply as a result of government determination to stick to its policy of means testing. Many have questioned the logic of establishing a Royal Commission only to ignore its key recommendation, and the proposed Scottish arrangements may put increasing pressure on the English settlement.

6. Pensions policy: options and analysis

The key problems we have identified with the current pensions settlement were summarised at the end of Chapter 4. To re-state them again:

- With low take-up of the MIG, and take-up certain to be an issue for the Pension Credit, pensioner poverty is still a key problem.
- Incentive problems under the current settlement remain acute. The Pension Credit does not resolve the incentive problems of the MIG but rather spreads them out over a larger number of people.
- Planning is very difficult for individuals. The pensions environment has become much more complicated since 1997, and the new policy instruments both increase the need for good quality advice and make such advice more difficult to provide.
- Public support for the pensions settlement is low. Many individuals feel that means testing retirement benefits is unfair: the settlement is not seen by the public to be equitable.

Is it possible to design an alternative settlement that would better meet the key objectives that we think any pensions system should be measured against? To re-cap, these objectives are:

- Ensuring that all receive an income in retirement that is at least adequate to lift them clear of the poverty line.
- Constructing a system that is clear enough for people to understand its main features so they can plan with some confidence for their retirement needs.
- Adequately rewarding and incentivising people to save for themselves.
- Not setting up future costs for the state that are unaffordable in the sense that they imply a sharp and ongoing rise in spending as a proportion of GDP.

We believe that a pensions settlement that could meet these objectives would be more likely to generate widespread popular support and be more politically robust. We do not believe that the current settlement is sustainable for the reasons outlined. We also argued that the clarity and transparency of any settlement needed to become a first order goal of any reform.

Any discussion of the options for pension reform has to start with a full understanding of how the pensions settlement proposed by the Government will look once the system, with its many separate features, is fully in place. This will then provide us with a benchmark against which to assess other reform options.

Our discussion of reform options draws extensively on two pieces of modelling work that have been done in collaboration with IPPR. The first modelling exercise has been undertaken by John Hawksworth at PricewaterhouseCoopers (Hawksworth 2002). This has attempted to cost out different pension reform options, projecting the costs as a proportion of GDP for each decade to 2050, and assessing the options against the four objectives outlined above. The second modelling exercise has been undertaken by a team at the ESRC SAGE Research Group (Falkingham, Rake and Paxton 2002). This has attempted to assess different pension reform options according to how well they deliver to individual women and men at the point of retirement and through later life. It should be noted that IPPR's policy conclusions are not the responsibility of these external partners.

These modelling exercises have looked at four possible sets of reforms. However, in this chapter we concentrate heavily on a comparison of the Government's base case with what we have described as the gold plated base case.

The Government's base case

The starting point is the Government's own pensions settlement, what we have called the Government's base case. This involves a price-indexed Basic State Pension, an earning-indexed MIG and the introduction of the State Second Pension and the Pension Credit. One can explore variations on this base case including for example not introducing the Pension Credit.

The gold plated base case

This is one of the most generous settlements that we might envisage. It involves raising the Basic State Pension gradually to the level of the MIG between 2002/03 and 2010/11 and then indexing it in line with earnings. In this option it is assumed that the Pension Credit is not introduced (though it is also compatible with the Pension Credit only being introduced as an interim measure and then phased out by 2010/11). In this case the MIG retreats to being a residual means tested benefit for those with incomplete entitlements to the Basic State Pension. One can also explore variations on this option such as ending state second pension provision or increasing the official retirement age.

The silver plated base case

This option involves raising the Basic State Pension to the level of the MIG at age 75 reflecting the higher levels of poverty faced especially by older single pensioners. This can be modelled with a price indexed Basic State Pension and the Pension Credit continuing for younger pensioners or with an earnings indexed BSP and no Pension Credit for younger pensioners.

Making the state second pension more generous

This option involves putting significant extra resources into the State Second Pension, which would allow the Pension Credit to be phased out over the very long-run and reduce the need for the MIG to top-up incomes. This can also be modelled with different assumptions, particularly about the level of the BSP.

These four options are of course not exhaustive. Even more generous than what we have called the gold-plated base case would be the introduction of a citizen's pension, where everyone would receive something equivalent to the BSP as a right without having to establish a contributions record. If it is correct that by 2020 most women and men will have achieved full entitlement to the BSP in their own right, then the current system will look more like a citizen's pension. However, the current system where people receive a benefit based on some record of contributions appears to be well understood and well supported. Given this our objective of promoting clarity and transparency would seem to suggest not overturning this feature of the current settlement.

The least generous option would be for the state not only to withdraw from second tier pension provision but to withdraw from first tier provision as well and retain only a means tested system to help the poorest in retirement, an option modelled by Falkingham *et al* (2002). A less drastic option would be to incentivise individuals to opt out of the BSP in the same way that they were encouraged to opt out of SERPS into personal pensions in the 1980s. In some discussion this option is based on an argument about the inherent superiority of funding over pay-as-you-go, an argument we do not find compelling. The impact on the state's finances would, if the system were actuarially fair, be neutral in the long run: the state would lose income in the short run as it paid out rebates and gain in the long run as fewer people had entitlement to the BSP. If the incentives to opt-out were made too generous the settlement would prove less affordable for the state in the same way as the reforms in the late 1980s generated net losses for the Exchequer. It would introduce another element of complexity into the pensions system and would not reduce either existing or future pensioner poverty. It therefore fails to meet any of the objectives we have set for pension reform.

The four pension settlements we explore here encompass the likely range of options that most people on the centre-left and probably the centre-right would be comfortable with. They allow us to probe in more detail the trade-offs inherent in the objectives we are trying to meet for the pensions system. We think the analysis leads us to choose a variation on the second option – the gold plated base case – as the best outcome, but exploring the other options enables us to clarify the case for the option we have chosen.

Table 6.1 Estimates of total direct spending on pensions as % GDP

	2000	*2010*	*2020*	*2030*	*2040*	*2050*
Government's Base Case						
with PC	5.0	5.6	5.2	5.8	6.1	6.0
without PC	5.0	5.3	4.8	5.1	5.1	4.8
Gold Plated Base Case						
BSP=MIG for all, no PC	5.0	6.5	6.5	7.8	8.6	8.6
and close SERPS/S2P	5.0	6.4	6.3	7.4	7.9	7.6
and abolish rebates	5.0	5.5	5.4	6.5	7.0	6.7
and raise retirement age to 67	5.0	5.5	5.4	5.8	6.3	6.0
Silver Plated Base Case						
BSP=MIG at 75	5.0	5.8	5.7	6.6	7.3	7.3
Higher State Second Pension						
without PC (not including increased costs of rebates)	5.0	5.1	4.7	5.1	5.2	5.0

Source: Hawksworth 2002. Author's calculations on impact of abolishing rebates.

The Government's base case

We start by establishing the overall cost of the Government's pension settlement. The modelling by Hawksworth (2002) suggests that the net cost of the Pension Credit will rise to 1.2 per cent of GDP by 2050. Overall, the Government's pension settlement will involve *direct* expenditure costs of six per cent of GDP by 2050, compared with five per cent of GDP in 2000-01, even if the BSP remains indexed in line with prices. We have discussed earlier how far these costings are compatible with those set out by the Government (DWP 2002) and this is discussed further in Hawksworth (2002), with the conclusion that they are broadly comparable. These represent of course only the direct expenditure costs: there will in addition be the costs of the 'true' tax expenditures and subsidies. These cannot be modelled but in this analysis they are assumed to remain at around the current level of 1.3 per cent of GDP.

The key punchline here is that the objective set out in the Prime-Minister's forward to the 1998 Green Paper that public spending on pensions as a proportion of GDP would fall, will now not be realised. This change to one key feature of the Government's pensions settlement opens up a very obvious question: had it been known in 1998 that such an increase in spending was possible would we have chosen a different means of delivering the other objectives for the pensions system?

There are other key questions that the modelling helps to clarify. The Pension Credit combined with a BSP indexed in line with prices will draw an increasing proportion of pensioners into means-testing with all the consequences for the incentives faced by people and their perceptions of the equity of the system that were discussed above. Even in 2003 around half of all pensioners are expected, according to government estimates, to be eligible for means-tested support. By 2050 up to 70 per cent of pensioners will be eligible for the means-tested pension credit (Hawksworth 2002). Falkingham *et al* (2002) look at an individual on average earnings of around £20,000 a year and with no employment breaks, saving the minimum in a stakeholder pension implied by the level of the contracted out rebate, with a generous 3.5 per cent annual real rate of return, and buying a non-indexed annuity. They would be eligible for the means-tested savings element of the Pension Credit after only three years of retirement. If they purchased an indexed annuity with their retirement savings pot in 2050, they would be immediately eligible for the means-tested savings element of the Pension Credit. If they lived to beyond 80 they would become entitled to the MIG as well.

Of much greater concern is that by 2050 anyone with income only from the BSP and the State Second Pension will *automatically* fall below the MIG threshold on retirement at 65. As Falkingham *et al* (2002) point out this raises real questions about the purpose of the State Second Pension. Someone who works all their life and makes contributions to the State Second Pension will not have a non-means tested income in retirement that will lift them above the poverty line. It is not clear that this fulfils the objectives for the State Second Pension that were outlined in the 1998 Green Paper.

The gold plated base case

The option of raising the BSP to the level of the MIG and then indexing it in line with earnings would silence most of the Government's critics on the centre-left in one fell swoop as it is what they have been campaigning for over many years. It would be generally very popular in the country as a whole. The option has been dismissed in the past by Whitehall on two grounds: firstly, affordability and, secondly, that it would deliver windfall gains to better off pensioners who do not strictly 'need' a higher income from the BSP.

Our modelling allows us to confirm the cost of this option. Without offsetting measures, raising the BSP to the level of the MIG by 2010-11 would add around 0.9 per cent of GDP to direct spending on pensions by this date when compared with the Government's base case. This estimate takes into account the savings by not having to introduce the Pension Credit and by fewer people having to claim the MIG top-up. It slightly overstates the extra costs, however, in that the BSP is taxable and 22 per cent and 40 per cent of the extra cost would be clawed back from better off pensioners. This is one way in which the option can be seen to be both more affordable and that the windfall gains to better off pensioners can be mitigated.

By 2050 this option would raise direct spending on pensions by about 2.6 per cent of GDP when compared with the Government's base case. Again this does not take into account the lower net costs that would result from some flow of income tax revenue back to the exchequer. Overall direct expenditure on pensions would total 8.6 per cent of GDP in 2050. This is significantly higher than in the Government's base case of 6 per cent of GDP, but is in no sense completely unaffordable. A glance back at the table in Chapter 2 shows that it would still leave public spending on pensions in the UK lower than in all other EU countries based on current projections. Simply indexing all taxes in line with price rises and thereby allowing the phenomenon of 'real fiscal drag' to increase tax revenue would increase the tax take as a proportion of GDP by 2.3 per cent in just one decade (IFS 2001). Nevertheless this significant increase in direct spending on pensions by definition carries with it an opportunity cost. The revenues devoted to increasing the BSP would not be available to tackle child poverty, increase spending on health care, education or public transport, or any other of the many priorities faced by government.

This reform option would score highly against the objective of securing an adequate retirement income for all and the objective of maintaining people's incentive to save for their own retirement. With nearly everyone automatically receiving a full non-means tested minimum pension at the age of retirement, we get round the problem of the inadequate take-up of the MIG and thus deliver a significant boost in income to the very poorest pensioners. The MIG would retreat to being a residual means tested benefit for those without a full entitlement to the BSP, a section of the population that we expect to see decline sharply over time.

In terms of incentives, the existence of a non-means tested pension in retirement at the level of the MIG would mean that individuals faced a much clearer incentive to accumulate their own savings through pensions or other vehicles. They would know that they were not going to be faced by an ill-understood system of means testing in retirement that might significantly reduce the return to their own savings. However, individuals facing significant housing costs in retirement might still face the high marginal tax rates implied in the housing and council tax benefit regimes, and this is the one significant incentives problem that the gold plated base case does not surmount. The answer here would lie in a fundamental reform of the housing and council tax benefit regimes.

It is highly unlikely that any government would simply raise the BSP to the level of the MIG and not take the opportunity to make other changes to the pensions settlement designed to achieve the other main objective of reform: a simplification of the system. From 2007 it is planned that the State Second Pension will become flat rate to be added to the value of the BSP for those who are contracted in. However, with the BSP raised to a level that would be somewhat higher than the Government's planned level for the combined BSP and State Second Pension, the opportunity would arise of simply phasing out the latter altogether. For those on low incomes the BSP would be generous enough in its own right to provide people with a minimum retirement income.

Taking the opportunity to phase out the State Second Pension would not only significantly simplify the system, it would temper the 'affordability problem' that Whitehall in particular will be concerned about. We can model the effect of phasing out the State Second Pension in the context of raising the value of the BSP. In itself over the short term this would make little difference. By 2010 the revised gold plated option shaves only 0.1 per cent of GDP from the overall cost of the pension reform package. However, by 2050 when the State Second Pension would have matured, its phasing out would lower direct public spending on pensions by one per cent of GDP when compared with the full gold plated option. This would leave the option costing overall 7.6 per cent of GDP in terms of direct public spending compared with the 6 per cent of GDP that is the cost of the Government's base case.

However, the analysis does not stop there. If the State Second Pension was phased out (perhaps from 2007) there would by definition be no need to retain the expensive system of offering rebates or lower contribution rates to people contracting out of state second pension provision. These rebates cost 0.9 per cent of GDP in 2000-01. We cannot model the cost of these rebates out into the future, but we can use the working assumption that the cost remains the same as a proportion of GDP. In this case abolition of the rebates means that in 2010-11 the total cost of the gold plated reform package as a proportion of GDP would be 5.5 per cent, *almost exactly the same as the Government's base case*. The reform is basically revenue neutral over the first decade. By 2050 the total cost of the gold plated option would be 6.7 per cent of GDP including the savings on the rebates compared with the six per cent cost of the Government's base case not including the rebates. The gold-plated reform option along with the phasing out of the State Second Pension is barely less affordable in the round.

It is important to clarify what is going on here and in particular the distributional consequences of what is being proposed. The initial cost of raising the value of the BSP to the MIG by 2010-11 is paid for by closing state second pension provision. In addition we abolish the rebates paid to those opting out of this provision and effectively everyone moves to the contracted-in rate of NICs. The main distributional impact here is to transfer resources *between* the current generation of workers who would have benefited from having the rebates paid into their pension pots or paying the lower contracted out rates and the current generation of pensioners who will benefit from the higher BSP. It is a transfer from the current workforce to their parents and/or grandparents. Over the long run it is a transfer *across* the lifetimes of individuals who give up their entitlement to state second pension provision in return for a more generous BSP.

Nevertheless some people – and especially those in Whitehall – are going to worry about the 'windfall' gains that will go to many of today's better off pensioners that do not strictly 'need' the extra income from the enhanced BSP. These pensioners are unlikely to complain about the extra income, but their sons and daughters may complain about losing their rebates or paying higher contribution rates.

The tax treatment of pensions

To what extent could some of the distributional consequences of the reforms be offset through changes to the current tax treatment of pensions and other forms of saving? The major distributional problem that many people might perceive with the gold plated reform package is that it will give a large windfall gain over the next decade to existing middle and high income pensioners, paid for by the current middle and high income workforce who will lose their rebates. Some of these windfall gains would be automatically taxed away at the pensioner's current marginal rate. However, given the existing quite generous tax breaks for the current generation of pensioners, the question arises of whether this distributional impact might be partially offset by reducing the value of those tax breaks. This would achieve some redistribution of the gains *within* the pensioner population away from more affluent pensioners who would otherwise stand to gain. It would also raise some revenue for the overall reform package.

Before we explore the options it is worth setting out the principles that should underlie any changes to the tax treatment of pensions and other forms of saving.

- a key objective for any centre-left government is to make the overall tax system significantly more progressive
- saving long-term in a pension needs to remain the most tax favoured form of saving
- an effort should be made to simplify the system if possible
- it would be a bonus if the overall cost of tax expenditures could be reduced to release resources for raising the basic state pension and/or to fund a more generous settlement in long-term care.

One modest way of reducing the windfall gains to better off pensioners would be to freeze the age allowances until they were at the proposed level for the BSP/MIG. This might satisfy most people's judgement of an equitable tax treatment in that pensioners reliant solely on the BSP would not be taxed on it, but pension income above this level would be taxed at the normal rates. With the minimum income set at £100 a week from 2003 and then indexed in line with earnings and the age allowances frozen in nominal terms from 2003, it would take only about 4-5 years for convergence to be achieved. This would imply a clear u-turn in government policy, which is to index the age-related personal allowances in line with earnings from 2003-4 for the remainder of the current Parliament. The proposed reform would generate some additional revenue over the middle of this decade as the BSP was being increased to the level of the MIG, but this gain in revenue would be modest.

The additional married couple's age allowance for the over 65s could be abolished outright at an appropriate point. With the BSP being raised in value significantly and an ever higher proportion of people establishing entitlement to the full BSP in their own right, any justification for the continuation of this allowance would appear to be very weak.

Getting rid of the tax-free lump sum is favoured in some quarters, though this would be politically difficult. It could not be done retrospectively of course and so would only affect those 'cashing in' their pensions from the date of the reform. Such a change would probably need to be phased in so as not to create a sense of inequity between age cohorts. It would not therefore raise much revenue in the medium term or offset the immediate distributional effects of the proposed reforms. The maintenance of the tax-free lump sum would be one way of ensuring that the tax advantages of saving in a pension vehicle were seen to remain intact.

The abolition of higher rate tax relief on pension contributions is attractive on distributional grounds as is abolition of the upper earnings limit on NICs. However, both would further impact on the current workforce rather than existing better off pensioners and so would not solve the perceived problem of the windfall gains to those current better off pensioners. The issue of higher rate tax relief on pension contributions raises important questions about the structure of the tax system that cannot be resolved here.

We have already flagged up other reforms to the tax treatment of pensions and other forms of saving, including the abolition of tax relief for equity based ISAs after 2004 and the ending of the loophole that allows grandparents to contribute to their grandchildren's pensions through the stakeholder vehicle. Alongside the freezing of the age allowances and the ending of the married couple's allowance, we have a package of reforms to the tax treatment of pensions and savings that would satisfy the principles set out above:

- the tax system would be made more progressive by abolishing equity ISAs that will from 2004 only be benefiting higher rate taxpayers anyway and by scaling back the age allowances.
- the abolition of equity based ISAs and the continuation of the tax free lump sum would mean that pensions remained clearly the most tax favoured form of saving
- the abolition of equity based ISAs and the married couple's allowance would simplify the system.

- some resources would be released to finance the increase in the BSP or to fund a more generous settlement in long-term care.

Some of the windfall gains to current better off pensioners would be tempered. However, it is an inevitable feature of a reform package that relies on increasing a universal benefit that a significant part of the gain will go the better off. This has to be traded off against the other objectives that are secured by the reform package: people receiving an adequate non-means tested pension in retirement; a clearer set of incentives for private saving; and a significant simplification of the system.

Another option: raising the official retirement age

Several countries have planned for or are considering raising the official retirement or pensionable age at which the state pension is paid. The US is raising its official retirement age to 67 by 2027 and this is also the age that Sweden has chosen. It is interesting that these two countries that are often seen to represent the polar models of advanced market economies are both implementing changes to the official retirement age similar to the one that is considered here.

Such a change needs to be justified on more than just the grounds of improving the affordability of the state pensions system. There is one particularly important argument to make. There is evidence that the official retirement age impacts on labour force participation rates (Disney and Johnson 2001, page 10). We could expect an increase in the official retirement age to drag up labour force participation rates in its wake, thus helping to achieve one of the goals that everyone recognises as desirable. Indeed the modelling by Hawksworth (2002) assumes that raising the official retirement age has this desirable impact on labour force participation, making the point that such an administrative change only has the full desired impact if it changes actual behaviour.

There are other principled arguments to make. Hawksworth (2002) models the impact of raising the official retirement age over the period 2020-2030. This would be the decade after the official retirement age would have been raised from 60 to 65 for women to align it with the age for men, which will occur between 2010 and 2020. This already announced reform would therefore set a useful precedent for raising the official retirement age further and sensitise the whole population to the issue. For the cohort first fully affected – that is those who would have reached 65 in 2030 – average life expectancy is now in the middle to late 80s for both men and women. So retiring at 67 would still leave an average of around 20 years of retirement for most men and women. Many people could expect to live for most of that period in a reasonably robust state of health. With an average of around 20 years of childhood and full-time education and training, people would spend around 40 years not in the workforce and around 45 years in it. It is intuitively plausible to think that you have to work for more years than you can live in 'leisure'.

The distributional impact of raising the official retirement age is easy to perceive. In effect the same cohort is paying for its own more generous state pension by being required to work a little longer – a redistribution *across* the lifetimes of these individuals. Whether the official retirement age is raised or not, the Government should engage the public in a debate about trends towards early retirement in the context of increased healthy life expectancy.

There are other practical steps that should be taken. The government has already recognised that a key priority of the new Jobcentre-plus service that will integrate the Employment Service and Benefits Agency should be to increase activity rates amongst the over 50s – the employment and pensions agendas are indeed inter-linked. The suggestion of the Performance and Innovation Unit (PIU 2000) that people should be able to take part of their pension while continuing to work part time for their current employer needs to be taken forward. And the Government will need to consider carefully the role of future legislation, which it is required to introduce by 2006 to comply with an EU directive, to prevent age discrimination and to promote age equality (Spencer 2002, forthcoming).

Currently, the gold plated reform package that we have proposed would still result in a significant increase in public spending on pensions over the period 2020-2040, when the bulge in the retired population occurs. They will now be entitled to a significantly more generous BSP than would otherwise be the case with the BSP indexed only in line with prices.

The modelling by Hawksworth (2002) analyses an increase in the official retirement age to 70 over the decade from 2020-2030. We have made a pro-rata adjustment to his costings to look at the impact of raising the official retirement age to 67. This would be sufficient to make the whole gold-plated reform package broadly revenue neutral. In this case overall expenditure on the reform package would be around six per cent of GDP in 2050, *exactly the same as in the Government's base case*. In practice of course other elements of the reform package such as the phasing out of the State Second Pension could be traded-off against a larger increase in the official retirement age than the one suggested here.

Conclusions on the gold plated base case

It should be clear that we think that the reform package outlined here with a much greater role for a more generous universal Basic State Pension satisfies the objectives for the pensions system better than the Government's current settlement. The issue of whether adequacy for pensioners is best delivered through a means-tested or a universal approach is an empirical one. The current government has in effect balanced the two approaches. The MIG has been used to channel resources to the poorest elderly but at the same time the BSP has been increased in real terms and

Winter Fuel Payments and Free TV licences (for the over-75s) have been introduced on a universal basis. The 2001 Pre-Budget Report showed that around two-thirds of the overall gains for the average pensioner family from these policies had resulted from increases in *universal* benefits with the MIG actually playing the junior role (HM Treasury 2001c, p89). Government policy has thus been more pragmatic and more universalist than would have been expected at the time of the 1998 Green Paper. Rejecting the gold-plated reform on the grounds that it is too universalist would seem strangely ideological for a government that prides itself on implementing what works.

The government's strategy has, however, been essentially ad-hoc, with annual adjustments made to the pension settlement. The political attractions of this approach to the Chancellor might seem obvious. However, it means that people really cannot see how the system is supposed to evolve over the long-term, which is the necessary background against which they can make their own plans for retirement.

However, what is being suggested here as part of the gold plated base case – the indexation of the BSP in line with earnings – will raise concerns in Whitehall. Again, however, this cannot be a matter of principle. The 2001 Pre-Budget Report stated explicitly that 'The Government is committed to raising the MIG in line with earnings throughout this Parliament' (HM Treasury 2001c, page 88). It also stated that 'the age-related personal allowances will be raised in line with earnings rather than prices from 2003-04 and for the remainder of the Parliament' (HM Treasury 2001c, page 92). Earnings indexation is therefore firmly on the Government's agenda. If in principle you can earnings link the MIG and the age allowances then in principle you can earnings link the BSP. Which of these you want to do is an empirical matter and depends upon your view of the affordability constraint. And of course the effect of the ad-hoc increases in the BSP plus the Winter Fuel Allowances is that the universal element of pension provision has broadly been linked with the increase in earnings since 1998 anyway.

There is another feature of the gold-plated base case that is not explicit but needs to be addressed. The withdrawal of the rebates for contracting out would not in itself alter the relative attractiveness of final salary (defined benefit) as opposed to money purchase (defined contribution) occupational pensions. However, the ending of the rebates might bring forward the decisions of some companies to end final salary schemes. Whether this is a matter of concern depends on a judgement as to whether final salary schemes are capable of being saved. If you think that the actuarial arithmetic that appears to spell the eventual decline of final salary schemes is remorseless, then a reform that might give that process an extra push might be seen as regrettable but unavoidable.

The silver plated base case

One frequent confusion in the debate over pension or wider welfare reforms is the equating of targeting solely with means testing. The original universal benefits introduced by Beveridge were well-targeted on groups that by and large suffered from low incomes. This included the BSP as in 1945 most pensioners were poor. The fact that by the 1980s and 1990s this was no longer universally the case as many of the retired had good private incomes was one argument advanced for the retreat from the universalism embodied in a somewhat more generous BSP going to all. However, if certain groups of pensioners still suffer from higher levels of poverty, this might justify an increase in the BSP aimed only at these groups. This would be a form of targeted universalism.

The easiest way of enabling such targeting would be to increase the BSP for older pensioners who tend to have lower incomes.

Table 6.2 Percentages of pensioners living in households with relative low incomes by age of head of family *1999-2000*

	Below 50% of mean	*Below 60% of median*
Under 70	20	20
71-75	25	25
76-80	29	29
80+	30	30

Note: After housing costs

Source: Households Below Average Income series

This then is the argument for what we have described as the silver plated base case. This consists of raising the BSP to the level of the MIG and indexing it in line with earnings for those pensioners aged over 75. The BSP would remain price indexed for those aged 65-74 and other features of the current pensions settlement would remain in place, including the MIG and the Pension Credit that would still be playing an important role for the 65-74 age group, and the State Second Pension.

The available data on the income distribution allowed Hawksworth (2002) to only model an increase in the BSP for those over 75. This would raise direct public expenditure on pensions to 5.8 per cent of GDP in 2010-11 compared with 5.6 per cent in the Government's base case and 6.5 per cent in the gold plated base case with the State Second Pension still in place. In 2050 this option would see direct public expenditure on pensions rising to 7.3 per cent of GDP compared with 6 per cent in the Government's base case and 8.6 per cent in the gold plated base case. Unsurprisingly then the silver plated base case is more affordable than the gold plated base case but costs more than the Government's base case.

This reform option scores poorly on the goal of simplifying the system. In fact it adds another layer of complexity with people having to adjust their behaviour to the prospective jump in the BSP at age 75 in the context of a pensions system where all the other features remain intact. This hike in the BSP at age 75 is quite significant. Expressed in terms of benefit levels as they were in 2000, the BSP could be worth just £34 at age 65 in 2050 and would then leap to £92 at age 75. Such a skewed BSP does not seem sustainable.

Thus increasing the BSP to the level of the MIG for the over 75s as a more targeted measure to alleviate current pensioner poverty, does not really resolve one of the critical structural issues facing the current pension system: the future of the BSP for everyone. The silver plated base case looks like another sensible pragmatic short-term solution that does not really meet the objectives for a sustainable pensions settlement over the long-term.

Making the state second pension more generous

The fact that the Government's pension settlement now implies an increase in direct public expenditure on pensions allows a range of options other than increasing the BSP to be explored. To many the attractions of going down the route of making the State Second Pension more generous seem obvious. It appears to be more targeted than a straightforward increase in the BSP, having been explicitly designed to be more generous to the lower paid when compared with the SERPS that it is planned to replace.

Modelling an increase in the State Second Pension is, however, rather difficult. Hawksworth (2002) assumes that the savings credit rate in the Pension Credit is reduced steadily from 60 per cent in 2010 to zero by 2050. The resources saved are used to increase spending on the State Second Pension so that it costs twice as much by 2050 (that is, 2.4 per cent of GDP as against 1.2 per cent of GDP in the Government's base case). To the extent that this extra money is focussed on those poorer pensioners who opt for the State Second Pension, this would lift them above the MIG. This reform option *appears* to turn out cheaper than the Government's base case, with *direct* public expenditure running at just five per cent of GDP in 2050 as against six per cent of GDP. Phasing out the Pension Credit saves some resources and the more generous State Second Pension reduces the cost of the MIG.

However, a more generous State Second Pension would need to be accompanied by more generous rebates for opting out otherwise more people will stay in the State Second Pension inflating its direct costs. The extra costs of the rebates cannot be modelled. However, a rule of thumb might be that a doubling of the value of the State Second Pension would need to be accompanied by a doubling of the cost of the rebates. These already cost 0.9 per cent of GDP in 2000-01. This would effectively make the total cost to the exchequer of this reform package similar to the cost of the Government's base case (Hawksworth 2002).

Falkingham *et al* (2002) also model an increase in the State Second Pension paid for by phasing out the Pension Credit. They point out that any increase in the State Second Pension would have to be considerable for people to avoid means testing in retirement. They also note that the more generous the State Second Pension is the more likely it is that the stakeholder target group will opt back in, thus increasing the direct expenditure costs to the state.

This reform package scores poorly against the objective of increasing the clarity of the system, though it does allow the Pension Credit to be phased out eventually. Moreover, the history of SERPS is salutary. It might be relatively easy for a future government to once again reduce the generosity of the State Second Pension safe in the knowledge that few might object because so few understand the system.

Conclusions

The results from the modelling exercises discussed here lead to the conclusion that it is possible to design an alternative pensions settlement that would better meet the key objectives against which any system should be measured.

The current pensions settlement ensures an adequate income for those who claim the MIG and will claim the Pension Credit, but with the drawback of considerable complexity and a very large role for means-testing with the associated problems in terms of take-up, incentives and people's sense of the equity of the system.

The gold plated base case, including the phasing out of state second pension provision and a modest raising of the official retirement age to 67 by 2030, best satisfies the key objectives we have set. Setting the Basic State Pension at £100 in 2003-04 prices will (along with the Winter Fuel Payments and other supplements to the Basic Pension) give all those with a full contributions record a non-means tested income at around the 'low cost but acceptable' benchmark for the incomes of the elderly. It will be just above the quasi-official poverty line of 60 per cent of median household income after housing costs. It will satisfy the objective of securing **adequacy**, albeit at a level of income few will regard as overly generous.

Importantly, it will do this without the complexities of the existing policy regime. The overall pensions system will be significantly simpler, assuring adequacy without involving significant means-testing or a complex and ill-understood state second pension. The proposed increase in the state retirement age to 67 will occur in the decade after the official retirement age for women has increased from 60 to 65, which should make the reform easier for people to comprehend. It thus scores highly in terms of the **clarity** and **transparency** of the overall pension settlement.

Box 6.1 Summary assessment of alternative state pensions policy options

Hawksworth (2002) explicitly scores the four different models against the four key objectives we have identified for the pensions system. The government base case scores poorly in terms of certainty and transparency when compared with the gold plated case. The gold plated case is nevertheless as affordable as the Government's model when combined with the phasing out of the State Second Pension and the associated rebates and the increase in the retirement age to 67 by 2030.

*Options**	*Affordability (cost as % of GDP in 2050)*	*Adequacy (minimum income levels)*	*Incentives to save for own retirement*	*Certainty and transparency index (best = 6, worst =1)**
Government's base case	6.0	moderate/high	PC better for low earners/worse for moderate earners	1
– without PC	4.8	moderate	poor for low earners	2
Gold plated base case (BSP=MIG for all)	8.6	very high	no means-testing but income effect could be negative	4
– with no S2P	6.7**	high	similar to above	6
– retire at 67 from 2030 and no S2P	6.0**	high for 67+/ low for 65-66s	similar to above	5
Silver plated base case (BSP=MIG at 75)	7.3	very high for 75+, high for others	means-testing retained for under-75s	3
Higher S2P and no PC	5.0***	high	less means testing should boost incentives	3

* PwC Index: Maximum score set at six for option 2b as this has no means-testing and no complex second state pension arrangements. For other options, up to three points deducted for the degree of means-testing and two points for options where the State Second Pension is retained. An additional one point deduction is made where the state retirement age is increased (due to the disruption to pensions planning).

** Including the savings from abolition of NIC rebates assumed to be 0.9 per cent of GDP each year.

***Excluding the cost of NIC rebates for those opting out of the State Second Pension, which could be significantly higher under this option.

Source: Hawksworth 2002

This can be illustrated by showing how far the proposed new settlement would significantly lower the need for potentially costly advice. Referring back to the simple framework outlined earlier for thinking about the different forms of advice needed by individuals:

- the question of *whether to save* should at least be significantly simplified by people having clearer expectations about what the state will provide in a non-means tested manner

- the question of *how much to save* would be unresolved and is discussed further below in the context of questions in relation to the issue of compulsion
- the question of *where to save* would be significantly simplified by the phasing out of the State Second Pension and equity based ISAs leaving funded pensions vehicles as the only form of tax-favoured equity based saving
- the question of *whether to contract out* of the State Second Pension or not would become redundant as the state would withdraw from second pension provision.

In these circumstances the questions of *who should provide* and *who should pay for* advice would become much less important. Overall the costs of providing advice should decline significantly – a major additional benefit of introducing a clearer and more transparent system.

The overall reform package favoured here passes the **affordability** test as well as the Government's pensions settlement, as we have tried to make the package broadly revenue neutral. The overall costs to the exchequer rise to around six per cent of GDP by 2050, but this is the same as the projected costs of the Government's settlement including the Pension Credit. Under that settlement the Government is confident that 'Over the longer term, the forecast spending on pensions remains affordable and sustainable' (DWP November 2001, page 7). The reform package suggested here is likewise affordable and sustainable.

In terms of the impact of the proposed reform package on **incentives**, the greater clarity and transparency of the system and the reduction in the prevalence of means-testing should give clearer incentives for people to save for their own retirement. However, offsetting this, the more generous Basic State Pension might have what economists would term a negative income effect, that is some people might save less given the extra income guaranteed to them by the state. As the Basic State Pension would still be set at a very modest level and most people would want to retire on a significantly higher income, those with the means would still face a clear incentive to save in a second tier pension vehicle.

Compulsion

The reform package would of course remove the option of paying into the state second pension and the associated rebates to those contracting out. The second tier vehicles that people could save into would be the various private funded options: occupational, personal and stakeholder pensions. Personal and stakeholder pensions could no longer rely on being fed by the rebates. A key question left unresolved is whether there should be **compulsion** to contribute to a private funded pension.

The reform package suggested by the Pensions Reform Group (Field *et al* 2001) gave a clear answer to the question of compulsion. This group advanced a similar analysis of the problems with the current pensions settlement as presented here and suggested that government policy, with its heavy reliance on means-testing, could be summed up as telling people 'don't save, but don't be too sure about relying on us either' (Field *et al* 2001, page 38). Their proposal for a Universal Protected Pension represented a hybrid of the pay-as-you-go Basic State Pension and a new, state administered (at arms length), strongly redistributive, funded, defined benefit scheme. The overall pension paid out would be much more generous than the enhanced Basic State Pension suggested here. However, this would be paid for by a significant increase in national insurance contribution rates, with these contributions diverted into the funded part of the scheme. This would represent a clear increase in compulsion.

In the gold plated reform package outlined here there could effectively be *less* compulsion, unless individuals were compelled to make minimum payments into some form of private funded pension. People would continue to pay the current contracted-in contribution rates but would lose their rebates for contracting out. Those personal pension pots fed solely by the rebates would now require people to add their own private savings on a voluntary basis if they were not to be effectively frozen in terms of new contributions. This could worry many of the providers of personal and stakeholder pensions, though they now feel obliged *not* to persuade most people to opt-out and fund their pension pots through the rebates. Some providers would advocate some level of compulsion, in terms of minimum individual contributions into funded pensions, doubting that the greater clarity and transparency of the proposed reforms would in itself allow providers to more effectively market their products. These providers also make the point that where employers make a contribution this can be just the incentive necessary for individuals to take up, say a Stakeholder, and contribute as well.

This discussion raises the issue of whether the state should compel employers to make contributions to their employee's pensions, whether they are occupational, personal or stakeholder pensions. Such compulsion does not exist in the current system, though many employers do of course contribute voluntarily. We have, however, seen that the manner and scale of those voluntary employer contributions appears to be changing significantly, with the decline of traditional defined benefit or final salary schemes and a switch to defined contribution schemes often with lower employer contributions. It was emphasised that it was not the switch itself which was the *cause* of lower employer contributions, rather a range of pressures were causing firms to lower their contribution rates and a switch to a defined contribution scheme was the *means* to achieve this. It was also emphasised that the true incidence of employer contributions should in an efficient labour market fall on employees in the form of lower gross wages.

Nevertheless there may be significant attractions in terms of presentation of there being a new contract between the employer and the employee to match the new contract being suggested here between the state and the individual, with employers and employees both paying into a funded pension. The question is whether this new contract between the employer and the employee should be underpinned by compulsion, as by definition would be the contract between the state and the individual with its more generous taxpayer financed pay-as-you-go Basic State Pension.

One problem with compulsory *minimum* employer and employee contributions into a funded pension is that this can become the *norm* for contributions rather than the floor, with the potential that current contributions above the minimum could fall towards it. Another objection is that over the life-cycle it is not necessarily optimal for an individual to be making compulsory contributions to a funded pension year-in and year-out, rather than reducing their debts or saving in some other way. One objection in principle to such compulsion is that the State has no right to tell any individual how much and in what ways to save, in the absence of external costs being imposed on the rest of society. One reason why some people advocate greater compulsion in the first place is so individuals do not rely on receiving means-tested benefits in retirement. However, in a pension settlement where the role of means-testing is residualised, the need to avoid such 'moral hazard' is also minimised.

A key argument in relation to compulsion must be that many employers will continue to provide a pensions contribution to their employees as part of the employment contract, albeit inevitably at a lower level of contributions than today. Providers should be able to convince individuals to make contributions, pointing out that although the enhanced Basic State Pension will remove the perceived penalty to saving, it will itself only provide a bare minimum income. The income effect of a higher Basic State Pension in reducing saving is likely to be modest precisely because the Basic State Pension will itself remain quite modest. It is not possible to say whether total private savings will go up or not under this reform package without further compulsion, but then that is not a first order goal for any pensions reform. On balance the proposed pensions settlement may work without additional compulsion, though it is likely that this would be an issue that policy makers would want to come back to at some point in the medium term.

Incentives

The debate on compulsion is perhaps jumping the gun. Clearly, the alternative strategy to compulsion is to make the existing emphasis on incentives work better for more people. It has been recognised that the current reliance on tax relief as the sole saving incentive does not work for many people, particularly those on low incomes. In their broader savings strategy, the Government is pursuing this approach and developing new means of incentivising people to save. We have already referred to the Savings Gateway and the Child Trust Fund, which include the notion of 'matched' contributions and kick-start capital endowments respectively. These policies are still being consulted upon so it is early days on how public policy can be more creative in the incentives it offers to get people to save. In the pensions arena, we need to learn from this wider debate and perhaps think more imaginatively about new or reformed incentives, before considering compulsion. A framework of coherent incentives might fit better with British culture and the evolution of our welfare state, and would also avoid some of the problems with compulsion identified above.

Assessed against our objectives for pensions reform the proposals of the Pension Reform Group (Field *et al* 2001) score highly in terms of adequacy for *future* pensioners. However, in itself the proposed Universal Protected Pension does not do anything for *current* poor pensioners. This is why in addition Field *et al* (2001) suggested that there are significant increases in the Basic State Pension for the over 75s and over 80s (a variation of our silver plated base case). Their proposals score highly in terms of the improvement in incentives to save, in so far as the incidence of means testing is reduced, but there is in addition of course the greater compulsion to save anyway. The proposals are clearly affordable in that the reforms are fully funded and the proposed variation on the silver plated base case would not be too costly. However, the proposals do not meet the objective of introducing greater clarity and transparency into the system, as they – intentionally – involve a significant departure from the system as it has evolved over the post-war period and with which people are familiar. A more generous Basic State Pension by its very simplicity would seem more likely to generate sustained popular support than a more wholesale reform that might be hard to explain.

Indeed it is the fact that the gold-plated base case builds on the existing settlement and its most widely recognised feature – the Basic State Pension – that may be its strongest point.

7. Long-term care policy: options and analysis

The key problems we have identified with the current long-term care settlement are

- The future costs of long-term care are uncertain and may be high.
- The means test is widely perceived to be unfair, particularly in its treatment of housing equity.
- The boundary between nursing and personal care is difficult to draw and operationalise, and this may lead to inefficient service provision.
- The difference in the consequences of developing cancer or heart disease versus Alzheimer's or Motor Neurone Disease, in terms of the individual's requirement to pay for their treatment subject to a means test, is widely perceived to be inequitable.

Is it possible to design an alternative settlement that would better meet the key objectives that we think any system of long-term care should be measured against? To re-cap, these first order objectives are:

- To provide everyone with a high standard of care which is appropriate to their need.
- To design a funding system which is both fair and seen to be fair.
- To ensure that policy choices do not set up unsustainable future costs.
- To design a system which is clearly understood, publicly supported and does not contain unwelcome incentive effects.

This report is concerned primarily with the funding of pensions and long-term care, and not directly with questions of provision. As such there are many issues that are central to the primary objective of providing a high standard of care but which we do not address here. For example, we will not discuss the appropriate organisation of older people's services or the way in which older people's care needs should be determined. However, many aspects of long-term care provision are closely bound up with questions of funding and have historically suffered because of inappropriate funding boundaries.

The recent debate over the funding of long-term care has been dominated by the Royal Commission on Long Term Care and the Government's response to its recommendations. We have found ourselves returning to the fundamental question of whether personal care should be provided free or on the current basis of a means test.

The Government argument has been that those who can pay for their personal care should pay from their own resources. However, there are fundamental problems with this position. The foremost is that it is intuitively unfair that individuals should suffer such different financial consequences from falling ill with cancer and falling ill with Alzheimer's. It is almost impossible to argue that the personal care required by an individual with severe dementia, or motor-neurone disease, is not health care: without such care their health will worsen and they will eventually die because of their illness. There is thus a clear inconsistency in the treatment of some of the diseases of old age as compared to the diseases of earlier life. This is one strong argument that the current arrangements do not represent the fairest way of funding provision.

In addition, if nursing and personal care were provided free on the basis of need then some of the practical difficulties of providing the most appropriate care would be ameliorated. In particular, the boundary between nursing and personal care would not need to be implemented in the way it is at the moment. Nurses would not have to make choices about delegating tasks to care assistants in the knowledge that this had financial implications for the individual being cared for. The requirement to assess the need of long-term care recipients will remain whatever funding system is in use. However, the abolition of the nursing/personal care divide could remove a layer of complexity whereby two specific and difficult to define categories of need have to be assessed. We are not clear why the Scottish Executive proposes to retain the boundary whilst making personal care free. Not only are there difficulties with clearly distinguishing nursing and personal care, but these difficulties are likely to become more acute over time as care practice evolves.

Public attitudes to the funding of long-term care are complex and difficult to interpret. It is clear from the qualitative and quantitative research described in Chapter Five that many people deeply resent the operation of the current means test, and particularly its treatment of housing equity as a relevant asset. The operation of the means test does not appear to act as a disincentive to asset accumulation, but our own research uncovered evidence that it may act as an incentive to behaviour such as the gifting of assets to relatives. It is very difficult to decipher attitudes to the personal/nursing care divide both because this is not a distinction which is well understood by the general public and because of its very recent introduction. Some individuals do indicate that they believe a contribution towards the cost of care in old age is reasonable. This may be an intuitive appreciation that some of the costs of care are simply living costs rather than health care costs, but this must remain uncertain at least until the current systems are more familiar to the public. However, the current arrangements have undoubtedly proved difficult to explain and defend in a clear and simple manner, and this has resulted in a failure to generate understanding and public support.

Serious concerns were raised at the time of the Royal Commission's report that making personal care free would be excessively expensive. As we have noted earlier, the Government did not publicly reject the proposal for this reason, but by claiming that there were better uses for the equivalent resources made an indirect argument about affordability. Concerns over the future costs of long-term care, and over the costs of making personal care free, do need to be taken seriously. However, we should distinguish carefully between the total future costs, the future public costs, and the incremental public costs of making personal care free. Given the foregoing arguments we have felt it necessary to re-examine these likely future costs, taking into account the concerns that have been raised since the publication of the Royal Commission's recommendations.

Costs of care in the future

Future long-term care costs are uncertain and sensitive to factors which are difficult to predict. Assuming individuals receive the treatment that they need, the total cost of long-term care is determined by factors like life expectancy, age and gender specific dependency rates,[25] provision of informal care and the unit costs of formal care. We need to examine the sensitivity of total care costs to these underlying factors to determine the affordability of future long-term care provision. Long-term care policy may also affect the total costs of care, but principally determines the division of such costs between public and private funding sources.

The following work draws extensively on research that the Personal Social Services Research Unit at the London School of Economics, and the Nuffield Community Care Studies Unit at the University of Leicester have carried out for IPPR in modelling the demand for long-term care in the UK (Wittenberg *et al* 2002). It should be noted that IPPR's policy conclusions are not the responsibility of these external partners. The central base case projections assume:

- That the number of older people by age, gender and marital status will change over time in line with the Government Actuary's Department latest projections.
- That dependency rates by age and gender will remain constant over the next 50 years, that is, a 70 year old woman in 2050 is assumed to have the same risk of ill health as a 70 year old woman in 2000. This is a cautious assumption given the likelihood of at least some improvements in age and gender specific dependency rates.
- There is a steady state assumption regarding the propensity within marital status groups to live with others.
- The level and pattern of care use according to gender, age, dependency, household type and housing tenure is assumed to remain constant over time.
- GDP grows at 2.25 per cent per year in real terms.

- Real unit costs are assumed to rise by 1.5 per cent per annum for health care and by one per cent per annum for social care.

These are very similar to the base case assumptions used by the Royal Commission on Long Term Care, for which PSSRU also carried out the core cost modelling work. The NCCSU model also assumes:

- That state pensions and other non-means tested benefits rise in line with inflation at 2.5 per cent per annum, whilst income support rates and real earnings rise two per cent per annum faster, that is at two per cent per annum in real terms.

The central base case assumes that the policies announced to the end of 2001 have been implemented by 2000 and then unchanged for the duration of the projections. The one exception to this treatment is that the Pension Credit is not incorporated in the modelling: this might have a small effect on the balance between public and private funding.[26] The resulting cost projections have been briefly introduced in Chapter 2 of this report:

Table 7.1 Central base case projections of public and private spending on long-term care in the UK 2000-2051 *% of GDP*

	2000	*2005*	*2010*	*2020*	*2031*	*2041*	*2051*
% GDP public	0.94	0.92	0.88	0.91	1.03	1.08	1.06
% GDP private	0.44	0.43	0.45	0.47	0.52	0.55	0.55
% GDP total	1.39	1.35	1.33	1.38	1.56	1.63	1.61

Source: PSSRU/NCCSU model projections

The central base case thus indicates stable total costs at just below 1.4 per cent of GDP until 2020, growth of 0.25 per cent of GDP between 2020 and 2040 and then a levelling out at just over 1.6 per cent of GDP from 2041 to 2051. Public costs indicate a very similar pattern of stability at around 0.9 per cent of GDP to 2020, growth to 2040 and levelling off thereafter at just over one per cent of GDP. There is a slight rise over time in the proportion of total costs which are met privately, the main reason for which is rising owner-occupation rates among older people. The central base case does not project an explosion of costs to the state, rather a very modest and manageable increase.

PSSRU/NCCSU have modelled three key sets of variations on these projections for IPPR. The first set examines the sensitivity of the base case projections to changes in factors which are predominantly exogenous to long-term care policy. The second set examines the way in which changing patterns of care, for example changes in the provision of informal care, affect costs. The third and final set investigates the effect of changes to the funding system, and particularly the way in which public funding of all personal care affects the balance between public and private expenditure.

Changes in factors exogenous to long-term care policy

Life expectancy, dependency, and unit costs are all exogenous to long-term care policy: they are not directly affected by governmental decisions over the funding or provision of long-term care. This is not to say that they are unaffected by other policy areas. Life expectancy and dependency might be altered by other areas of health policy: this has certainly been the case in the long run over the last century.

Unit costs are significantly affected by government policy over the pay of nurses and carer staff. For example, the Department of Health is likely to remain a key negotiating party to national pay agreements. Government could also specify care standards which increased the demand for staff, potentially driving up wages. The national minimum wage, which is set by the Secretary of State for Trade and Industry, is another important driver of costs in the health and social care sector. The average hourly wage of care assistants in 1998 was £4.57 (Henwood 2001) which was only modestly above the level of £3.60 at which the minimum wage was introduced in April 1999 on the recommendation of the Low Pay Commission. Increases may thus directly raise the wages of the lowest paid workers in the care sector, and may also marginally affect those earning wages slightly above the minimum level.

Life expectancy

Future life expectancies are a key parameter in determining the number of elderly people potentially needing care. PSSRU's modelling draws on the Government Actuary's Department population projections, with the base case using the 2000-based central projections. In the past, projections of life expectancy have tended to be underestimates, so that the actual number of those over 85 years old has tended to rise around one per cent per year faster than in official projections (Shaw 1994). Whilst the latest projections use a new methodology, PSSRU has also modelled costs on the basis of a range of different assumptions. The most pessimistic in terms of life expectancy uses the Government Actuary's 'low life expectancy' projections which assume that mortality rates will be constant by 2032. The most optimistic corresponds to the rate of previous underestimation, and a slightly less optimistic scenario uses the Government Actuary's 'high life expectancy' case.[27]

Even by the end of the 50 year period modelled in Table 7.2, the Government Actuary's high and low life expectancy projections imply a relatively narrow range of cost outcomes. Only the assumption of continued significant underestimation of the number of very elderly people by the official projections has a significant impact, raising annual costs by an additional 0.32 per cent of GDP by 2051 over those for the central base case. It is important to recognise that this would impact on both public

Table 7.2 Life expectancy sensitivities

	2000	*2005*	*2010*	*2020*	*2031*	*2041*	*2051*
Central base case: GAD principal projections							
% GDP (public and private)	1.39	1.35	1.33	1.38	1.56	1.63	1.61
Difference from the central base case:							
GAD low life expectancy case	0.00	-0.01	-0.02	-0.05	-0.10	-0.16	-0.21
GAD high life expectancy case	0.00	0.02	0.02	0.04	0.08	0.14	0.17
Numbers of those 85 and over rise 1% per year faster than base case	0.01	0.04	0.07	0.14	0.26	0.29	0.32

Source: PSSRU/NCCSU model projections

and private funding, with public expenditure rising by 0.2 per cent of GDP and private expenditure rising by 0.12 per cent of GDP above the base case.

Dependency rates

Another important determinant of costs is the future health of older people. Because this is difficult to predict, our base case makes a conservative assumption that age and gender specific dependency rates remain constant from 2000 to 2051. Once again PSSRU has modelled a range of assumptions ranging from pessimistic to optimistic. The most pessimistic case shown here is that age specific dependency rates rise by one per cent per year, that is, that people get progressively less healthy earlier in their lives. A more optimistic assumption than the conservative base case is described as the 'Brookings' scenario after the work carried out at the Brookings Institution (Wiener *et al* 1994). In this scenario, 'as life expectancy rises, years without dependency rise by the same amount, whilst years with dependency remain constant' (Wittenberg *et al* 2002). In other words, as generations live longer they experience the same period of relative disablement as previous, shorter lived generations. They thus experience longer periods of good health. The most optimistic scenario shown here assumes a one per cent decrease in dependency rates per year. Note that all changes are assumed to have occurred by 2031, with dependency rates constant from then onwards.

The increased dependency case modelled in Table 7.3 has a significant impact on future costs, but it should be considered an unduly pessimistic case in terms of health outcomes. The Brookings scenario reduces cost relative to the central base case by 0.17 per cent of GDP by 2051, whilst the decreased dependency case has about double this effect.

Table 7.3 Dependency sensitivities

	2000	*2005*	*2010*	*2020*	*2031*	*2041*	*2051*
Central base case: no change in dependency rates							
% GDP (public and private)	1.39	1.35	1.33	1.38	1.56	1.63	1.61
Difference from the central base case:							
Increased dependency	0.00	0.06	0.11	0.25	0.46	0.48	0.48
Brookings Scenario	0.00	-0.02	-0.04	-0.09	-0.15	-0.16	-0.17
Decreased dependency	0.00	-0.05	-0.10	-0.20	-0.34	-0.36	-0.35

Source: PSSRU/NCCSU model projections

Unit costs of health and social care

One of the most important factors affecting the total cost of long-term care is the unit cost of provision, for example the cost of an hour of nursing care at home or a week's stay for an individual in a residential home. Providing long-term care is labour intensive, so a key driver of unit costs is wages of caring staff. Another important factor is the technical efficiency of provision. On the one hand, increases in technical efficiency might mean reductions in the cost of providing a specific caring activity, for example because of more effective management of labour. On the other hand, increases in technical efficiency might mean also more effective or appropriate care, reducing the average cost of care provided. Our central bases case assumes that health care costs rise by 1.5 per cent per year in real terms whilst social care costs rise by one per cent per year in real terms. These figures assume a continuation of the trends of the past 15 years for pay and prices. The low case assumes no real terms increase in unit costs, and the high case assumes two per cent increases for both health and social care. This higher figure is used as the long run assumption for average real earnings growth elsewhere in this report. However, it represents a high case here because sector wages are only one element, although an important one, of

Table 7.4 Unit cost sensitivities

	2000	*2005*	*2010*	*2020*	*2031*	*2041*	*2051*
Central base case: 1.5% pa health care, 1% pa social care increases							
% GDP (public and private)	1.39	1.35	1.33	1.38	1.56	1.63	1.61
Difference from the central base case:							
Low case: no real rise	0.00	-0.07	-0.14	-0.28	-0.46	-0.60	-0.70
High case: 2% pa real rise	0.00	0.06	0.12	0.25	0.47	0.67	0.87

Source: PSSRU/NCCSU model projections

sector unit costs. A long-term increase in unit costs of two per cent per year thus assumes greater than two per cent increases in wages and no offsetting increases in technical efficiency of provision. This is a pessimistic view of long run unit costs.

The unit cost sensitivities examined here have a much greater impact on total costs than either the life expectancy or dependency variations examined earlier. Compared to the central base case, our high unit cost assumptions increase total expenditure by almost 0.9 per cent of GDP by the end of the period. The unit costs of care are a critical variable in assessing the affordability of long-term care policy.

The three base cases: central, low and high

Several exogenous factors could simultaneously diverge from the central base case assumptions. Because the number of possible combinations is large, three different base cases have been constructed using three sets of assumptions about exogenous factors. The central base case makes the assumptions which are indicated as the base case in each of the previous three sets of sensitivity analyses.[28] The high base case chooses a set of assumptions which lead to higher costs, and vice versa for the low base case. Box 7.1 summarises these assumptions.

Box 7.1

Central base case assumptions:
- GAD principal population projections
- Dependency rates remain unchanged
- Unit costs rise by 1.5 per cent per year for health care and 1 per cent per year for social care in real terms

Low base case assumptions:
- GAD low life expectancy projections
- Dependency rates fall in line with 'Brookings' scenario
- Unit costs rise by 1.5 per cent per year for health care and 1 per cent per year for social care in real terms

High base case assumptions:
- GAD high life expectancy projections
- Dependency rates remain unchanged
- Unit costs rise by two per cent per year in real terms

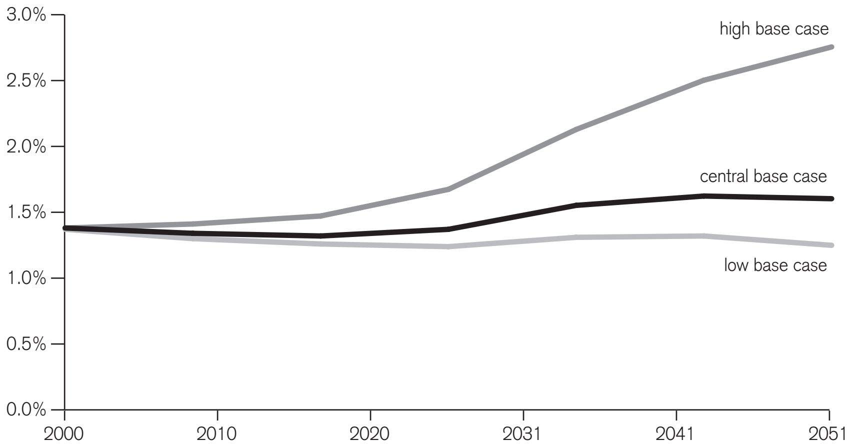
It should be noted that we are not attempting to *predict* future costs of long-term care. Instead we are attempting to *project* these costs on the basis of a model and a set of assumptions. There is inevitably uncertainty about these assumptions, and it is almost certain that future spending will not in fact match the central base case projections. In addition, costs projected for the distant future are less certain than those for nearer time periods. Despite these caveats, we believe that the central base case represents a reasonable set of assumptions, and further, that the PSSRU/NCCSU projections represent the best available guide to the likely future costs of long-term care. The range of costs implied by the three base cases is shown in Table 7.5.

Table 7.5 Total public and private long-term care spending as % of GDP

	2000	*2005*	*2010*	*2020*	*2031*	*2041*	*2051*
Central base case	1.39%	1.35%	1.33%	1.38%	1.56%	1.63%	1.61%
Low base case	1.38%	1.31%	1.27%	1.25%	1.32%	1.33%	1.26%
High base case	1.39%	1.42%	1.48%	1.68%	2.13%	2.50%	2.75%

Source: PSSRU/NCCSU model projections

Figure 7.1 Total public and private long-term care spending as % of GDP



Source: PSSRU/NCCSU model projections

The PSSRU/NCCSU model in Figure 7.1 also allows total costs to be allocated between private and public funding sources. Some health care costs are allocated directly to the NHS, and private expenditure is allocated directly to service users. The expenditure on other social services is divided between local authorities and service users by simulating the operation of the charging and means testing regimes (see Wittenberg *et al* 2002 for further detail). Table 7.6 summarises the public costs for the three base cases on the assumption of a continuation of current charging and means testing policies.

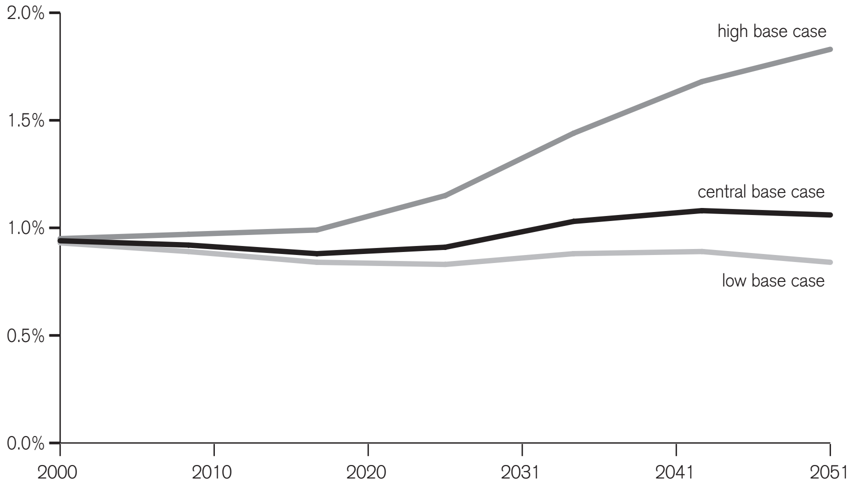
There is little divergence between the three base cases until 2010: in this year public spending under the high base case assumptions is just 0.1 per cent of GDP above the central base case, with total spending 0.15 per cent of GDP higher. After this the divergence between the central and high base cases becomes progressively

Table 7.6 Public long-term care spending as % of GDP

	2000	*2005*	*2010*	*2020*	*2031*	*2041*	*2051*
Central base case	0.94	0.92	0.88	0.91	1.03	1.08	1.06
Low base case	0.93	0.89	0.84	0.83	0.88	0.89	0.84
High base case	0.95	0.97	0.99	1.15	1.44	1.68	1.83

Source: PSSRU/NCCSU model projections

Figure 7.2 Public long-term care spending as % of GDP



Source: PSSRU/NCCSU model projections

larger. By the end of 50 years total spending is 1.14 per cent of GDP higher and public spending is nearly 0.8 per cent of GDP greater under the high base case assumptions than under the central base case. This would represent a dramatic increase in costs to the state, driven principally by increases in the unit costs of care.

Changes in patterns of care

The base cases described above take account of changes in marital status. This affects the likelihood of an individual receiving informal care, and therefore affects the likelihood of needing formal care. For example, elderly individuals with partners are less likely to need residential care than those living alone, because spouses are a key source of informal care which may delay the requirement for formal residential care.

What the base cases do not incorporate are changing patterns of care. The PSSRU model projects numbers of older people by various categories of dependency, household status etc, and then allocates a probability of needing particular care services to each group. These probabilities are estimated from past data, and do not change with time in the base case scenarios.

Patterns of care may change for various reasons. They may change because of factors largely outside the control of government, for example because of a fall in the number of dependent elderly living with their children. Patterns of care may change as an intended result of government policy, for example because of the longstanding drive to shift the balance from residential to domiciliary care. Patterns of care may also change as result of changes in policy concerning payment for long-term care. For example, the note of dissent to the Royal Commission's report suggested that introducing free personal care could lead to a reduction in informal care and an increase in the demand for formal care. The effects of changes in policy concerning payment for care will be considered later in this report. Our focus here is on the first two types of change.

At present, those who live with others are more likely to receive informal care and less likely to enter residential care than those who live alone. PSSRU/NCCSU have modelled the effect of a decline by one third in the proportion of single dependant elderly people who move in with their children, with this decline assumed to have taken place by 2031. They have also made cost projections on the much more pessimistic basis that dependent elderly people living with others, including their own spouse, are just as likely to enter residential care as those who live alone. Both of these scenarios simulate a fall in the provision of informal care which is exogenous to government policy.

Informal carers are often themselves elderly and in relatively poor health, and government policy recognises that carers require more support than they have previously received. PSSRU has modelled this change by projecting the effect of giving dependent older people with carers the same package of non-residential services as older people living alone. Such a system is described as 'carer-blind' (Twig and Atkin 1994). Supporting carers in this way may delay or prevent the more dependant partner's admission to residential care, but this benefit is not modelled in the carer blind scenario. However, a series of scenarios which do recognise potential shifts in the future from institutional to domiciliary care have been modelled. Such a shift would be consistent with government policy (Department of Health 2000a), and would also be consistent with the widespread desire amongst older people to stay in their own home rather than enter residential care wherever possible (Royal Commission on Long Term Care 1999). Table 7.7 summarises the effect of these changes to the pattern of care.

The most striking thing about Table 7.7 is the relatively small impact of changing assumptions about the future pattern of care. Only the 'carer blind' and 'increased chance of residential care' scenarios have any significant impact on total or public spending. It should be noted that the first of these makes the very conservative assumption that there is no benefit, in terms of reducing the need for residential care, from increasing the supply of non-residential support. As indicated above, the NHS Plan makes the assumption that there is such a benefit.

Table 7.7 Changes in patterns of care

	2000	*2005*	*2010*	*2020*	*2031*	*2041*	*2051*
Central base case							
Total costs % GDP	1.39	1.35	1.33	1.38	1.56	1.63	1.61
Public costs % GDP	0.94	0.92	0.88	0.91	1.03	1.08	1.06
Difference from the central base case:							
Decline in dependant elderly living with their children							
Change in total costs %	0.00	0.01	0.01	0.02	0.04	0.04	0.04
Change in public costs %	0.00	0.00	0.01	0.01	0.02	0.02	0.02
Increased chance of residential care							
Change in total costs %	0.00	0.03	0.06	0.13	0.22	0.22	0.20
Change in public costs %	0.00	0.01	0.03	0.07	0.13	0.13	0.11
Carer blind scenario							
Change in total costs %	0.00	0.02	0.04	0.09	0.16	0.16	0.15
Change in public costs %	0.00	0.01	0.04	0.08	0.14	0.14	0.13
10% shift from residential to non-residential care							
Change in total costs %	0.00	-0.02	-0.03	-0.07	-0.07	-0.07	-0.07
Change in public costs %	0.00	-0.01	-0.01	-0.01	-0.01	-0.02	-0.01

Source: PSSRU/NCCSU model projections

The 'increased chance of residential care' scenario makes another very conservative assumption: that dependant elderly people living with others are equally likely to enter residential care as those living alone. In practice it is highly likely that those living with others, especially their spouses, will receive at least some informal care which should reduce their chances of entering a residential or nursing home.

IPPR's qualitative research programme specifically investigated attitudes towards caring and being cared for in an attempt to shed light on the likelihood of patterns of such care changing. The research demonstrated a consensus across generations that providing care informally for others is a good thing, an important social duty and a responsibility that goes hand in hand with being part of a family. A significant gender bias did, however, exist. While men did refer to taking on support roles it was evident from their comments that the bulk of the physical caring work was being taken on by their wives or sisters. The women respondents also tended to talk in more emotional terms about the importance of their role in providing care for parents and partners. In terms of whether they expected to care for their own parents, many in the 30 to 45 year age group (the youngest in our survey) repeated the sentiments of older generations: that providing care, particularly for partners, would be something that came naturally. These individuals were no less committed to the principle of providing informal care than those from older generations.

There was a widespread recognition of the burden of responsibility that comes with providing care, and of the potential obstacles to doing so. These were identified as proximity of residence to the person in need of care, the degree of care required, and the pressure of work on the potential carer. One area where a difference in age groups was particularly apparent was in attitudes to receiving care: whilst older age groups expected and were comfortable with receiving informal care from relatives, the younger groups often said they would prefer to receive formal care.

Changing the funding system

Nursing care

The Government's response to the Royal Commission accepted the recommendation that the nursing element of long-term care should be free in all settings. Free nursing care is now being implemented in England. As noted earlier in the report, individuals will be assessed and classified into one of three levels of need corresponding to three weekly payment bands of £35, £70 and £110 for 2001. The average payment is expected to be £85. The situation in Wales is different: the National Assembly there has decided to introduce a flat rate system allocating £100 to each person requiring nursing care. In Scotland the proposed system is different again: in addition to banded payments for personal care, those requiring nursing care will receive a flat rate £65 to cover these additional costs. For the central base case UK projections of long-term care costs, PSSRU have assumed an average UK wide figure of £85 per individual requiring nursing care.

To test the sensitivity of the projections to changes in this amount PSSRU have also examined the case where the entire UK adopts a flat rate payment of £110. The effect of this variation on total costs relative to the central base case is negligible, because nursing care is still assumed to be delivered on the basis of need rather than funding. Concerns have been raised in some quarters that the provision of additional public funds for nursing care could cause owners of nursing homes to raise their fees, in particular because the money for free nursing care is being paid to the nursing home rather than the individual. However, it is difficult to predict the extent to which providers will be able to take advantage of the new money like this or whether competition will limit such effects. We assume that payments for nursing care effectively reduce payments for individuals. The only effect of increasing the generosity of this payment is thus to shift a small amount of the funding requirement from private to public sources, increasing public spending by 0.02 per cent of GDP by 2051.

Personal care

The key recommendation of the Royal Commission was that nursing and personal care should be exempted from means testing: that these should be free for the individual on the basis of assessed need.[29] This recommendation was rejected by the

Government, and by the note of dissent in the Commission's report, on the grounds that it was potentially very expensive and it did not represent the best use of available resources.

As a result of the equity arguments in favour of treating personal care like other health care, and because of the unfortunate new boundary that has been established between nursing and personal care, we have decided to revisit the issue of the potential costs of providing personal care free.

Given that long-term care is provided on the basis of need, it would seem clear that the effect of abolishing means testing for personal care would be to switch some payments from private to public sources, without necessarily altering the total costs. However, there is a vigorous debate about whether introducing free personal care would in fact increase the demand for care, thereby increasing total costs as well as causing the substitution of public for private expenditure.

The majority report of the Royal Commission made the argument that personal care would not be available on demand, but rather would be available following an assessment of need. They argued that their other assumptions were conservative and could thus absorb some genuine need which might have been suppressed by the charging regime. They also examined evidence from Canada, The Netherlands, the US, France and England on this issue of demand inducement. Overall, their conclusion was that it was impossible to tell whether or not demand would increase as a result of their proposal, and as a result they did not account for any demand inducement in their costing. PSSRU has recalculated, on a UK basis and using more up to date information, the costs of introducing the Royal Commission proposals on the assumption of no demand inducement.

The note of dissent in the Royal Commission's report argued, in contrast, that making personal care free would lead to a significant increase in the demand for both domiciliary and residential care. The demand for domiciliary care could rise because of substitution of formal for informal care, and some people might also demand higher amounts of domiciliary care. The note of dissent also argued that the demand for residential care might increase for a number of reasons. Firstly, families might be less willing to provide informal care themselves and more willing to see their relatives go into institutions. The cynical way of thinking about this is that relatives are currently incentivised to provide informal support because home charges erode their inheritance. The second reason free personal care might increase residential care demand is that it might make the elderly themselves more willing to enter care. The note of dissent referred to the introduction of Supplementary Benefit in the UK (where expenditure rose massively) as an example of what could happen when the cost of care to individuals was reduced. However, as noted earlier in this report, Supplementary Benefit was paid without an assessment of need and created perverse incentives for Local Authorities to place people in homes when they may have been better served by domiciliary care.

When projecting the cost of free personal care in Scotland, the Care Development Group implicitly accepted part of the argument made in the note of dissent. They allowed for an element of substitution of formal for informal domiciliary care, and also allowed for an increase in the total demand for domiciliary care. On the basis of work commissioned from Stirling and Aberdeen Universities and 'related research on this issue in America' the Group settled on a figure of a 12 per cent substitution of formal for informal homecare. It should be noted that homecare is not the only form of non-institutional care, which includes day care and private care. PSSRU has modelled the impact on costs of an increase in non-institutional personal care demand of 12 per cent, and also a higher case allowing for a 25 per cent increase.[30]

The note of dissent to the Royal Commission was not concerned only with inducement of non-institutional demand, but also with an increase in demand for residential care. The Scottish Care Development Group did not examine this possibility. To simulate such an increase in demand, PSSRU has projected the costs of free personal care under the assumption described earlier as 'Decline in dependant elderly living with their children'. This makes the assumption that one third fewer dependant elderly people move in with their children, and thus enter residential care.

The costs of these scenarios are shown in Table 7.8.

Table 7.8 Introducing free personal care*

	2000	*2005*	*2010*	*2020*	*2031*	*2041*	*2051*
Central base case							
Total costs % GDP	1.39	1.35	1.33	1.38	1.56	1.63	1.61
Public costs % GDP	0.94	0.92	0.88	0.91	1.03	1.08	1.06
Difference from the central base case:							
Free personal care with no demand inducement							
Change in total costs %	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Change in public costs %	0.16	0.16	0.17	0.18	0.20	0.21	0.21
With 25% increase in demand for non-institutional services							
Change in total costs %	0.05	0.05	0.05	0.05	0.06	0.07	0.08
Change in public costs %	0.21	0.21	0.22	0.24	0.27	0.29	0.29
With decline in co-resident care by children and corresponding increase in demand for residential care							
Change in total costs %	0.00	0.01	0.01	0.02	0.04	0.04	0.04
Change in public costs %	0.16	0.16	0.18	0.20	0.23	0.24	0.24

* Whilst retaining means testing for hotel costs in residential settings

Source: PSSRU/NCCSU model projections

With no demand inducement, there is no change in total costs projected from introducing the Royal Commission proposals. There is, however, a significant and immediate jump in public costs of 0.16 per cent of GDP, or about £1.6 billion in 2000-01 terms for the whole UK. Public spending then increases very modestly to 2051 at which point it is 0.21 per cent of GDP above the central base case projections.

The assumption of a 25 per cent increase in the demand for non-institutional care simulates a significant substitution of formal for informal care. In the broadest terms, it can be interpreted as significant numbers of carers deciding to exchange some of their informal care for formal support. However, it should be noted again that there is little evidence to indicate the likely size of such an effect as a result of making personal care free. In our qualitative research we asked our sample how the availability of free personal care would affect their decision to provide care themselves. Some spontaneously volunteered that such a system might be open to abuse, but many were keen to stress that the availability of such care would not affect their caring decisions, and some were quite indignant about the idea. The experience of Scotland should provide vital hard evidence in this area.

How much more expensive is making personal care free if there is an increase in the demand for non-institutional services as a result? If demand for such services increases by 25 per cent then public costs rise by an additional 0.05 per cent of GDP in 2010.[31] This additional increase rises to 0.08 per cent of GDP by 2051. These are increases in both public costs and at the same time total costs, as the new demand is both a new real cost to the economy and is paid for by the state. The overall effect is to raise the total cost of long-term care by 0.08 per cent of GDP and the public cost of long-term care by 0.3 per cent of GDP relative to the central base case without policy change. Compared to the base case projections and the Royal Commission assumption of no demand inducement, these additional increases are quite modest.

As noted earlier, the issue of demand inducement concerns residential as well as domiciliary care. To simulate the effect of demand inducement for residential care, PSSRU has modelled the introduction of free personal care plus the scenario described earlier as a decline in the numbers of dependant elderly living with their children.

Assuming a decrease of one third, by 2030, in the numbers of the dependant elderly moving in with their children has little effect on the costs of making personal care free. As in the case of demand inducement for non-institutional care, the impact on total costs is the same size as the increase in public costs. Relative to the Royal Commission assumptions of no demand inducement, public and total spending rises by an additional 0.04 per cent of GDP by 2050.

Pessimistic cases

The above variations on the introduction of free personal care all make the central base case assumptions about exogenous factors. We should also consider the situation where exogenous factors drive costs up in an environment of free personal care. Table 7.9 compares some pessimistic scenarios.

Table 7.9 Introducing free personal care: pessimistic cases

	2000	*2005*	*2010*	*2020*	*2031*	*2041*	*2051*
Central base case							
Total costs % GDP	1.39	1.35	1.33	1.38	1.56	1.63	1.61
Public costs % GDP	0.94	0.92	0.88	0.91	1.03	1.08	1.06
Difference from the central base case, with free personal care and 25% increase in demand for non-institutional services							
Change in total costs %	0.05	0.05	0.05	0.05	0.06	0.07	0.08
Change in public costs %	0.21	0.21	0.22	0.24	0.27	0.29	0.29
High base case							
Total costs % GDP	1.39	1.42	1.48	1.68	2.13	2.50	2.75
Public costs % GDP	0.95	0.97	0.99	1.15	1.44	1.68	1.83
Difference from the high base case, with free personal care and 25% increase in demand for non-institutional services							
Change in total costs %	0.05	0.05	0.05	0.05	0.07	0.08	0.08
Change in public costs %	0.21	0.22	0.24	0.27	0.34	0.41	0.45

Source: PSSRU/NCCSU model projections

The introduction of free personal care plus the assumption of significantly increased demand for care would increase total costs by 0.08 per cent of GDP and public costs by 0.29 per cent of GDP by 2051 compared to the central base case. These increases, whilst significant, are dwarfed by the effect of the high base case assumptions about exogenous factors. Compared to the central base case, the high base case *without the introduction of free personal care* represents an increase of 1.14 per cent of GDP in total costs and 0.77 per cent of GDP in public costs by 2051. As we know, the factor which is overwhelmingly responsible for this increase is the assumption of higher unit costs of care. This observation should put into perspective concerns about the introduction of free personal care generating additional demand for services: the cost of new demand is small in comparison to the effect of increases in unit costs.

The most expensive scenario considered here is the high base case, with free personal care, plus significant demand inducement. By 2051 total costs are 0.08 per cent of GDP higher than under the high base case without the introduction of free personal care. Public costs, however, are 0.45 per cent of GDP higher by the same date: a large increase, but still only half of the size of the increase in public costs represented by the high base case compared to the central base case.

Conclusions

Making personal care free to the individual on the basis of need addresses our key objective of **equity**. We do not believe it is fair to draw the current distinction between nursing care needs and personal care needs: both are forms of health care. Providing personal care free would thus mean that the health care needs caused by the diseases of old age would be treated in a consistent way to those which are caused by acute illnesses. This would be both fair and seen to be fair: older people would no longer be subject to funding their own health care needs.

If personal care were to be funded on a universal basis by the Government, individuals would still be responsible for paying for their own 'hotel costs' in residential care settings. Housing and living costs in retirement are something which individuals can reasonably be expected to save for. There is thus an argument that hotel costs should be considered an individual's own responsibility, subject to a means test. However, there is also an argument that such costs should also be paid for by the state in addition to those of nursing and personal care. It is true that hotel costs may be higher in a residential setting than the costs to an individual of living at home, and in a sense this additional cost is the result of a health problem. Hospital inpatients may be considered to be in a similar situation, and they are not significantly charged for their hotel costs. However, this is partly for reasons of administrative efficiency, and partly because patients usually stay for only a relatively short period in hospital, during which time they continue to incur many of the costs of their usual accommodation. The situation is different for long-term care, where stays are much longer, and the residential setting effectively becomes the individual's home.

The equity arguments in favour of providing free personal care are strong, but they would not necessarily be conclusive if they generated unacceptable problems with **affordability**. A better understanding of the likely costs of long-term care now allows us to re-examine this issue. The foregoing modelling work projects the additional cost of making personal care free at some 0.2 to 0.45 per cent of GDP by 2050.[32] This is a significant sum, but in no sense strictly unaffordable. Abolishing equity-based ISAs, reducing the value of the age related allowances, and aligning the upper limit on NICs to the higher rate of income tax would generate more than enough revenue to pay for the introduction of free personal care and would be fiscally progressive. These are all tax reforms that would be consistent with the Government's other policy objectives, but carrying them out in tandem with introducing free personal care would make them much more palatable to the better off individuals that they would affect. We accept that the provision of free personal care would financially benefit those who would otherwise pay for their care, meaning better off pensioners. In isolation, such a policy would thus be fiscally regressive. The progressive tax reforms indicated here would help to address this concern.

The really significant driver of both public and total costs is the long term trend in the unit costs of care. In a way, much of the argument about the costs of long-term care has thus missed the point: long-term care policy will not really decide the costs at all. The provision of long-term care incurs a real economic cost: expenditure allocated to long-term care is unavailable for other uses, regardless of whether the Government or an individual is paying the bill. In addition, all expenditure on long-term care is ultimately financed by individuals, either through direct payments or through taxation. Large increases in the unit costs of long-term care would represent a serious challenge to policy makers regardless of whether or not personal care was funded by the Government and free to the individual.

The costs of making personal care free have been extensively explored in this chapter. They represent a significant shift of funding from private to public sources, but the key issue is the total cost of care, which is driven principally by unit costs. If making personal care free increases demand there will be a small additional increase in the total costs of care. Such increases will be limited, however, by the provision of free care on the basis of need rather than request. Our conclusion is that the balance between equity and affordability is best struck by making personal care free: the affordability arguments do not trump the requirement to treat health care fairly and consistently, by providing it free on the basis of need.

Adequacy, or the provision of a uniformly high standard of care on the basis of need, is a key objective of long-term care policy. As this report has focussed on funding there are many key issues around provision which we have not addressed. Making personal care free does not in itself inject new resources into the system. It may, however, improve the standard of care for a number of other reasons.

The boundary between nursing and personal care is likely to generate significant practical difficulties, particularly for the nurses and care staff who will be required to implement it on a case by case basis. Nurses in particular are concerned about their new role as the gatekeepers of free care. Whilst it will always be necessary to assess an individual's various care needs and determine who should deliver the care, the provision of the best care should not be obstructed by the funding boundary between nursing and personal care.

There are concerns that some at least of any increased funding for long-term care is already being absorbed by care homes themselves with them raising their fees in an effort to restore operating margins. It is widely perceived that these were reduced to dangerously low levels in the 1990s as a result of the squeeze on public funding for care, one consequence of this being a reduction in supply as some providers exited the market. We can view this issue alongside that of the low wages paid to many care workers. It is possible that the whole cost base of the sector is unsustainably low and that increased funding will indeed be required simply to ensure that an adequate supply of provision is maintained. As we have seen with the labour costs issue, these funding questions appear far more serious in magnitude than those relating to whether or not to make personal care free. And they will remain serious regardless of where the boundaries are drawn in terms of the public and private funding of different forms of care.

Another adequacy issue arises from the possibility of demand inducement. New demand for personal care as a result of making it free to the individual is usually discussed as a possible negative consequence. In fact, some of this new demand may be welcome. Carers, particularly spouse carers, are often themselves frail and in need of improved support services. If they are able to substitute some of their care for formal help then this may both improve their own quality of life and potentially extend their ability to provide care to their partner at home.

We have been relatively cautious about the ability of private sector financial products to solve the problems of funding long-term care. However, if personal care was provided free, the situation might be somewhat improved from the customer's perspective. If such products only had to fund hotel costs, their price would significantly fall, bringing them into the reach of more people. Making personal care free would also end the uncertainty about what long-term care insurance is supposed to cover, allowing financial service providers to develop and market their products more confidently. It would also become clearer to consumers what such products were for: to cover the cost of comfort during infirm old age, rather than to pay for the residual of care home costs minus some contribution from the state. On the other hand, the insured sums would be significantly reduced as they would not have to cover any personal care costs, and this might require the industry to develop simpler products with lower administrative costs to remain profitable.

Removing the funding boundary between nursing and personal care would be consistent with our goal of improving the **clarity and simplicity**. The practical benefits of removing the nursing/personal care divide have already been discussed. In addition, it will make it easier for individuals to understand the system and their own responsibilities, and it will become much easier for government to make the political case for its long-term care settlement. It could be argued that because hotel costs will still be shared on the basis of a means test, public support will not be forthcoming for a long-term care settlement which offered free nursing and personal care. However, it would be far easier to argue for a system where health care needs are publicly funded and living costs remain in part the responsibility of the individual.

Making personal care free would be a popular policy, because the fairness arguments discussed throughout this report are strong and are intuitively appreciated by many people. But if personal care were free then government could make a clear case for its long-term care policy: the state will meet older people's health care costs, regardless of where such care is delivered, regardless of the cause of need, and regardless of who delivers the care. Current policy cannot be defended like this.

Conclusions

Our task has been to map and analyse the approach to pensions and long-term care policy under Labour. Various criticisms have been levelled at the Government over its retirement strategy and we have tried to assess whether these are well founded. By dispelling myths, clarifying objectives and exploring alternative policy options, we have investigated whether the Government's current settlement should continue to be pursued or whether a change of direction is necessary. We have firmly concluded the latter.

On pensions, the evidence is clear-cut. Our analysis reveals that a policy framework which relies heavily on means-testing retirement benefits is flawed. This perhaps feels an uncomfortable conclusion for IPPR, a centre-left organisation, to have reached. Surely, as progressives, we support directing limited resources to those most in need? As we have said consistently throughout this report, we are supportive of the Government's aims and its primary focus on tackling pensioner poverty. Where we part company is how best to achieve those aims. If a means-tested approach was working for poor pensioners and working for people planning for retirement, then we would be in accord with the Government. But it is not working. Even if a reinvigorated campaign saw take-up of the MIG improve, many pensioners would still be reliant solely on the Basic State Pension, which if price indexed will fall further and further below the poverty line. The introduction of the Pension Credit, complexity aside, creates incentive problems that cannot be resolved. In theory, the Government's strategy has some merit. In practice, it falls short of eliminating pensioner poverty and providing an environment whereby people can understand their entitlements, save and be rewarded for doing so.

The centrepiece of our suggested reforms – to increase the Basic State Pension to the level of the MIG and ensure it retains its value in relation to earnings in the future – is the only way to guarantee all pensioners escape poverty. Moreover, it allows a radical simplification of the system – the Pension Credit becomes redundant and SERPS/ State Second Pension can be closed – creating a framework which people can understand. This policy reform delivers for both current pensioners and people currently planning for retirement. It delivers for people in poverty and it delivers for the working poor who will no longer be penalised for their thrift. We also believe it delivers for government: with the closing of SERPS/State Second Pension and a modest increase in the official retirement age to 67 it is affordable, and the political rewards of what would be a highly popular reform would be significant.

On long-term care, our analysis leads to less clear conclusions. Our central question has concerned whether personal care should be provided free. The adoption of free personal care in Scotland has allowed us to assess what benefits it might bring if introduced in England. It clearly illustrates that difficulties persist. Means-testing

A revenue neutral package

Policy change	*Change in cost to the Exchequer as % of GDP* *2010*	*2050*	*Paid for by*
Raise BSP to the level of the MIG and index in line with earnings	+0.9%	+2.6%	1. Phasing out PC, closing SERPS/S2P and abolishing rebates 2. Raise retirement age to 67 by 2030
Introduce free personal care assuming some substitution of formal for informal services	+0.2%	+0.3%	3. Abolish equity-based ISAs and reduce value of age allowances 4. Align upper limit on NICs to higher rate threshold for income tax

clearly remains to assess individuals' contributions to their hotel costs. The divide between personal and nursing care remains in Scotland, and government contributions are still capped. The future costs of different policy options are highly uncertain and sensitive to factors very difficult to predict. On balance, we have concluded with fairness being the pivotal issue, that personal care should be provided free. This does imply higher costs to the Exchequer, but we have shown how these could be offset by other revisions to retirement policy.

In the introduction to this report, we set ourselves a challenge to develop a contract with rights and responsibilities which are clear to citizens, the financial services industry and government. We recognised that this implies some permanence to allow all stakeholders to plan for the long-term. Unfortunately, public policy cannot be protected from a change in government or changes in any government's priorities. Would a Conservative government not simply re-break the link with earnings? Would a future Labour government want to direct resources away from retirement to meet its pledge to eliminate child poverty? One solution is to take decisions out of the hands of politicians. An independent body to control elements of retirement policy is one solution. We have concerns about the practicality and democratic accountability of such a move and believe there is an alternative.

How do you make the retirement framework sustainable if you cannot commit future governments to particular policies? A policy persists when it is popular, and policies are popular when citizens have high awareness and understand their value. The 'untouchable' Child Benefit is a good example. Previous governments got away with SERPS reforms because individuals were not fully aware of their impact within a complex pensions environment. Similarly, Labour was harangued over the 75p increase to the Basic State Pension because it was highly visible. We think a simple framework with the Basic State Pension at its core could be sustainable to political forces because it would be popular, easy to understand and changes will be noticed.

As we have said earlier, a policy settlement needs to be fair and seen to be fair. In long-term care, the introduction of free personal care is justified on the basis of fairness and transparency.

Ensuring the security of all citizens in retirement is a key element of social justice. If the elderly in our society are in poverty or receiving inadequate care, we are failing to make progress. We hope our recommendations describe a contract which will ensure better provision of pensions and long-term care for millions of older people and which also contribute to a renewal of trust in the Government and support of the welfare state. The political rewards are indeed great.

Endnotes

1 1951 figures from ONS, 2031 figures from Government Actuary's Department 1998 projections.

2 Increases in unemployment, sickness and incapacity benefit were de-coupled from increases in earnings and tied to increases in prices, leading to their decline relative to earnings and living standards. The treatment of state pensions is discussed below.

3 That is, uprated in line with earnings since their construction in 1997 (MBA) and 1999 (LCA) to maintain their relative value.

4 This issue is discussed further in Chapter 4.

5 Those in occupational and personal pensions may, however, be contributing on an entirely voluntary basis if their contributions do not contain any element of contracted out NIC rebates.

6 It is also a condition of a scheme being classified as approved for tax purposes that the employer does make a contribution.

7 There may be some overlap between these groups, for example, some people may have both a personal pension plus either SERPS or an occupational scheme.

8 Based on figure of £473 per week in New Earnings Survey April 2001 in Labour Market Trends September 2001.

9 That is 60 per cent of median household income after housing costs.

10 The estimates are constructed by comparing benefit claims with responses to the Family resources Survey. Ranges represent 95 per cent confidence intervals.

11 The figures in the table above should not be interpreted as showing a statistically significant worsening of take-up rates between 1998/99 and 1999/00. Take up rates are estimates given as 95 per cent confidence intervals, and in all cases shown the confidence intervals for 1998/99 overlap with those for 1999/00.

12 This is the average for those with SERPS entitlements, who comprised 91% of men in this age category in 1998.

13 These details have not yet been finalised by DWP. However, setting the disregard at the guaranteed minimum level of £100 would mean that income between £100 and £135 would attract a withdrawal rate of 40 pence per £1 for the Pension Credit and then an additional £1 x (0.65+ 0.20) = 85 pence per £1 for HB and CTB. This would result in a potential withdrawal rate of 125 per cent between these income limits: clearly unacceptable.

14 This does not include knock-on effects to Housing Benefit or Council Tax Benefit.

15 On the assumption that the guarantee element of the Pension Credit is uprated in line with average earnings in all years after 2003 and the savings credit threshold in line with prices.

16 The two exercises use somewhat different modelling techniques and assumptions which are discussed in Hawksworth 2002.

17 The original formula was 25 per cent, but this is set to decrease to 20 per cent by 2009-10.

18 Those earning below the Lower Earnings Limit or employed for less than three months are not counted towards the five employee threshold.

19 On the condition that the member has at least ten years of service.

20 Includes residential and nursing homes.

21 From the 1995 Budget onwards.

22 Joel Joffe and David Lipsey.

23 In fact it is not paid directly to the individual, but it does reduce the requirement they may have to contribute towards the cost of home fees.

24 It should be noted that the conditions under which an individual may be assessed as needing nursing care are quite different from those which trigger a long-term care insurance claim: those qualifying for the £70 per week medium nursing care may not qualify for an insurance claim.

25 Dependency in this work is defined as having difficulty with, or not being able to perform, activities of daily living.

26 Because the pension credit increases pensioner income, it may increase the proportion of care fees paid for by individuals. However, by January 2002 the Department of Health had not issued guidance on how Pension Credit income will be treated by the means test.

27 The Government Actuary high and low cases are from the 1998-based projections, as the official high and low variations of the 2000-based projections are not due until later in 2002. The 1998-based principal projections differ little from the 2000-based principal projections.

28 The foregoing analyses used the base case assumptions for all variables except the factor being examined, so for example the life expectancy sensitivities all assume base case dependency rates and unit costs.

29 They also recommended that there should continue to be means testing for hotel costs in residential settings.

30 The Scottish Care Development Group also allowed for an increase in the demand for homecare services as a result of 'currently unmet need'. The increase they allowed for was of similar size to the increase they expected from the substitution of formal for informal care.

31 If the introduction of free personal care did lead to a 25 per cent increase in demand for non-institutional formal care, it is likely that such demand would build up over a transition period as carers became aware of the new arrangements and adjusted their own provision.

32 That is: 0.2 per cent of GDP assuming the central base case and no demand inducement, 0.45 per cent assuming the high base case and significant demand inducement.

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