



Work and Pensions Select Committee inquiry into pensions reform

Submission by Institute for Public Policy Research (ippr)

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Summary

- The Pension Commission's Second Report ('Turner Report') is a valuable contribution to the UK pensions debate.
- The Turner Report correctly identifies the main problems with the current state pension system.
- However, ippr disagrees with Turner's recommendation that the Basic State Pension (BSP) be uprated with earnings starting from its current level, because this does nothing to close the gap between the BSP and the Pension Credit Guarantee (PCG).
- ippr recommends instead that the BSP be raised to the PCG level immediately and uprated with earnings thereafter. This can be paid for by abolishing the contracted-out rebates in the National Insurance system, abolishing the Savings Credit for pensioners and closing the State Second Pension (S2P) to new contributions. ippr's proposals are also much simpler than Turner's, and this is very important in creating a state pensions regime that people can understand and plan within.
- In the long run there is a strong case for either (a) a 'Citizen's Pension' based on residency rather than past contributions, or (b) making the contributory BSP more inclusive by 'crediting in' working age people for activities other than work (which the Government has already started to do). Either of these strategies would vastly reduce the extent to which future pensioners have to rely on means testing.
- ippr is broadly supportive of the Turner Report's National Pensions Savings Scheme (NPSS) largely because auto-enrolment will help overcome inertia towards savings decisions among employees without the drawbacks of 'hard compulsion'. Also the scheme is very low-cost compared with private sector defined contributions schemes. However, the Government will need to be prepared to negotiate on the exact details of the scheme to secure support from employers if it wants to implement NPSS.
- The Turner Report's recommendations on increasing the state pension age, and raising the effective age of retirement, are very sensible.
- The tax treatment of savings was outside the Pension Commission's remit, but there is a fundamental need for a review of savings policy, perhaps by a 'Savings Commission'.
- There remain considerable challenges for the Government in convincing a sceptical public that the Turner package, or whatever pension reform package it presents in the forthcoming White Paper, is desirable.

Introduction

1. The Pension Commission's Second Report (hereafter referred to as the 'Turner Report') is an exhaustively researched, coherently argued and valuable contribution to the debate over the future of pensions provision in the UK. The Institute for Public Policy Research (ippr) agrees with some of the Turner Report's recommendations, but disagrees with others. In this submission we give an exact account of our agreements and disagreements with the recommendations. Where we disagree, we explain why, and give details of our preferred alternative.

2. ippr is the UK's leading independent progressive think tank, and has a distinguished tradition of intelligent pensions research and commentary. We played a key role in the debate which led up to the formation of the Pensions Commission with the publication of *A New Contract for Retirement* by Richard Brooks, Sue Regan and Peter Robinson in 2002. In 2005, *Working Later* by Peter Robinson, Tim Gosling and Miranda Lewis examined the objectives of pensions reform and the problem of early labour market withdrawal, and showcased new qualitative evidence on people's attitudes to working later in life; this research was one of the sources of evidence quoted in the Turner Report. Our response to the Turner Report is largely drawn from our existing work but we have been careful to take on board the new evidence from the Pensions Commission in framing our exact recommendations.

Proposals for reform of the state pension system

3. The Turner Report correctly identifies the main problems with the current state pension system. These are as follows:

(a) The Basic State Pension (BSP) is not set at a sufficiently high level to lift pensioners out of poverty – hence a pensioner with a full BSP entitlement, but no other source of income, has to rely on the means-tested Pension Credit to provide the minimum adequate level of income to avoid poverty.

(b) The gap between the BSP and the Pension Credit Guarantee level will continue to grow as long as the current policy (whereby the BSP is uprated by prices, but the Pension Credit Guarantee (PCG) is uprated by earnings) is maintained. This will lead to an inexorable increase in the extent of means-testing among future pensioners.

(c) The extent of means-testing is exacerbated by the fact that many current pensioners do not have full National Insurance Contributions records for BSP, and so have to rely much more, and in some cases entirely, on PCG. Like all means-tested benefits, PCG has less than 100 per cent take-up (the most recent figures from Department of Work and Pensions at www.dwp.gov.uk/asd/income_analysis/NSPR0304.pdf suggest that only around 60 to 65 per cent of eligible pensioner households take up the Pension Credit). This leads to poverty among some of the most vulnerable pensioner households. Attitudinal research suggests that means-testing pensioner incomes is also unpopular among pensioners themselves and much of the rest of the population, and undermines popular support for the Government's pensions policy.

(d) The increase of means-testing leads to a decrease in willingness to save among people currently of working age on low to medium incomes, even though the Government has introduced the savings element of the Pension Credit to try to counteract this problem.

(e) The earnings-related component of the state system, State Second Pension (S2P), is very poorly understood by people of working age. In particular, the decision whether to contract in or out of S2P is one that is very difficult for most people to take with any confidence, even after advice from an Independent Financial Adviser.

(f) Overall, the system is too complex, and undermines the ability of individuals to make rational decisions about how and to what extent they should save for retirement.

4. Despite having identified the right set of problems, we are not convinced that the Turner report recommends the right solutions for state pension reform. There are two key problems with the Turner proposals. First, the recommendation that the BSP be uprated with earnings *from now on* does nothing to reverse the gap that has opened up between the BSP level and the pensioner poverty line since the decision was made in 1980 to uprate BSP with prices rather than earnings; it merely stops the gap becoming any worse. Millions of pensioners will continue to be heavily reliant on means-tested support to secure an adequate standard of living under this proposal. Second, the Turner recommendations do nothing to reduce the complexity of the state system. There will continue to be two tiers of state support – BSP and S2P. Indeed, the Turner Report suggests the possibility of the BSP and S2P becoming payable at *different* ages, which would increase the complexity of the system still further.

5. ippr recommends instead that the BSP be raised to the Pension Credit Guarantee level with immediate effect, and then uprated with earnings in future. At the same time, S2P should be closed (while continuing to honour S2P and SERPS rights accrued up to the present day) and the related National Insurance rebates for contracting out should be abolished. This would have the following beneficial effects:

(a) A pensioner with full entitlement to the BSP would no longer require additional means-tested assistance to enjoy a living standard above the poverty line.

(b) The system would be dramatically simplified. This would reduce administrative costs as well as making it easier for people to plan their approach towards saving for retirement. When combined with the contributory National Pensions Saving Scheme (examined in paragraphs 10-16 below), it would make it much easier to explain to people what the State would guarantee in terms of retirement income, and therefore how much individuals would be expected to provide for themselves – a balance of responsibilities that is very unclear in the current pension system.

6. The Turner Report recommends against raising the BSP to the PCG level, largely on cost grounds. The Report suggests that it would cost an extra 1.6 per cent of GDP to introduce a BSP that was paid *universally* at the PCG level, that is to all pensioners, not dependent on past contributions. Our immediate recommendation of paying the BSP at the PCG level, but dependent on existing contributions records, would not be as expensive as this. Most of the necessary extra Government revenue necessary to implement this policy could be raised by ending the contracted-out rebates in the National Insurance system, which amounted to 0.9 per cent of GDP in 2004-05. Additional revenue would be created by abolishing the Savings element of the Pensions Credit, which would become redundant if the BSP were raised to the PCG level (as the BSP is not a means-tested benefit). Statistical modelling of the costs of implementing this proposal carried out by PricewaterhouseCoopers for ippr in 2002 indicates that a combined policy of (a) paying the BSP at the PCG level but dependent on past contributions records, (b) closing S2P to new contributions (while honouring existing accrued rights), (c) abolishing the National Insurance contracted-out rebates and (d) abolishing the Savings element of Pensions Credit would be roughly revenue neutral, and hence affordable.

7. The Turner report is also against raising the BSP to the PCG level because a lot of the pensioners who would gain from this policy would be in households that are already well-off. This is a fair criticism but can be dealt with by making adjustments to the income tax regime which pensioners face. The Basic State Pension counts towards taxable income for Income Tax purposes; hence it should be possible to adjust the tax allowances for pensioners so that the gains from the policy are reduced or eliminated for wealthy pensioner families. As the tax allowances for pensioners are already different from those for people of working age, this approach would not lead to any additional complexity in the income tax system. It could also provide extra revenue which could be used for additional spending or to cut taxes elsewhere in the system.

8. The Turner Report also considers the option of paying the Basic State Pension based on a residency criterion, irrespective of past contributions (the so-called 'Citizen's Pension' option.) ippr's view is that the replacement of the contributory Basic State Pension with a non-contributory Citizen's Pension is not a realistic option in the short term, largely because (as Chapter 6 of the Turner Report points out) Britain does not have a pre-existing database of individual residential records that could be used to determine eligibility – this would have to be built up over several years before such a scheme could go ahead. Nonetheless, the Citizen's Pension is a potential option for reform in the medium to long term (say, 2020 or later) as it leads to still greater simplification of the pensions system, and has the potential to remove means-testing for the huge majority of pensioners who would still be means-tested under the proposals outlined in paragraph 4 above (that is, those who have incomplete state pension contribution records.)

9. Recent comments by the Secretary of State for Work and Pensions (Hutton, 2006) seem to indicate that the Government is not in favour of introducing a Citizen's Pension largely because it would undermine the 'contributory principle' underpinning support for the state pensions system, whereby a retired person receives the state pension as a reward for contributions made through employment or other favoured activities (such as caring for relatives) over his or her adult life. ippr is sceptical as to the value of the contributory principle as a guide to pensions policy, largely due to its nebulousness (see Reed and Dixon, 2005 for full details). However, there may be an alternative route to something very like a Citizen's Pension. The Government has already extended the range of circumstances in which individuals of working age can be 'credited in' with BSP contributions through the National Insurance system (caring for disabled relatives or children, being unemployed and actively seeking work, and so on) and is looking to extend the 'crediting in' regime still further. Taken to its logical conclusion and combined with uprating of the BSP to the PCG level, this approach could lead to an equally large decline in the extent of means-testing through a different route. Therefore it is a valid alternative to a residency-based pension. Either of these alternatives would be better than the status quo.

Proposal for a National Pensions Saving Scheme

10. The Turner Report's proposal for a National Pensions Saving Scheme (NPSS) is a sensible attempt at a workable solution to the problems with private pension provision in the UK in recent years which the Report identifies (correctly in our view):

- (a) Declining proportions of private pension coverage among younger cohorts of employees
- (b) The ongoing drift towards closure of Defined Benefit pension schemes in the private sector

(c) Declining levels of average employer contributions as the composition of schemes shifts towards Defined Contribution schemes over time

(d) High annual management charges in Group Personal Pension schemes and Individual Personal Pensions

(e) The failure of Stakeholder Pensions as a mass take-up, low-cost private pensions vehicle.

11. ippr has in the past been opposed to greater compulsion on employees or employers to make pension contributions. Our view was that the priority was a drastic simplification of the environment in which individuals make their savings and pensions decisions during their working lives, by simplifying the state system (as explained in paragraph 5 above) and making the tax treatment of savings and pension contributions transparent, clear and stable over time. We believed that the decline in coverage levels of private pensions among younger cohorts of workers was largely due to the complexity of the current pensions system, and that once this was sorted out, pensions coverage would increase. We worried that greater compulsion would be seen as just an additional tax on employees and/or employers. Moreover, because some individuals may be using other, non-pensions savings vehicles to provide funds for retirement (e.g. investment in housing, ISAs, and so on) compelling everyone to save into a pension scheme could lead to over-saving in some cases.

12. However, the analysis in the Turner report makes two crucial new points which we had not considered to any great extent in our previous work:

(a) There is considerable inertia in individual decisions, which can lead to young workers not enrolling in a pension scheme, and then regretting the decision later on. As the First Report of the Pensions Commission, published in October 2004, points out, cutting-edge research in behavioural economics and psychology shows that thinking about pensions choices from the traditional economist's framework of a rational far-sighted agent may be inappropriate in many cases. It can make a difference what the *default* pension enrolment situation is for people who enter a job. Under the current system, the default for the private sector worker is not to be enrolled in a pension scheme (unless the employer offers a final salary scheme, which is increasingly rare). Under the Turner proposals the default would be enrolment in NPSS. The review of empirical evidence in the Turner report suggests that this difference in the default position could lead to a substantial increase in overall pension coverage in the UK.

(b) Annual management charges for Group Personal Pensions and Individual Personal Pensions are very high relative to the cost of running a large company pension scheme, and relative to the cost of state-run funded schemes in other countries. If the Turner Report is correct in its assumption that NPSS could be run at an annual management charge of 0.3 per cent or less, this would lead to a huge increase in the return on funds invested in the scheme over a typical working life, relative to an investment in a typical private personal pension. Thus NPSS represents a much more efficient model for 'growing' pension savings over time than is currently available from private sector defined contribution pension schemes.

13. It is also important to emphasise that NPSS is *not* a compulsory scheme in the strict sense of the term. Employees would be enrolled automatically on beginning a job (unless their employer offered a more generous pension scheme they could join), but with the option to opt out if they so chose. Thus the scheme is one of 'soft compulsion', which is less likely to be accused of being 'just another tax' than schemes with a 'hard compulsion' element. Individuals who had decided to save for their retirement through other means would not be forced to over-save.

14. ippr is therefore in favour of the general principle of NPSS. However, there is likely to be considerable opposition to some of the specific details of the scheme from employers and employer organisations:

- Many employers, and employer organisations such as the CBI, are worried about the additional cost burden that the three per cent employer contributions will create.
- The Association of British Insurers has claimed that the scheme could be run more efficiently by the private sector than by the state.
- Christine Farnish, head of the National Association of Pension Funds, has accused the scheme of being a 'throwback to the Stalinist era' that aims to nationalise a large chunk of private pensions saving.

15. It should be possible to defuse most of these objections without jeopardising the viability of the scheme. On the employer costs point, the introduction of the scheme could be accompanied by an offsetting reduction in employer National Insurance Contributions to keep the overall burden on employers neutral, if this were necessary to secure employer buy-in. On the ABI's point, the main advantage of running NPSS as a state scheme is that the mechanisms for deduction of contributions at source (PAYE Income Tax and National Insurance deductions on payslips) are already in place and well understood by firms and employees, and could be adapted for NPSS contributions with relative ease and low cost. Nonetheless it may be worth contracting some aspects of the scheme out to the private sector through a competitive tendering process to secure the most efficient provider (e.g. fund management). The NAPF's criticism that the NPSS represents a 'Stalinist' model for state-directed pensions saving seems to indicate a complete misconception of the Pensions Commission's proposals. Lord Turner has been very careful to stress that the individual NPSS accounts will be the legal property of *individuals*, to be invested according to individual preferences.

16. Although there may have to be some negotiations with employers to secure buy-in to the NPSS, it is certainly useful to secure *some* commitment from employers to pay contributions, even if it is a rather modest one. This is because *employees* will be more likely to join the scheme if they feel that they are getting a contribution from their employer which they would otherwise not have received. Although standard economic theory indicates that employer contributions will be paid for by employees through lower net wages in a 'perfectly competitive' market, in practice there is considerable scope for 'imperfect competition' in labour markets, meaning that in practice the employer contribution (or some proportion of it) may indeed be an additional payment into the employee's pension fund which is *not* fully offset by lower net wages. Thus we support the Turner Report's recommendation that employers make a modest contribution into NPSS for those employees who are enrolled in the scheme.

Proposals for increasing the state pension age

17. The proposals for increasing the state pension age outlined in the Turner report seem sensible to ippr and are a vital part of any sustainable pensions settlement for the long run. Back in 2002, ippr was one of the first organisations to make a coherent case for an increase in the state pension age (to 67 by 2030) as part of a socially just and economically sustainable package of pension reforms that reflect the fact that men and women are now living much longer, and this trend is set to continue into the 21st century. The logic behind the Turner Report's presentation of the case for a gradual rise in the state pension age from 2020 onwards is hard to disagree with. At the same time Turner is clear to stress that a *gradual* rise from 2020 onwards, sufficient to maintain the ratio between years in work and years in retirement as longevity increases, will be quite sufficient. So it is not necessary for the retirement age to rise suddenly to 70 by 2030, for instance (as some of the organisations who submitted evidence to the Pensions Commission were arguing).

The Turner reforms and the tax treatment of household saving

18. Reforms to the general tax treatment of household saving were outside the remit of the Pensions Commission, and so the Turner Report makes no specific recommendations on this issue. Given that pensions saving represents a considerable proportion of total saving by households, if the Pensions Commission recommendations are effective in raising amount of pensions saving in the household sector (as we believe they will be if implemented), this should result in a considerable boost to the household savings rate even in the absence of any other reforms.

19. However, there remains the need for a fundamental review of the tax treatment of savings. The Pensions Commission can serve as an example of good practice here, and it would be a good idea for the Government to establish a 'Savings Commission' with the objective of conducting as thorough a review of the policy options for savings policy as the Pensions Commission was able to achieve for pensions policy. The key points that ippr would like to see addressed in such a review are as follows:

a) Tax incentives for savings along the lines seen in the UK in recent decades (e.g. PEPs and ISAs) have favoured higher rate taxpayers much more than people on lower earnings. Thus they are regressive in their distributional impact at the same time as doing little to encourage savings among people on lower incomes.

b) There needs to be a more thorough examination of alternative approaches to encouraging household saving which use matching contributions from Government (such as the Savings Gateway pilots)

and/or which aim to build up a stock of assets over time (such as the Child Trust Fund). These work much better for encouraging savings among poorer households than do tax incentives.

c) To make it easier for individuals to make rational and sensible choices over how much to save, the system of Government support for savings needs to be as simple and easy to understand as possible, consistent with the Government's distributional objectives.

Raising the effective age of retirement

20. The proposals contained in Chapter 8 of the Turner Report for raising the *effective* age of retirement by facilitating later working and flexible retirement look very sensible, and are along the lines suggested in ippr's recent work on this subject (Robinson, Gosling and Lewis, 2006).

Convincing the public

21. To conclude, we wish to emphasise three additional points that need to be considered by the Government when working out how to convince the public that a package of pension reforms based on the Pension Commission's recommendations, or indeed *any* realistic package of pension reforms is desirable:

22. Even if the Government does not manage to reform the pensions system, the declining generosity of state pensions and private pensions will effectively force people to 'choose' to work longer. It would be far preferable to create a system that people understand and that allows them to make sensible long-term plans for retirement, rather than waking up to cold reality later in the day.

23. The Government should not underestimate the amount of informing and persuading individuals about the realities of increased life expectancy in the 21st century that is going to have to take place. Our focus group research with men and women aged between 25 and 55 indicated that in general, people simply did not believe that they were going to live to an older age than their parents' generation did, *even when presented with the latest actuarial projections*. Men, on average, underestimated their life expectancy by almost five years and women by almost six years (see Robinson, Gosling and Lewis, 2006). There is a real mismatch between reality (or at least, actuaries' current best estimates of reality) and people's expectations. This mismatch needs somehow to be addressed if people are to plan for retirement in a rational manner.

24. There is a real danger that the settlement which the Government reached with several groups of public sector workers in November 2005, whereby existing recruits will be allowed to retire on defined benefit pensions at age 60, will be viewed by workers in the private sector as very unfair, at a time when the generosity of private sector pension provision is declining and the Government is indicating that after 2020 people will have to prepare themselves for later retirement. Therefore, the Government needs either to (a) give a convincing explanation why the generosity of the public sector pensions deal is not inconsistent with its overall strategy of encouraging later retirement, or (b) revisit the deal to make it more consistent with the overall strategy. If neither of these options is possible, it will make it all the harder to 'sell' a set of pensions reforms based on the Turner blueprint to a sceptical public.

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