Ending Pensioner Poverty

Reforming the State Pension System

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SUMMARY

PENSIONER POVERTY should be unacceptable in Britain today – yet is all around us. The British pension system is inadequate. It is bewildering in its complexity. It is expensive. And it is fails to provide an adequate standard of living for a large proportion of pensioners.

This paper proposes a number of reforms to the state pension system. These fiscally neutral reforms would end the morally unacceptable situation whereby millions of people have to live on less than £100 a week in retirement. They would involve:

- sweeping away a myriad of complex benefits allowances and entitlements and replace them with a universal pension system designed to allow all people a comfortable living from the age of 70 onwards;
- increasing the Basic State Pension for a single person from £77.45 per week to £120 per week without a corresponding increase in public expenditure;
- reducing the dependence of pensioners on means-tested benefits, thereby encouraging individuals to make their own provision for retirement and enabling the abolition of the requirement to invest in an annuity on retirement;
- treating everyone equally through the introduction of a universal basic state pension set at a level that will not force pensioners to rely on other state benefits;

- providing a safety net for those who have not made their own provision;
- raising the state pension age to 70 on a phased basis over 20 years, giving people enough time to prepare for the change.

The reformed pensions system would have the following characteristics:

- it would be simple;
- it would be popular;
- it would be effective.

CHAPTER ONE

CURRENT PROBLEMS

The reduction in tax advantages

In 1997 the Labour Government abolished redeemable dividend tax credits for private pension funds and cut National Insurance Rebate payments made to private pensions funds. These two changes amounted to a £6.5 billion annual tax charge on pensions. This is money that used to be received by private pension funds. Hence the tax incentives for pension saving have been substantially reduced by the current Government. In effect, a Pensions Tax was introduced.

There is little doubt that substantial tax benefits for pensions can encourage a preferential allocation of savings to pensions.[1] The Pensions Tax has however created a second problem. Because it raised so much money so quickly, the equivalent of between 2p and 3p on the basic rate of income tax, a simple reversal of the Pensions Tax would now have a serious negative impact on the public finances. There can therefore be no outright guarantee that an incoming Government would be able or willing to reverse the Pension Tax. So while noting that the abolition of dividend tax credits has undermined the attractiveness of pensions as a form of saving, any reform of pensions cannot assume a reversal of the Pension Tax or any other increased tax allowance.

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[1] There is some debate about whether tax advantages increase overall saving levels, as opposed to the affect of its allocation. However, there is strong evidence that tax incentives do strongly affect allocation. The Sandler Review's report of the collapse of pensions saving in New Zealand following the withdrawal of tax incentives is telling in this regard.

Means-testing

There has been a major extension of means-testing. 40% of pensioners currently receive means-tested benefits. With the introduction of the Pensions Credit, this is expected to rise to between 56% and 59%.[2]

Yet means-testing is a major disincentive to save for retirement. The Government's Minimum Income Guarantee and the Pension Credit that will replace it are both means-tested benefits. Those who have savings of over £6,000 begin to lose out progressively. In addition, means-testing is intrusive and complex: between a quarter and a third of those entitled to it do not claim their benefits.[3] It encourages a dependency culture and reduces the incentive to save for many low to moderate earners. Those who have saved nothing at all will get the same overall income as those who have saved. The Pension Credit aims to tackle this, but does so ineffectively, since those who have saved £12,000 will still get no Pension Credit and those who receive it will not in fact be much better off.

Means-testing is also deeply unpopular. Focus group research by the Institute for Public Policy Research (IPPR) has demonstrated just how much people dislike means-testing.[4] The IPPR found that few people saw means-testing as a way of targeting help at those most in need. Instead, the focus groups believed that it punished those who had been hard-working and prudent. Participants considered that taxpayers who had worked hard deserved their relative wealth. People also objected to the stigma of means-testing, the difficulty in claiming means-tested benefits and the invasion of privacy. The focus groups came out in support of a mixed regime of a flat rate pension for all and additional provision on a contribution-related basis – exactly the position that existed prior to 1997. Few saw that the State should have a redistributive role.

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2 House of Commons Library letter to David Willetts MP, 10 November 2000.

3 Department of Social Security, *Income Related Benefits: Estimates of Take-up in 1999-00*.

4 IPPR, *A new contract for retirement*, 2002, p.37.

These concerns are reflected in the comparatively low take up of means-tested benefits. In 1999/00 official figures showed[5] that between 22% and 36% of pensioner households did not take up the Minimum Income Guarantee, 7% to 15% did not take up Housing Benefit and 30% to 36% did not take up Council Tax Benefit.

The results seem quite clear – people do not like means-testing because it is embarrassing and because it punishes prudence and saving. It is a strong disincentive to save and the existence of means-testing in the pension system can only be seriously damaging to any policy aimed at encouraging private pension provision. Any reform of pensions aimed at encouraging greater private pension provision must therefore include the abolition of means-testing.

Insufficient current pension saving

Private pension saving is at inadequate levels. This is despite a finding by MORI in 1997 that 92% of the population believes that there will come a time when State pension provision does not provide for people, with a private pension being required to make ends meet (in 2002 85% polled held this view).[6] But this belief does not appear to translate into an incentive to save in practice. In fact, another poll found that only around half of people below retirement age are currently saving for retirement or paying into a pension, with a quarter saying that they have not really considered saving for retirement.[7]

Nearly two thirds of private sector final salary pension schemes are now closed to new entrants, and half those still open are contemplating closure.[8] New employees are typically being offered a Group Personal Pension with companies making contributions

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[5] DSS, *Income Related Benefits: Estimates of Take up in 1999/00.*

[6] MORI poll for Direct Line in 1997, and poll carried out by MORI Financial Services, published on 12 July 2002.

[7] MORI poll published on 28 February 2002.

[8] Association of Consulting Actuaries Press Release, May 2002.

at about half the rate that would have been made to a defined benefits final salary scheme. Thus an increasing proportion of private pension saving is in personal pension schemes where the risk of investment performance, interest rates and inflation is taken by the individual not by the employer (as in defined benefits final salary pension schemes).

The Government hoped that stakeholder pension schemes would fill the gap in pension provision for the five million people who earn between £10,000 and £20,000 but who do not have any pension provision. But the take-up of stakeholder pensions has been disappointing to the point of disastrous, with only between 2% and 5% of the target income group taking out a stakeholder pension. Many employees are likely to wonder how a stakeholder pension will benefit them, as their employer is not obliged to make any contribution. Those who have taken up a stakeholder scheme, where the employer does not make contributions, will receive fewer benefits when compared with pension schemes where employers do make a contribution.

An ageing population

People are living longer – overturning the assumptions on which the current state pension system was based. As noted recently by the Pensions Policy Institute, 62% who were born in 1885 then lived to collect their pension.[9] 90% of those born in 1980 will live to 65 in 2045. Longevity is increasing by about two years a decade. This is increasing the cost of all pensions to the State. In addition, the lack of economic activity among those over 65 is harming the economy.

There is more and more discussion about whether the pension age should be raised.[10] One pension provider – AXA – has already

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9 Data are for the proportion of 25 year old males who lived to the age of 65. *Raising State Pension Age: are we ready?,* Pensions Policy Institute, 2002.

10 For example, IPPR op. cit.; Rt Hon Frank Field MP, *How Savings Damage your Retirement,* Politeia, May 2003; *Raising the State Pension Age: are we ready?,* Pensions Policy Institute, 2002.

called for a rise in the retirement age to 70. Raising the retirement age to 70 would mean that around the same percentage of the population in 2050 would be entitled to a state pension as is entitled to a pension at present. Such a policy would, therefore, offset the problem presented by the demographic age shift currently taking place in the UK.

The problem of the State Second Pension (S2P)

S2P will become progressively less and eventually irrelevant. The Government has modified the State Earnings Related Pension (SERPS) formula and renamed it as “S2P”. It is intended to be more attractive to those on low earnings. It is likely that S2P will become a flat rate pension in due course. However, as the sum of the Basic State Pension and S2P is projected to be less than the level that would qualify for the pension credit by 2050, many question whether it serves a sensible purpose. For this reason, either a substantial reform to S2P is required that will enable it to continue to be relevant and provide a further pension for people in old age, or S2P should be abolished as part of a wider reform of the pension system.

Poor returns from compulsory annuities

Private pensions pay less than they used to. Members of private pension schemes are obliged to buy annuities by the age of 75. These are widely perceived to be poor value for money. Annuity rates are now about half what they were a decade ago, as inflation and interest rates are lower. There is evidence that annuity rates of return have also been suppressed due to the Government’s recent policy of repaying large amounts of debt (although this policy has merit in macro-economic terms). In addition, the Minimum Funding Requirement for occupational pension schemes has created demand for long-dated Government Stock, used by pension providers to pay annuities.

Obstacles to reform of annuities

The requirement to use pension fund proceeds to purchase an annuity creates rigidity and hampers the scope for reform. Many attempts have been made to reform annuities, one of the most recent being a Private Member's Bill promoted by David Curry MP in 2002 (The Curry Bill). However, a major concern – particularly of the Treasury – is that without a compulsory annuity, feckless pensioners might fall back on state benefits.

The Curry Bill proposed limiting the size of the compulsory annuity to one that would keep a pensioner free of income-related benefits. The remaining funds would be allowed to remain invested in a gross fund, to be withdrawn in lump-sum form, subject to tax, or bequeathed, again subject to tax. Supporters of the Curry Bill suggested that the minimum annuity would have to yield more than the Minimum Income Guarantee/Pension Credit at retirement, in the belief that the excess would be sufficient to keep the pensioner off means-tested benefits.

However, the Government is committed to increasing the Minimum Income Guarantee in line with earnings for this parliament, and possibly beyond. While it is reasonably easy to calculate the size of the annuity required to keep a pensioner above the *current* threshold of the Government's Minimum Income Guarantee and Pension Credit, it is not possible to purchase an annuity that will increase in line with earnings. As a result, an annuity whose payments currently exceed the Minimum Income Guarantee at retirement might fall short as time passes.

A greater problem lies with Council Tax Benefit and Housing Benefit, where the maximum benefit depends on the housing costs and Council Tax bill of each individual. The following table shows the take-up of both benefits.[11]

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11 DWP, *Housing Benefit and Council Tax Benefit Quarterly Summary statistics,* May 2002.

	% of household receiving	Average amount paid (per week)
Housing Benefit	16%	£54.70
Council Tax Benefit	19%	£10.80

About 10% of the population receive Housing and Council Tax benefit. As pensioners do not generally work and are likely to be poorer than the working population, the percentage of pensioners on these benefits is likely to be greater, although direct figures are not available on this. However, official figures do show that just over a third of "pensioner units" were in receipt of income-related benefits (including Housing Benefit and Council Tax Benefits)[12].

It is difficult to see how people being paid annuities would be kept clear of these benefits. One possibility would be to impose a higher minimum annuity, but at prevailing annuity rates such a minimum annuity would cost over £100,000 and, on some estimates, £200,000. With the average pension pot being just £25,000, according to Government figures, the liberalisation that would be introduced by the Curry Bill would not apply to most of the population. This proposal, therefore, appears to be beset by so many practical problems that it is effectively a non-starter. In order to tackle the annuity problem, a more radical shake up of means-testing, the basic state pension and the annuity system will be required.

Confusion and a lack of trust

Few people really understand pensions. The complexity of pension regulation has been a serious problem – and particularly for defined benefit, final salary pension schemes, the entire system requires radical simplification.

The lack of political consensus over reform of the pension system means that pension savers lack confidence in making long-term plans. There is also some mistrust of the current Government's motives in relation to pension saving and

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12 *Pensioners' Income Series 2000/*1, The Pension Group.

retirement provision. A MORI poll found that some people believe the Government is encouraging individuals to save as much as possible (for example in stakeholder pensions) as part of a "plot" to abolish the state pension; another poll found that 35% did not trust the Government to look after their money.[13]

Nor do people trust private pension providers. A MORI poll found that 31% of respondents did not trust pension companies.[14] Those least likely to trust the life industry were the less well off and the over 55s (those most reliant on the services of the life industry). Many people are simply confused. One poll found widespread confusion in focus groups among people in their 30s on moderate and low incomes about their pensions options.[15]

It seems clear that pensions need to be reformed in a way that will re-build trust in pensions and private pension saving. At the same time the Government needs to set out a simple and robust system that is supportable in the medium and long term. Both reforms need to be easily understandable and be a settlement that will stand both the test of time and changes in governing party and political ideology.

Not the best savings option

Many people do not believe that a pension is the best savings option for them. This is particularly the case with younger people, for whom retirement is far off. A MORI poll found that 15 to 20 year olds were more likely to want to save than the over 45s. But when it came to savings allocation, 26% wanted to invest in a home, while only 6% wanted to save for a pension.[16] This illustrates the tendency for younger people to have more interest in getting a home and car before they think about a pension.

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13 MORI poll published on 28 February 2002 and poll carried out by MORI Financial Services, published on 12 July 2002.

14 MORI poll published on 12 July 2002.

15 MORI poll published on 28 February 2002 and poll carried out by MORI Financial Services.

16 MORI poll for lycos.co.uk published 25 February 2001.

Lack of political action

The much-delayed Pensions Green Paper was eventually published in January 2003.[17] While some simplification of annuities is proposed, the reality is that there will be little change. Beyond certain changes to allow people to mix work and retirement benefits, and changes to make annuities a little more flexible, the Government is not considering more deep-seated reforms in the face of every growing public concern and deteriorating pension savings and returns. The Green Paper makes it clear that no change to the state retirement age is under consideration at all, preferring to permit a greater pension to those that elect to retire later.

At the Labour Party Conference in October 2003, Andrew Smith MP, Secretary of State for Work and Pensions did put forward a proposal to offer pensioners a lump sum of "up to £30,000" for those people who deferred their state pension for five years. However, it soon emerged that those pensioners who were able to claim pensions credit would find themselves penalised, not rewarded, if they took up this offer.

Recent Conservative Party proposals have fared little better: they suggested restoring the link between the state pension and the growth of average earnings, rather than the rate of inflation – reversing a policy of previous Conservative governments which specifically broke the link 25 years ago. However, the Government Actuary showed in his Quinquenniel Review of the National Insurance Fund that, with this reform, the cost of the State Pension would rise from 6.2% to 8.7% of GDP between now and 2060. While the Conservative approach may be an imaginative short-term attempt to alleviate current pensioner hardship over the next Parliament, it is not a long-term solution as it fails to address the deeper crisis.

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[17] DWP, *Simplicity, Security and choice: Working and saving for retirement*; see also *Simplifying the taxation of pensions: increasing choice and flexibility for all*, a joint Inland Revenue, Treasury consultation document.

Summary of the problems with the current state pension system

The current UK pensions system is not working and has largely lost public confidence. There is a lack of policy cohesion and considerable unfairness in the system resulting from the interaction of:

- The Pension Tax of 1997, removing £6.5 per annum from private pension funds;
- A major extension of means-testing, the effect of which is to punish the prudent who have saved;
- Private pension saving is at inadequate levels;
- People are living longer – overturning the assumptions on which the current state pension system is based. This is forcing savings to be spread more thinly;
- The requirement to use pension fund proceeds to purchase an annuity creates rigidity and hampers the scope for reform. The effect is that private pensions pay less than they used to;
- Few really understand pensions – the regulatory framework is complex and there is public mistrust of all involved in the pensions industry;
- The lack of positive Government action to tackle the problems that exist and provide a genuine and fundamental reform of the state pension system that will stand the test of time.

CHAPTER TWO

AN AGEING SOCIETY

ANY CONSIDERATION of the reform of pensions must consider the impact of a simple demographic truth: that the population of the UK is ageing.

The National Population projections on 15th August 2002 illustrate the extent to which the population of the UK is ageing and longevity is increasing.

In the UK, life expectancy at birth is projected to rise 3.1 years from 75.8 years in 2000-01 to 78.9 years in 2024-25 for males. For females, the rise is projected to be a more modest 2.6 years from 80.6 to 83.2 years. After 2024-2025, the increase in longevity is predicted to slow down gradually – by 2040, women are predicted to live for around 84 years and men for just under 80 years. [18]

Increased longevity is one reason for the ageing of the UK population. So too is a fall in fertility rates. Fertility rates fell below the "replacement level" of 2.1 children per woman in the late 1970s and have continued to fall. In 2000-01, the total fertility rate fell to just over 1.6 children per woman. A slight increase is projected, but only to 1.74 children per woman.

This means that there will be fewer young people and more older people as time passes. To some extent, the fall in the fertility rate will be offset by net inward migration, predicted to be 135,000 a year. But this net migration will not make up the deficit to a significant extent.

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[18] *The 2000-based national population projections for the United Kingdom and its constituent countries*, Government Actuary's Department, August 2002.

The impact on pensions

The Government Actuary projects that the number of people over state pension age will increase by 11% over the next decade (from 10.8 million in 2000 to 11.9 million in 2011). With the increase in women's pension age to 65, the increase in the number of pensioners will slow, so that by 2021 there will be 12.3 million pensioners. The increase in the number of pensioners will then accelerate again and it is predicted that by 2040 there will be 16 million pensioners.

The Government Actuary's report notes that without the increase in the state pension age for women, the number of pensioners would have been 14.3 million by 2021, eventually peaking at 18 million. Expressed as a percentage of the population, the number of people over 60 will rise from around 20% of the population currently to around 30% by 2041. From 2041 until 2071, the over 60s are predicted to remain at around this level.

This demographic change means not only more pensioners whose pensions will have to be funded but also fewer working people per pensioner – the "dependency ratio". There are currently around 3 pensioners per 10 persons of working age – by 2051, there will be almost over 4 pensioners per 10 persons of working age. In other words, more of the current earnings of people of working age will have to fund the pensions of those who have retired. This will clearly have economic consequences.

The following table shows how much the cost of pensions would increase, assuming that the same average state pension payment as today:

	2002-03	**2011**	**2040**
No. of pensioners	10.8 million	11.9 million	16 million
Average payment by state	£4,213	£4,213	£4,213
Total	£45.5 billion	£50.1 billion	67.4 billion
Additional state expenditure		+ £4.6 billion	+ £21.9 billion

CHAPTER THREE

OPTIONS FOR REFORM

A Tax incentive for pension saving

At the National Association of Pensions Funds (NAPF) Conference in May 2002, NAPF Chairman, Peter Thompson said:

> If you are being asked to lock your hard-earned cash away for 30 years or more, and then to have to buy an annuity at the end, you should receive more favourable tax treatment than you do on your short-term savings which you can draw out at any time, and spend on whatever you like.

This is a fair point and it should be borne in mind when making any recommendations for the tax treatment of short-term savings. As noted in the Sandler Review, tax incentives are important when considering the allocation of savings.[19] Hence, if the policy objective is to encourage pensions savings, such savings should attract greater tax incentives than other types of saving. Obviously, the Government's Pension Tax broke this rule.

Current Reform Proposals – the IPPR Proposal

In March 2002, the Institute for Public Policy Research produced two proposals that had many interesting aspects. The main features of the first – the Gold-Plated Option – are:

- increasing the Basic State Pension to the level of the Minimum Income Guarantee/Pension Credit by 2010 and be linked to earnings thereafter;

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19 R. Sandler, *Medium and Long-Term Retail Savings in the UK – A Review*, July 2002.

- increasing the State Pension Age to 67 during the decade starting in 2020 (this is the date by which female state pension age will reach 65);
- phasing out the pension credit by 2010, as it would no longer be necessary;
- abolishing the State Second Pension and all Contracting Out Rebates.

This option has been costed to be as affordable, in the long term, as the current State Pension regime. Perhaps just as important, it is expected to be cost neutral over the next decade. The cost in 2050 is projected to be rise to 6% of GDP, compared to 5% today.

The IPPR proposal has drawn support from across much of the political spectrum (with the exception of the Minister at the Department for Work and Pensions, Andrew Smith MP). It might be expected to survive a change of Government and could provide the stable framework essential for long-term financial planning.

Its advantages are that it almost eliminates means-testing, thereby greatly improving incentives to save. Prospects for stakeholder pensions are improved and greater flexibility to the rules on annuities can be introduced. However, the proposal itself, with a long-term cost of 6% of GDP, is expensive.

The IPPR proposal relies on the abolition of contracted-out pensions rebates to fund its reforms. As a result, contracted-out occupational and personal pensions would lose approximately £11 billion of contracted-out rebates annually – in effect a second pension tax. This would have a substantially negative impact on private pension schemes (although there is a case to be made that the existence of such rebates has disguised under performance by pension providers). Nevertheless, the abolition would have twice the impact of the abolition of dividend tax credits.

The IPPR's second proposal – the Silver Plated Option – is less costly. Under this, the improvement in the Basic State Pension is confined to those over age 75 and the Minimum Income

Guarantee/Pension Credit would remain for those under that age. However, this option fails to deal with the central problem of means-testing. But it could provide a better solution to the annuity problem as the first requirement for annuity purchase would be to fill the ten years between age 65 and 75. At current interest rates, this would mean that a £100,000 pension fund could provide an annuity of £11-12,000 a year instead of the current £6,000 or so.

In addition, the Pensions Policy Institute has also considered a number of reform proposals, focussed on reforms to S2P and age additions to the Basic State Pension.[20]

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[20] The Pensions Policy Institute, A *guide to state pension reform*, July 2003.

RAISING THE RETIREMENT AGE

As noted by the Pensions Policy Institute, 62% of those born in 1885 then lived to collect their pension[21], while 90% of those born in 1980 will live to 65. The aim of a retirement pension is to provide for people when they are past working age and need to stop working. Increased longevity has meant larger numbers of people living longer. People are generally more capable and healthier at older ages than was previously the case. More people are fitter and healthier at 65 now than was the case half a century ago when the basic state pension was introduced in its current form.

Raising the retirement age to 70 could have the following impact:

- the Basic State Pension could rise from £77.45 a week for a single pensioner to £120 a week – and would continue to be linked to inflation.[22]

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[21] Data are for the proportion of 25 year old males who lived to the age of 65. *Raising State Pension Age: are we ready?,* Pensions Policy Institute, 2002.

[22] In a Parliamentary Written Answer of Mr Ian McCartney MP to David Ruffley MP, the Department for Work and Pensions stated that moving the pension age to 70 could result in a Basic State Pension of £120 per week. These figures assume all savings from not paying the Pension Credit, but ignore the effects on other benefits. Other commentators appear to agree with this figure. For example, the Pensions Policy Institute suggested it could be £104 plus further sums resulting from the abolition of means-tested savings, making a total of around £115 per week; see *Raising State Pension Age, are we ready?,* PPI, 2002.

- public expenditure on the Basic State Pension would remain level;

- a Basic State Pension of £120 a week would enable the abolition of the means-tested Pension Credit.

- Housing Benefit and Council Tax Benefit would still be payable on a needs-assessed basis, as at present. However, by increasing the value of the Basic State Pension, the number of pensioner households that would be in receipt of income-related benefits would fall by 50%, with an equivalent savings on the payment of such benefits.[23]

- These savings could first be applied to cover the increased cost of means-tested benefits that are likely to become payable for people aged between 65 and 70.

- the requirement to take out an annuity could be abolished as the new Basic State Pension would be greater than the amount needed for most means-tested benefits.

These reforms would mean that pensioners would no longer be penalised for saving and all pensioners would benefit from a much increased State Pension. Moreover, older pensioners who tend to be poorer, would receive a significantly increased pension that would be likely to do much to tackle the problem of increases in pensioner poverty with increases in age. Pensioners with savings would have fargreater choice over how to spend or invest their savings. They would be free to decide whether to take an annuity for a limited number of years, or to draw down funds as and when required. Pensioners would also be able to choose to leave all or part of their private pension fund untouched – and to leave it to their heirs on their death if they so wish. Indeed, people could

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[23] DWP, *The Pensioners' Income Series 2000/01*, 2002.

retire at say, 65 and fund the first few years of retirement from their pension savings before the new Basic State Pension kicked in at 70.

The introduction of choice in this way would do much to replace the lost trust and confidence in long-term savings. It would stop people feeling that long-term savings are somehow "wasted" on annuities. Moreover for many people the assurance of a decent state pension would allow them to enjoy their savings more effectively in early and more active retirement.

Everyone to benefit from the Basic State Pension

Access to the Basic State Pension currently depends on the National Insurance Contribution record of the pensioner. Poorer communities are more likely to have high and persistent unemployment rates where it may not be possible to get employment for sufficient qualifying years, or that pays enough to achieve a contribution record. In addition, many have found themselves without a state pension when they expected to get one – a particular problem for married women, as indicated by recent press reports.

The new reformed Basic State Pension would be a universal entitlement for all from the age of 70 onwards, regardless of National Insurance Contributions.[24]. In order to prevent abuse of the system by overseas visitors and migrants, a system of qualifying years could be introduced to ensure that the new Basic State Pension is paid only to those who have lived in the UK for an extended period.

The cost of the reformed Basic State Pension

The cost of providing a universal Basic State Pension would be an extra £1.5 billion a year.

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24 For many years, National Insurance Contributions have in reality been taxation. The current conditions that have to be met to receive a Basic State Pension in fact only serve to punish the lower paid or unemployed workers – those who most need the Basic State Pension.

This cost could be paid for via a parallel shake up of the SERPS/State Second Pension scheme. Under the reformed Basic State Pension, the Government's redistributive State Second Pension policy will not be necessary as the new basic state pension will be generous and enable a decent living retirement. Equally, the current system where £11 billion in rebates are paid to private pension schemes simply recycles tax revenues into pension funds.[25] SERPS/State Second Pension should, therefore, be abolished with existing contribution entitlements and payments being honoured, but no further contributions or payments made going forward. Likewise pension rebates should also be abolished. If complete abolition is not seen as desirable, the entitlements could be reduced by such an amount as would permit the introduction of the universal basic state pension.

Abolishing SERPS/State Second Pension and pension rebates outright would, all else being equal, result in a cut in National Insurance Contributions. However, as well as allowing for a tax cut, abolition should in part fund the universal Basic State Pension. Abolition would therefore provide room to cut taxes and enable individuals to determine how to save, rather than taxing them simply to make payments to their private pension funds.

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[25] The whole SERPS/State Second Pension system is a financial merry-go-round that few understand and that makes little sense. It would be better not to tax people at all than tax them and pay that tax into a person's private pension fund.

WINNERS AND LOSERS

RAISING THE STATE RETIREMENT AGE TO 70 creates a gap in pension provision terms for those aged between 65 and 70, assuming that they wish to retire.[26] Individuals would have a choice:

- to carry on working to 70;
- or to fund the first five years of retirement themselves (the average pension pot of around £25,000[27] would buy an annuity that would pay about £6,000 a year between the ages of 65 and 70);
- or to rely on state benefits such as Income Support.

More older people would thereby have both the incentive and the liberty to continue work to the benefit of their own prosperity and the strength of the country's economy.

There would be no "winners or losers" in the classical sense under this reform as it is a redistribution across the lifetimes of the individuals, not across groups of individuals as such. The table overleaf sets out the likely impact on pensioners in a variety of case studies.

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[26] For those who wish or need to carry on working to 70, it would be necessary to change the law so that all employment contracts and pension scheme normal retirement ages are automatically changed. The Government's recent moves in this direction are to be applauded.

[27] DWP, *Modernising Annuities*, 2002.

	Gladys	Henry	Charles	Phyllis	Bertie	Steve
CURRENT FROM AGE 65 ONWARDS						
Savings	£100,000	£100,000	£12,000	£0	£8,000	£0
Savings Interest (per week, @3%)	£58	£58	£7	£0	£5	£0
Private Pension (per week)	£200	£0	£40	£0	£0	£0
State Pension	£77	£77	£77	£0	£77	£77
Income Support	£0	£0	£0	£55	£0	£0
Pension Credit	£0	£0	£0	£0	£24	£22
Council tax and Housing Benefit	£0	£0	£0	£65	£58	£65
Total Income	**£335**	**£135**	**£124**	**£120**	**£164**	**£164**
WEEKLY INCOME AGED 65 TO 70 UNDER PROPOSED PENSION REFORMS						
Savings	£100,000	£75,000	£0	£0	£8,000	£0
Savings Interest (@3%)	£58	£43	£0	£0	£5	£0
Private Pension/annuity	£200	£115	£95	£0	£0	£0
Income Support	£0	£0	£0	£55	£0	£54
Council tax and Housing Benefit	£0	£0	£0	£65	£58	£65
Total Income	**£258**	**£158**	**£95**	**£120**	**£63**	**£119**
WEEKLY INCOME AGED 70+ UNDER PROPOSED PENSION REFORMS						
Savings	£100,000	£75,000	£0	£0	£8,000	£0
Savings Interest (@3%)	£58	£43	£0	£0	£5	£0
Private Pension/annuity	£200	£0	£40	£0	£0	£0
Council tax and Housing Benefit	£0	£0	£0	£65	£58	£65
Basic State Pension	£120	£120	£120	£120	£120	£120
Total Income	**£378**	**£163**	**£160**	**£185**	**£183**	**£185**

Gladys has a good private pension and savings of £100,000. She has no entitlement to state benefits apart from the state pension. At 65, she chooses to retire and to leave her svings untouched. She is £75 a week worse off between the ages of 65 and 70 under the proposed scheme, but intends to supplement this income with part-time work (or she can use part of her savings to buy an annuity). After the age of 70, she is £41 a week better off for the rest of her life.

Henry has savings of £100,000. This is his only asset. At the age of 65, he chooses to invest £25,000 in an annuity to cover the next five years of his life. He is £19 a week better off between the ages of 65 and 70, and £24 a week better off from the age of 70 onwards.

Charles has savings of £12,000 and a small private pension that yields £40 a week. At 65, he chooses to use his savings to buy an annuity that yields a further £55 a week for the next five years of his life. His income of £95 a week would mean that he would be eligible for some housing and council tax benefits. However, he has savings of £12,000 and is therefore not entitled to any benefits. He is therefore £29 a week worse off between the ages of 65 and 70 (but he would be well advised to spend all his savings to qualify for means-tested benefits).

Phyllis is a widow. She has not had any children and has no savings. At the moment, she has no State Pension entitlement whatsoever. Under the proposed scheme, her position would remain the same between the ages of 65 and 70; but she would be £66 a week better off from the age of 70onwards.

Bertie has savings of £8,000 and no pension. He receives Council Tax and Housing Benefit. Under the proposed scheme he would not receive income support between the ages of 65 and 70 because of his savings. Like Charles, he qould be well advised to spend his savings. From the age of 70 on, he would be £18 a week better off.

Steve has no savings and no pension. He receives Council Tax and Housing Benefit. Under the proposed scheme he would receive income support between the ages of 65 and 70 when he would be £36 a week worse off. From the age of 70 on, he would be £20 a week better off.

Maintaining the same level of expenditure over a smaller class of pensioners will not only provide a decent living pension – it will also tackle much of the problem of the coming demographic shock to the Government's finances.

Under the reformed system, those aged between 65 and 70 will either continue working or fund the first few years of retirement from their own pension. Those who wish to retire, but have not saved, will receive income support until they reach the age of 70. There will, therefore, continue to be a safety net available where it is necessary. But it will not (indeed must not) be a generous safety net as it is important to incentivise people to save for old age.

The Government and some commentators have put forward the case for an elective system where pensioners decide whether to retire at 65 or wait and receive a larger pension at 70. This is attractive as on the face of it no-one would "lose out" given that people would make their own choices on when to retire. The problem with this type of scheme is that it is likely to be extremely expensive. This is because people tend to act in their best financial interests. So a person who has been a manual worker and is likely to have a short retirement will tend to draw the pension from 65, whereas the Kensington housewife will tend to draw the pension from a later date in order to receive a larger sum. This is not cost neutral since those who have shorter retirements effectively subsidise those who are more long lived. If people can elected when they are eligible for the Basic State Pension, this statistical balancing act is likely to be upset with considerable revenue implications for Government.

CONCLUSIONS

PENSIONER POVERTY should be unacceptable in Britain today – yet is all around us. These fiscally neutral, affordable proposals would end the morally unacceptable situation whereby millions of people have to live on less than £100 a week in retirement.

Pensions for all

The contributory principle that underpins the Basic State Pension is discredited. It simply serves to punish those who were on lower incomes during their working lives or those who have stopped work to look after children. The Basic State Pension should therefore be a universal benefit. This would particularly help women, those who were on lower incomes or those who had a history of unemployment – in other words, those who most need to benefit from the basic state pension. The cost would be around £1.5 billion. This should be funded from the reduction or abolition of SERPS/State Second Pension and pension rebates.

Bigger Basic State Pension

A higher, more generous Basic State Pension, available only from the age of 70, would be affordable and enable intrusive means-testing to be scrapped. Overall expenditure on the Basic State Pension would not be cut. The new reformed Basic State Pension would pay around £120 per week (at current price levels). It would increase in line with the maintenance of the existing pension settlement of expenditure at 5% of GDP, with reviews every three years or so to prevent excessive fluctuation of pension payments.

Reduce Means-Testing

The means-tested Minimum Income Guarantee/Pension Credit would be abolished. Pensioners who have failed to make any provision for themselves should be looked after – but not so generously that others are punished for saving. Pensioners who fail to save will receive the new basic state pension of £120 per week and should therefore not require significant social security benefits. However, Housing Benefit and Council Tax Benefit would continue to be available on the current needs-assessed basis.

No annuity requirement

As proposed, the new reformed Basic State Pension is high enough for all pensioners to be above the level at which they needed further assistance (other than Housing Benefit and Council Tax Benefits in need-assessed cases). Thus the compulsory requirement for retirees to use their pension fund to purchase and annuity could be abolished. Pensioners should be free to decide when, if and how they draw down income or capital from their pension funds. It would then be possible for a person to leave his (or her) pension fund to his heirs.

Abolishing pensioner poverty

The new reformed £120 a week universal Basic State Pension and the abolition of the annuity requirement is the basis for a new pensions settlement between Government and people. It would achieve the goal of a decent income with some disposable money left over. In addition, the ending of the annuity requirement will ensure that people will no longer believe that pension savings are "lost" to them for all time, thus encouraging people to have greater confidence in pension savings.

Implementation

This reform could be introduced between 2010 and 2020 on the same timetable as the increase in women's pension ages. It would not require people to have greater savings – but it would require them to work for longer. This may be a painful change for many, but it a basis for a lasting, fairer pensions settlement.

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