CENTRE FOR ANALYSIS OF SOCIAL EXCLUSION
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The Pensions Green Paper

- The government's pensions Green Paper - *A new contract for welfare: partnership in pensions* - proposes fundamental changes to the UK's retirement income system. Members of CASE and of the Department of Social Policy at the LSE have looked at the likely implications of the reforms for pensioner poverty, income security in old age, economic growth, the National Insurance system, tax reliefs, and women. This brief summarises their conclusions.
- Rake, Falkingham and Evans show how the Government's proposals may result in extended means-testing in old age. The narrow margin between the basic pension plus the State Second Pension (SSP) and the means-tested Minimum Income Guarantee (MIG) means that many people will retire on incomes below means-tested benefit levels. Indexation rules mean that even people who meet the SSP's qualifying conditions in full could end up relying on means tested benefits soon after retirement.
- Agulnik's analysis of the redistributive effects of the SSP shows that it will result in much better benefits for low earners than would have been the case under SERPS. However, financing this improved provision through National Insurance Contributions will mean that the burden of paying for the new scheme will be heaviest for those close to the upper earnings limit.
- Barr questions the macro-economic advantages of increasing the amount of funded pension provision via Stakeholder pensions. He finds there is no particular reason to favour the proposed balance of 60% private pension provision to 40% public provision over some other ratio. He also finds that Stakeholder pensions will not offer contributors complete income security in retirement due to uncertainties about investment returns, annuity rates and future inflation.
- Falkingham and Rake argue that the Government's proposals have failed to incorporate fully the needs of women. Women will be under-represented amongst Stakeholder pensioners, and the exclusion of very low earners and carers with children over 5 from eligibility for the SSP will adversely affect women.
- Agulnik looks at the proposed tax relief rules for Stakeholder pensions. While there are good reasons for the proposed £3,600 limit to tax relief on contributions, the retention of the existing rules for personal and occupational schemes is anomalous.

Further information

Full responses to the Green Paper by members of CASE may be found in CASEpaper 23, *Tightropes and Tripwires: New Labour's proposals and means-testing in old age* by Katherine Rake, Jane Falkingham and Martin Evans, and CASEpaper 24, *Partnership in Pensions? Responses to the Pensions Green Paper*, by Phil Agulnik, Nicholas Barr, Jane Falkingham, and Katherine Rake. Copies are available free of charge from Jane Dickson, CASE, at the address below, or can be downloaded from our internet site: http://sticerd.lse.ac.uk/Case/.

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The Green Paper's Proposals in Outline

- The living standards of the poorest pensioners will be protected by tying the level of Income Support for the over 65s to increases in earnings (with the basic state pension remaining indexed to prices). The benefit will be re-branded as a 'minimum income guarantee'.
- The State Earnings-Related Pension Scheme (SERPS) will be replaced with a new State Second Pension (SSP). The SSP will eventually be a flat-rate scheme, providing improved second pensions for people earning below £9000 a year and some non-earners (such as carers). People earning between £9,000 and £18,500 will also benefit through increased 'contracted-out' rebates paid to private pension schemes.
- Stakeholder pensions will be introduced to provide a new, cheaper saving option for people with earnings above £9000 who do not have access to an occupational scheme. A simpler tax regime, but with a lower overall contribution ceiling, will apply to the new schemes.

Tightropes and Tripwires: New Labour's Proposals and Means-Testing in Old Age

Katherine Rake, Jane Falkingham and Martin Evans

This paper analyses what the Green Paper's proposals deliver to low paid workers – are the low paid protected from a means-tested old age? It is argued that the Green Paper's proposals incorporate *tightropes* and *tripwires* for the low paid. The proposals will create a tightrope for the low paid because their income from the basic pension and SSP will be so near the means-tested minimum that little is gained in retirement from a lifetime of work and contribution. Tripwires exist because common life events disrupt basic and secondary pension entitlement. The proposal's tripwires include periods of unemployment, sickness or training, extended periods of caring for children, time below the lower earnings limit, and bereavement. As a result many will retire below the means-test level despite having paid contributions for most of their working life. These tightropes and tripwires may result in extensive means-testing of low paid workers and this raises concerns about the incentives for the low paid to make additional savings for their retirement. The paper raises questions about the sustainability of the proposals, the complexity of the proposed pension system, the robustness of the Government's assumptions about family formation and labour market participation, and the sensitivity of Government projections to fluctuations in annuity markets.

The Proposed State Second Pension and National Insurance

Phil Agulnik

The pensions Green Paper proposes to replace the State Earnings Related Pension Scheme (SERPS) with a new State Second Pension (SSP). This paper looks at the rationale for the introduction of the new scheme, calculates its redistributive effects, and sets out some limitations of the government's approach.

The government’s central objective is to ensure that all pensioners have an income at or above the poverty line. This will be achieved through a means-tested ‘Minimum Income Guarantee’. However, the government recognises that, on its own, this strategy would create severe saving disincentives for lifetime low earners, who might rationally reduce the amount they contribute to a pension in order to be eligible for additional retirement benefits. The rationale for the replacement of SERPS with the SSP is therefore to ensure that this problem of ‘moral hazard’ is reduced.

Distributional analysis of the SSP shows that, though some ‘lifetime poor’ people will not gain from the proposals due the relatively tight eligibility conditions, in general the additional benefits provided by the new scheme will be strongly pro-poor. But, given that no-one’s pension entitlements are reduced, this extra provision must be financed through higher contributions. Relative to the previous policy, which would have led to a substantial fall in National Insurance Contribution (NIC) rates, the new scheme keeps NIC rates at roughly their current level. The fact that this additional revenue will be used to benefit low earners means that the scheme is highly redistributive. Nevertheless, the fact that the SSP will be financed from NICs also means that the burden of paying for the new scheme will be greatest for people earning around the upper earnings limit.

The paper concludes by suggesting that the potential flaws in the government’s scheme – its complexity, its less than complete coverage of the lifetime poor (and hence ineffectiveness in eradicating pensioner poverty), and its somewhat muted redistributive effects – arise largely from its failure to tackle the ambiguities inherent in the contributory nature of national insurance.

A Public-Private Partnership in Pensions: Getting the Balance Right

Nicholas Barr

The paper assesses stakeholder pensions, particularly the claims that they offer greater security and have macroeconomic advantages.

So far as security is concerned, stakeholder pensions, like any money-purchase scheme, face pensioners with a series of risks related to the quality of management, stock-market fluctuations, annuities market risk, potential inflation, demographic effects and political risk. Thus stakeholder pensions, though potentially a major advance on previous personal pensions, are not completely secure – because by their nature they cannot be.

The paper argues, second, that the macroeconomic advantages of a change in balance away from state pay-as-you-go pensions towards funded stakeholder pensions should not be overstated. Specifically, the macroeconomic gain from shifting the balance from 60% public spending: 40% private spending to one of 40:60 is less than the Green Paper implies. A different balance between state and private pensions is economically feasible.

The paper concludes with two sets of recommendations. The first suggests ways of enhancing the security of Stakeholder pensions, for example through full indexation; the second proposes ways to bolster the state pension, both by making it more generous and by introducing a flexible retirement age.

‘Partnership in Pensions’: Delivering a Secure Retirement for Women?

Jane Falkingham and Katherine Rake

As women rely more on the State as a source of income in old age, and constitute the majority of the pensioner population, the ability of the reforms to deliver a fair deal to women should be a key criterion on which to judge the proposals. Analysis of the Green Paper reveals a number of features of the new pension system that mean many women will continue to be denied income security in old age.

- The State Second Pension offers credits for child care that are considerably less generous than those currently offered by the basic pension. This will penalise those who cannot, or do not, re-enter the labour market as soon as their children start primary education.
- The reformed system continues to work on the assumption that a ‘normal’ working life spans 49 years. Women, who rarely meet this norm, will continue to be penalised by lower benefits in old age under the new system.
- The reforms make no provision for the pensions of those 2 million women who earn under the lower earnings limit each year. Those women who accept low paid employment which they can combine with unpaid caring labour, or whose lack of skills mean that they command low pay, will continue to pay a pension penalty in later life.
- The government predicts that only a third of members of the new Stakeholder pension schemes will be women. The reforms will do little to tackle women’s under-representation in the ‘privileged’ pension sectors – Stakeholder pensions, just like occupational pensions, will continue to be populated in the majority by men.

Pension Tax Reliefs and the Green Paper

Phil Agulnik

This paper looks at the distributional effects of the current system of tax reliefs and the proposed regime for Stakeholder pensions. Though it is often claimed that tax relief on pension contributions merely defers tax revenue, this is not the case. The current system does involve substantial losses for the Exchequer, with the benefit of this lost tax revenue going predominantly to high earners. The proposed tax rules for Stakeholder pensions are an improvement, but the retention of the existing regime for personal and occupational schemes is anomalous and may be confusing in practice. The limit of £3,600 on contributions to Stakeholder pensions should apply more widely.

POLICY IMPLICATIONS

The analyses provided by the various authors suggest the government's proposals suffer from a number of problems. Principally these relate to:

- the likelihood that means testing in old age will continue to affect low paid workers; the differences in indexation rules for retirement benefits mean that the basic pension and SSP will over time lose their value relative to the Minimum Income Guarantee,
- the distributional effects of financing the proposals through National Insurance Contributions,
- the uncertainties which people with Stakeholder pensions are likely to face,
- the fact that women will continue to be relatively disadvantaged in old age, and
- anomalies in the tax treatment of Stakeholder and other pension vehicles.

Many of these problems might be ameliorated through comparatively minor amendments to the strategy outlined in the Green Paper. However, they might also suggest the need for a more radical re-think of the government's proposals. The papers discuss a number of policy options; some would involve extra public spending. However, it should be noted that under the Government's proposals, total pension spending is expected to fall significantly relative to GDP.

MEANS-TESTING IN OLD AGE (Rake, Falkingham and Evans)

As proposed the State Second Pension will not ensure that everyone is able to enjoy a retirement with an income above the level of means tested benefits. A greater distance could be put between first and second tier pensions and the Minimum Income Guarantee by:

- insuring a greater distance between contributory pensions (the basic pension plus SSP) and the MIG; this could be done either by raising the level of the basic pension or by increasing the generosity of the SSP;
- maintaining this distance by uprating the SSP, the basic pension and the MIG by earnings;
- making coverage of the SSP more comprehensive, through extending credits for periods out of employment and/or reducing the number of qualifying years needed for full entitlement.

NATIONAL INSURANCE CONTRIBUTIONS (Agulnik)

The extra expenditure involved in the State Second Pension and its related system of rebates will curtail the projected fall in National Insurance Contribution rates. This means that, because of the existence of an upper limit to such contributions, people with earnings around the upper limit will lose out most (relative to previous policy). The redistributive effects of the proposals could be enhanced by:

- reducing the benefits paid to higher earners in the form of rebates, for instance through capping rebates at the amount which someone earning £18,500 would be entitled to;
- reintroducing a Treasury grant to the National Insurance Fund, so that revenues from (income) tax absorb the cost of additional spending;

- raising the upper earnings limit, e.g. to the starting point for higher rate tax;
- abolishing National Insurance altogether, replacing contributory benefits with universal pension payments, and maintaining revenue through increasing tax rates or through a new social security tax.

STAKEHOLDER PENSIONS AND UNCERTAINTY (Barr)

Stakeholder pensions will be subject to the same uncertainties regarding investment returns, annuity rates and inflation as other 'money purchase' pension vehicles. These uncertainties could be reduced by the government:

- allowing flexibility over the timing of cashing-in of pension savings (thereby addressing stock market fluctuations);
- replacing limited price indexation by full price indexation, through a prudent mix of indexed gilts and indemnities to pension funds;
- intervening to iron out fluctuations in annuities markets, or providing annuities directly via the Bank of England.

A SECURE RETIREMENT FOR WOMEN (Falkingham and Rake)

The assumptions underlying the Green Paper about what constitutes a 'normal' working life do not reflect the experiences of women. Their needs could be more fully addressed by:

- extending eligibility to the SSP by reducing the number of contributory years and extending credits for child care;
- ensuring that SSP rights are inheritable, with at least 50% of the deceased partners rights passing on to the survivor;
- making pension provision for those who fall below the lower earnings limit.

TAX RELIEFS FOR PENSIONS (Agulnik)

The UK's existing system of tax relief for pension contributions predominantly benefits the better-off. The proposed tax rules for Stakeholder pensions are an improvement, but create anomalies. Tax reliefs could be made more progressive by:

- extending the proposed £3,600 contribution limit for Stakeholder pensions to all personal and occupational schemes, making the system for Stakeholders less anomalous and slightly reducing the cost of tax reliefs;
- reducing the costs of tax reliefs more radically, for instance by making pension contributions a benefit-in-kind for National Insurance Contributions;
- using the resources released to finance a higher rate of relief on all pension contributions, to introduce matching grants on pension contributions, or to finance a higher basic pension.