Civitas Online Report

Pension Reform: Work Till You Drop?

David G. Green

Summary

- Raise the retirement age to 70 in steps of 6 months per year over 10 years.
- Require contributions sufficient to meet the state minimum but no more.
- Scrap all up-front tax reliefs, but make pension benefits tax free.

Personal responsibility

Should we work longer before expecting a state pension? Should contributions be compulsory? These questions can't be settled without considering the wider obligations we owe each other. For at least the last 400 years we have always had a state safety net. Material help is available to everyone, because we never know who might need it. Once accepted, however, it is legitimate to expect every citizen to make provision against misfortune when able to do so.

What should these expectations be? We can reasonably expect to make provision for the normal expenses of living, and for periods when expenditure will be high—most notably when children come along—or when income is lower, especially during retirement. If a person plans to have children, then the lifetime plan will need to include a partner to allow for the children to be both cared for and supported financially. Provision also needs to be made against misfortunes such as the early death of a partner, or illness, which may both reduce income and increase expenditure.

Is it realistic to expect people to take personal responsibility for self-support during old age? It is widely accepted that the presence of a safety net may encourage some individuals to rely on the state rather than their own endeavours. This difficulty is at the heart of the current debate about pension reform. To what extent should provision of a pension be compulsory?

Compulsion Now?

At present the basic pension is compulsory, and so too is payment towards the state second pension (also called the Additional State Pension, abbreviated as S2P and previously known as SERPS from 1978 – 2002), although individuals can 'contract out' and pay their national insurance contributions into a private pension.

Despite being contributory, both the basic pension and S2P are pay-as-you-go systems, financed from current tax revenues and not from a separate actuarially-sound

fund. In 2005/06 employees paid 11% of earnings between the Primary Earnings Threshold (PET) of £4,895 (£94 per week) and the Upper Earnings Limit (UEL) of £32,760 (£630 a week), plus 1% on earnings above the UEL. If their earnings were between the Lower Earnings Limit (LEL) of £4,264 (£82 a week) and the PET, they were treated as if they had paid NI contributions.

The benefit is based on years during which NI has been paid. In 2005/06, for earnings between the LEL (£4,264) and the Lower Earnings Threshold (LET) of £12,100 individuals receive 40% of earnings. Anyone who earns between £4,264 and £12,100 is treated as if they earned £12,100. Earnings between the LET and the Upper Earnings Threshold (UET) of £27,800 acquire a pension of 10% and earnings between the UET and the UEL of £32,760 receive 20%.

In 2005/06 the Basic State Pension (BSP) was £82.05 per week for a single person and £131.20 for a married couple. A married couple's pension is payable when the wife has an insufficient contribution record to receive more than 60% of the full amount. With a full contribution record a wife would also receive £82.05. The state pension is payable at 65 for men and 60 for women, but between 2010 and 2020 it will become 65 for both.

At present a man will receive a full BSP after making contributions (or being treated as if he had made contributions) for 44 of the 49 years between ages 16 and 65. If someone does not have a full contribution record then they receive a partial pension.

However, someone who has not paid sufficient contributions to earn the full pension simply has their income topped up under the Pension Credit scheme, previously called the Minimum Income Guarantee (MIG). There are two elements: the Guarantee Credit and the Savings Credit. In 2005/06 the Guarantee Credit topped income up to £109.45 per week for a single person. For example, someone with £100 pre-benefit income (including BSP, SERPS, S2P and any private pension) would receive an additional £9.45 in guarantee credit.

Under the MIG, topping up penalised people who had small private pensions and so the Savings Credit was introduced for income above the level of the BSP. For example, a single person over 65 receiving the BSP of £82.05 plus a small private pension of £10 a week would have a total income of £92.05. Up to the guaranteed amount (£109.45) Savings Credit is 60% of the difference between actual income and the BSP. The difference is £10 and so the Savings Credit is £6, and total income will be £115.45. A person whose income was exactly the same as the guaranteed income (£109.45) would receive the maximum Savings Credit of £16.44.

A person with an income above £109.45 would find their Savings Credit subject to a 40% reduction. Take, for example, a single person with an income of £129.45. The maximum Savings Credit is £16.44 and it is reduced by 40% of the difference between actual income (£129.45) and the guaranteed amount (£109.45). The difference is £20 and the reduction, therefore, is £8, leaving £8.44. Total income after benefit adjustments will be £117.89. For individuals earning just over £150, 40% of the difference between their income and the guaranteed income is greater than the maximum Savings Credit of £16.44 and so there would be no entitlement.

One problem with this complex system is that many people are deterred from claiming. The DWP estimates that during the financial year 2001/02 between one-quarter and one-third of 'benefit units' were on incomes below the guaranteed level due to failure to claim their entitlement.

Additional benefits are also payable. Housing Benefit is a means-tested benefit paid to people living in rented accommodation and pensioners who receive the Guarantee Credit automatically receive full Housing Benefit covering all their rent. Housing Benefit is normally withdrawn at the rate of 65p for each additional pound of income. But in order to prevent pensioners from having their Pension Credit payments removed through the Housing Benefit taper, it is not tapered away until income reaches £125.89, the level of the Guarantee Credit plus the maximum Savings Credit.

Council Tax Benefit (CTB) is a means-tested benefit that assists people with Council Tax and entitlement is calculated using the same income as for Housing Benefit. The taper rate for CTB is a 20p reduction for each pound in excess of the threshold. As Housing Benefit and CTB are calculated together the combined taper where someone is entitled to both is 85p for each pound of extra income.

Disability Living Allowance (DLA) is a tax free, non-contributory and non-income-related benefit to cover the extra costs of people who are severely disabled before reaching the state pension age. It is not possible for someone aged 65 or over to make a new DLA claim, but people who claim and qualify for the allowance before reaching age 65 can keep it after that age, so long as they continue to satisfy the conditions.

For people who are aged 65 and over when they claim help with disability-related extra costs, Attendance Allowance (AA) provides a tax free, non-contributory and non-income-related benefit. DLA and AA are not taken into account in calculating entitlement to Pension Credit, Housing Benefit or CTB, but they entitle recipients to disability premiums for Housing Benefit and CTB and to receive the disability additional amount under Pension Credit.

In addition pensioners are eligible for a variety of other cash and non-cash benefits, including the Winter Fuel Payment which is £200 for a household with someone aged 60 or over. In 2004 an additional £100 payment was to be made to households where someone is aged 70 and over. A free TV licence is available for those who live in a household where someone is aged 75 and over and free prescriptions and eye tests for those aged 60 and over.

The Pensions Commission estimated the cost of these additional benefits as follows. The total cash cost of the Winter Fuel Payment and the free TV licence was expected to be £2.9 billion in 2004/05 and a further £7 billion was expected to be spent on Housing Benefit and Council Tax Benefit for pensioners. Expenditure on AA and DLA for pensioners was put at £6.5 billion in 2004/05.

For many, being a pensioner has become a story of claiming extras from the state. Many would prefer a system that offered hope of an adequate income without the necessity for means testing.

The Main Alternatives

Four main alternatives to pay-as-you-go systems are generally put forward. The first requires payment of compulsory contributions but allows individuals a choice of pension provider, such as Chile. It is defended as increasing choice compared with a scheme requiring a compulsory contribution to a state pension. The second approach is a funded state pension, such as Singapore's. The third urges free market provision but calls for the government to encourage locked-in savings by means of tax breaks. The main line of reasoning used in support of this method is that people are short-sighted and, without encouragement, will not choose the most suitable means of saving, which is said to be the deferred annuity.

The fourth approach prefers to put few, if any, limits on the methods by which people can provide for their old age and also opposes the use of the tax system to encourage particular types of provision. The government in this view should neither discriminate between methods of provision, nor require contributions to any given scheme. But, it has a responsibility to provide an income safety net for those who fail to provide for themselves.

Is Compulsion Necessary?

The strongest argument for compulsion is that, if the state maintains a safety net, then some individuals will be more likely to rely on it rather than to provide for themselves. Therefore, so the argument goes, people who are capable of saving but do not or will not,

should be required to do so. But, should the desire to avoid free riding outweigh all other considerations? What are the potential disadvantages of compulsion?

1. A compulsory pension is defended as a means of eliminating free riders, but it does not completely achieve that objective. Some people never earn enough to accumulate a pension fund. Some refrain from work. Some work in the black economy. Moreover, compulsion increases the incentives to work 'off the books'. Countries with compulsory schemes, such as Chile, still have to maintain a state guarantee funded from taxes.

2. Compulsion is applied to people who would have saved anyway. Many are compelled to save in a manner which may not be the best for them. Self-employed people, for example, may prefer to invest in their own businesses and such investments may well prove to be a more sound method of provision than a compulsory contribution to an annuity.

3. Compelling individuals to contribute a fixed percentage of their income to a private pension throughout life assumes a stable pattern of employment. But the pattern of work has changed. Earlier in the century it was possible to assume that most people were employees, but this is no longer true. The labour market continues to change, with far fewer workers now expecting to spend their career with one employer and many more preferring self-employment. A compulsory scheme crowds out flexible alternatives that would allow adjustment to changing circumstances. For all these reasons, the more flexibility the better, to allow variations in saving patterns, gaps, sudden bursts of effort, or a change of strategy from reliance on dividends or interest to capital growth.

4. A compulsory scheme, based on a percentage of income, also fails to acknowledge the legitimacy of changes in saving and spending priorities over the lifecycle. It is legitimate to have different priorities when younger. For example, when a married couple have children to support, then the death of the breadwinner would be very serious, as would incapacity for work. But when the children are grown up, early death has less serious financial consequences.

5. Inevitably a compulsory scheme must be regulated, and the regulations limit the access of new companies to the market and diminish the scope for innovative competition. In Chile, for example, a relatively small number of regulated companies have a guaranteed market. The result is that they do not need to try so hard.

6. To contribute to a pension by locking away savings for 20–30 years is not the most prudent savings strategy. To hand over money today to a private company knowing that you will be forced to buy an annuity in 2030 is inherently risky. The company might be a mutual at the moment, but what will it be in the future? Companies can and do increase

their charges (which might be from 13 per cent to 39 per cent of contributions); investment performance varies; annuity rates fluctuate; policy towards bonuses may change; and the government might change the tax or regulatory regime again. These uncertainties explain why in 1998, after only a few years, about 6.5 million people had invested £105 billion in PEPs and TESSAs, despite their less favourable tax treatment. Subsequently ISAs have been successful. They are popular because they allow people to move their savings in the light of changing circumstances. It is not short-sighted to want to avoid relinquishing control of your retirement income. It is prudent.

Thus, compulsion does not fully achieve its primary objective—to avoid free riding—but it has a harmful effect on other people, many of whom would have made sensible provision. These are arguments against compulsion but they are also strong arguments against tax concessions. If compulsion is a *requirement* to put money into a bad investment, tax breaks are an *inducement* to put money into a bad bet. The objective of policy should, therefore, be to create a regulatory framework which allows the maximum flexibility whilst guarding against fraud and financial abuse. Historical experience makes a compelling case for flexibility and freedom of initiative.

But is it possible for the government to avoid free riding? The temptation to rely on state benefits instead of making adequate contributions earlier in life is the result of offering unconditional benefit payments on reaching a certain age. The Government has accepted that this system creates a moral hazard, but it has chosen to deal with it by coercing people who do not need to be coerced, many of whom have made arrangements more suitable for their own circumstances than any pension, whether a basic state pension or the State Second Pension.

A more effective method of reducing the moral hazard would be to require individuals to build up a fund sufficient to buy an annuity equivalent to the state minimum. Initially it would need to take the form of an obligation to pay a percentage of income into a fund, but once a sufficient fund had been accumulated, saving would be voluntary. The fund would be their personal property, but on retirement individuals would have to buy the minimum annuity required by law. Any balance could be taken as a lump sum, used to buy an additional annuity, or left to accumulate further interest. Currently a fund of 100,00 will buy an annuity of about £6,000 a year for a man aged 65 and his wife aged 60, with a two-thirds pension for the survivor when one dies.

Raise the Retirement Age

We should also raise the state retirement age. We now live much longer and enjoy good health well beyond 65 and the state pension age could be raised in stages, perhaps by six months per year so that in ten years it will be 70. There is a basic obligation to work until illness, frailty or death intervene, but a case can be made for working until a fixed retirement age of 70, at which point it can be assumed that many people will be getting frail. Assuming the current school leaving age of 16, a retirement age of 70 allows individuals up to 54 years to accumulate a retirement fund. A sum of about £70,000 should buy an annuity, at current prices, equivalent to the current state minimum of £109 a week (including the pension credit). Inevitably, some people will never accumulate enough, but this scheme would reduce the number of individuals dependent on means testing to the bare minimum.

Tax Concessions

Finally, the current tax regime for pensions should be revised. If compelling people to contribute to a pension is wrong, so too is offering them a tax inducement. A better system would be to replace it with the tax regime for ISAs, but with much higher investment limits. Schemes could then evolve with the minimum of regulation offering any combination of saving, protective insurance, investment for income or capital growth, long-term lock-in, short-term access, linkage or non-linkage to annuities.

Work Till You Drop

What strategies could an individual pursue in this environment? First, there is 'work till you drop'. A prudent person could plan to go on working until he or she was no longer able to do so. In some cases such a person would die while still working, and in others he or she would work until illness or frailty intervened. The main risk is that a relatively young person may become too ill or frail to work, and so prudent people would ensure that they had a disability insurance policy, payable at any age, and which preferably paid a high income replacement benefit linked to salary. But, as we have seen, if individuals were compelled to pay a fixed percentage of their income into a pension, their ability to provide for possible misfortunes would be diminished.

It would also be perfectly prudent for a family to follow a two- or three-generation plan. A family could build up assets—property, durable goods, shares, cash savings—with the intention of handing them on from generation to generation. Purchasing an annuity involves giving a capital sum to an insurance company which undertakes to pay an agreed

sum per year until death. The insurer takes the risk that the capital will run out, but members of a family might prefer to take that risk themselves. If the oldest surviving generation, for example, opts to live on its capital rather than to buy an annuity, the risk of their capital running out before they die gives their children an incentive to diminish expenditure, perhaps by caring for their parents themselves. They might use the capital to build a 'granny annex', so that their parents were close at hand. Or they might purchase 'long term care insurance' to guard against the high cost of residential care.

Such a property-based strategy offers considerable flexibility for families of quite modest means. For most people, investing in the family home has been a good bet for much of this century and by trading up or down, or using the property as collateral for a loan, cash can be made available at different stages of the lifecycle.

To sum up: provision would be a personal responsibility, but no one would be allowed to fall below the state minimum. Everyone would be expected to save enough to avoid relying on the work of other people, but compulsion would be kept to a minimum.

29/11/05