Partnership in Pensions? Responses to the Pensions Green Paper

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Centre for Analysis of Social Exclusion

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Editorial Note and Acknowledgements

This volume contains four papers that are responses to the Government's Green Paper on Pensions, *A New Contract for Welfare: Partnership in Pensions*.

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Abstract

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 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. Agulnik's analysis of the redistributive effects of the State Second Pension (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 then 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.

The Proposed Second State Pension and National Insurance

Phil Agulnik

The pensions Green Paper (DSS, 1998) proposes substantial changes to second tier pension provision in the UK. In particular, the government plans to replace the State Earnings Related Pension Scheme (SERPS), introduced barely twenty years ago by the last Labour administration, with a new State Second Pension (SSP). According to the Green Paper, this will result in "*dramatically better pension provision for those earning less than £9,000 a year*" and, through increased payments to private pension schemes, will also provide "*extra help to those on middle incomes (£9,000 - £18,500 a year)*".

This paper looks at the rationale behind the Green Paper's proposals, calculates the redistributive effects of the SSP, and sets out some criticisms of the government's gradualist approach. The paper is divided into five sections. Section one discusses the objectives for pension policy set out in the Green Paper, and puts the government's strategy into historical context by examining how and why second tier pension provision developed in the UK. Sections two and three then look at the detailed operation of SERPS and the SSP, describing the rather complex administrative procedures involved and showing how the pension entitlements earned differ under the two schemes. The analysis shows that, though some 'lifetime poor' people will not gain from the proposals due to the relatively tight eligibility conditions for the SSP, in general the benefits of the new scheme will be strongly pro-poor. However, as described in section four, the fact that the SSP will be financed from National Insurance Contributions (NICs) means that the burden of paying for the new scheme will be heaviest for people earning around the upper earnings limit, with very high earners paying proportionally less.

Section five then concludes, showing how 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 National Insurance.

1 The government's strategy

The Green Paper's central objective is to ensure that all pensioners have an income at or above the poverty line; as the summary states: "*Our package of reforms is aimed squarely at the real problem – ensuring that we all have security in retirement.*" Historically this objective has lain at the heart of UK pension policy, with the goal of achieving a minimum income standard being a common thread running through the early development of the welfare state, from Lloyd-George's 'People's Budget', which first established state pensions at the start of the century, through to the Beveridge-inspired reforms of the post-war years. However, the emphasis the Green Paper places on achieving a minimum standard stands in stark contrast to Labour's ambitions when they were last in office.

In relation to pensions, the major achievement of the Wilson/Callaghan governments was the introduction of SERPS, a scheme which, as its name suggests, is concerned with relating individuals' retirement income to their earnings in work. As such, SERPS is a means for individuals to redistribute resources across their lifecycle; it does not, by and large, redistribute between members of the same cohort.[1] Consequently, it is of little help in achieving the government's minimum retirement income objective; as the Green Paper puts it: "*SERPS, being earnings-related, gives least to those in greatest need*".

Of course, this criticism entirely misses the point of SERPS. The scheme was not designed with the minimum income objective in mind but with the separate objective of protecting individuals' accustomed living standards. The Green Paper's real criticism of SERPS is therefore not that it does not do what it set out to, but that what it set out to do is not worth doing. While the last Labour government defined 'poverty' in relation to both a universal minimum standard and individuals' previous earnings, New Labour accepts only the former part of this definition. Nevertheless, despite this rejection of the earnings-replacement principle the Green Paper retains a significant role for second tier pensions. Indeed, the proposals will lead to a major

1 SERPS does, however, result in significant inter-generational redistribution. While this is in part simply a function of the way in which pay-as-you go pension schemes work, a more important reason is that SERPS was designed to come to maturity over a period of 20 rather than 49 years (as the working life assumed in the scheme would imply), causing early retirees to gain at the expense of later generations.

expansion in this form of provision. How can this be explained? The answer, possibly, lies in the way UK pension policy has developed over the last twenty five years.

Pension policy since 1975

When SERPS was introduced it was envisaged that a minimum income for all pensioners would be ensured through the basic pension. To this end, the 1974-79 Labour government legislated that the value of the basic pension, and of other benefits, should increase automatically in line with the higher of earnings or prices. As the level of the basic pension and means tested assistance were approximately the same at that time, this policy offered the prospect that almost all pensioners would automatically attain the minimum income standard without means tested assistance.[2] Moreover, it also ensured that the minimum standard kept pace with increases in prosperity among the working population.[3]

However, this commitment to increasing benefits in line with earnings was abandoned in 1980 by the incoming Conservative government. While not explicitly stated at the time, the new policy was to uprate all benefits in line with prices. This therefore meant that the minimum income standard fell relative to average living standards. Note, therefore, that parsimony was achieved through reducing the relative value of all benefits rather than through targeting benefits on the most needy (e.g. via means testing).

In contrast, the new government is clearly committed both to improving the living standards of the poorest pensioners (those on Income Support) and to targeting benefits. While the basic pension will

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2 While in theory entitlement to the basic pension depends on an individual's labour market history, the existence of a very extensive system of credits means that almost everyone retiring in the future will receive the maximum possible payment (Johnson and Stears, 1996). Note though that, even if the basic pension became fully universal, and was set at the level of the minimum income standard, the problem of housing costs would mean that some pensioners would still be reliant on additional assistance from the state. For the remainder of this paper, however, this caveat is ignored; in effect means tested assistance is taken to be synonymous with Income Support.

3 In fact, this policy would have gradually increased the relative level of the minimum standard, as the effect of the 'higher of earnings or prices' formula would have been to ratchet up the value of the minimum during recessions. See Bradshaw and Lynes (1995) for a full discussion of the effect of alternative formula for uprating benefits.

remain tied to prices, the Green Paper states that the *"long term aim is that the new minimum income guarantee* [Income Support] *should rise in line with earnings"*.[4] Over time the effect of this policy will therefore be to widen the gap between the minimum income and the basic pension, thus entrenching means testing. This is where the SSP comes in. Because the new scheme offers much better pension benefits to low earners (see Section 3) the hope is that, when the scheme matures, widespread reliance on means tested benefits will be avoided.[5] In effect, the idea is to use the SSP to bridge the gap between the basic pension and the minimum income standard. However, it is questionable whether the scheme in its current design will be fully effective in this role; see Rake, Falkingham and Evans (1999) for a discussion of this issue.

Rationale for the SSP

It is important though to understand why the government wants to reduce means testing in the future. There are three possible objections to relying on means tested benefits to secure a minimum retirement income standard:

1. They are not very effective in relieving pensioner poverty as, possibly due to social stigma, take-up is less than complete.
2. They may have an adverse effect in terms of horizontal equity; means testing is 'unfair' to people who, having worked and saved in earlier life, might expect a higher retirement income than more spendthrift peers.
3. They may affect saving incentives among the working population.

As the Green Paper's policy for today's pensioners indicates, the government are either blasé about the first problem or, more charitably, are confident that stigma can be reduced and take-up increased through administrative reforms. Similarly, as indicated by its policies in other areas (*viz*. the move towards targeting benefits for the incapacitated, widows and, to a lesser extent, children), the government are little

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4 Arguably, some increase in the real value of Income Support would have inevitable in any case (see Pension Provision Group, 1998).

5 The government estimates that in 2050 the proportion of pensioners claiming Income Support will be reduced from around a third to around a quarter as a result of the introduction of the SSP (written parliamentary answer 12.1.99). Note though that, as the SSP will only just have matured in 2050, some of this continued reliance on means testing reflects the fact the majority of the pensioner population will have retired before this date, and hence will not benefit fully from the new scheme.

concerned with horizontal (as opposed to vertical) equity. Neither pensioner poverty *per se*, nor equity, are the real reasons for the introduction of the SSP. Instead, it is the last problem – the potential effect of means testing (or the prospect of means testing) on individuals' saving behaviour during their working lives – which is the chief motivation for the replacement of SERPS.

At present this problem of 'moral hazard' is relatively minor; for a single pensioner under 75, with a full National Insurance record, Income Support is only some £11 a week above their basic pension entitlement. But under the policy outlined in the Green Paper this differential will grow over time, and moral hazard would undoubtedly become a relevant policy concern if no countervailing action were taken. The purpose of the SSP is therefore clear: it exists to ensure that low and middle earners get more automatic assistance in building up their pension entitlements, thereby reducing the saving disincentives associated with means testing.

Apart from the economic arguments for minimising moral hazard, a more prosaic justification may also be relevant. In the terminology of Le Grand (1997), means testing promotes 'knavish' behaviour which is, at once, both rational and, from society's point of view, irresponsible. Rather than conjoining social rights and responsibilities, means tests set one against the other – greater 'responsibility' (in terms of higher saving) may lead to lower rights to benefit, and vice-versa. Given this, it would clearly be disingenuous for the government to simultaneously exhort people to save while operating a policy which penalised them for so doing. The SSP therefore makes it tenable to operate a policy of means-testing for today's pensioners without affecting the saving decisions of workers, or the rhetoric of government.

2 SERPS

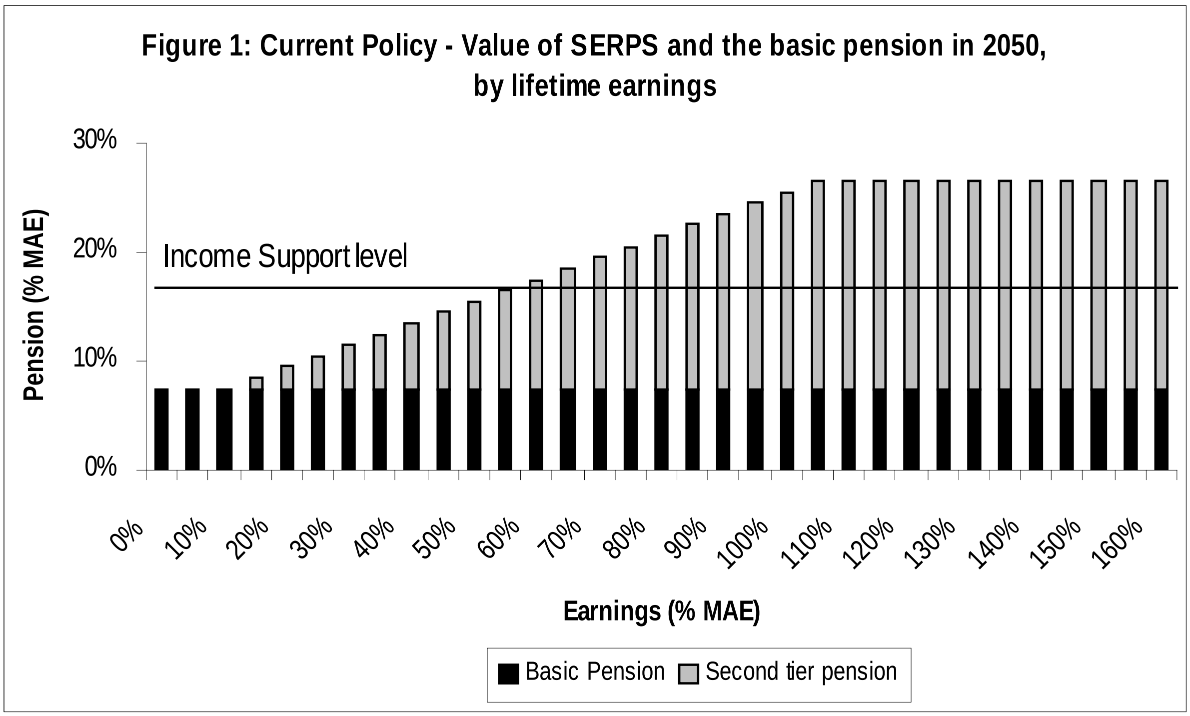
The benefits provided by SERPS are fairly simple to describe. As reformed by the Conservatives in 1986, the scheme provides all employees with a second pension worth 20% of their average lifetime earnings between a lower and an upper limit (set at £64 and £485 a week (£3,300 and £25,000 a year) respectively in 1998/9). At present these earning limits are statutorily linked to the level of the basic pension, the lower limit being the same as the basic pension and the upper limit being between 6.5 and 7.5 times this amount. Therefore, under existing legislation, if the basic pension remains tied to prices the earning limits will fall gradually from their current relative levels of, respectively, 15 and 115% of male average earnings (MAE). However, this situation has been radically altered by the March 1999 Budget, which aligned the lower limit with the personal tax allowance (and also raised the upper limit). As the level of the personal allowance has more-or-less kept pace with earnings over the last twenty years it seems reasonable to assume that, under the Chancellor's proposals, an earnings-link for the contributions base for National Insurance will be (re)established. Therefore, while the analysis in this paper is based on the 1998/9 levels for the lower and upper NIC limits, it is assumed that these limits will both increase in line with earnings in the future.[6]

Figure 1 illustrates the value of the pension provided by SERPS for people with constant earnings throughout their working lives.[7] For convenience the Figure also shows the value of Income Support (i.e. the minimum income standard). This is set at 17.5% of male average

6 Note, however, that the Green Paper assumes that the NIC earning limits will remain tied to prices. Hence the illustrations of the effects of the SSP and SERPS provided here are not directly comparable to the government's estimates. Note also therefore that the analysis here effectively ignores the proposed 'shadow' lower earnings limit, whereby individuals will be brought into the National Insurance system once their earnings cross the current threshold but will then face a zero rate band of NICs on earnings up to the actual lower limit. If this entry level were permanently linked to prices then, over time, such a policy would gradually reduce the number of people excluded from the SSP due to low earnings and also cause the value of the benefits it offers to grow (see footnote 13). At the same time though it will impose additional administrative costs on employers, and will act to further blur the distinction between the SSP and the basic pension. It is doubtful whether it will prove a durable arrangement in the long term.

7 More precisely, the Figure shows the value of first and second tier pension benefits which would be paid on retirement in 2050 to someone with a complete (49 year) work history who had unchanging earnings throughout their life (relative to average earnings). People earning less than the lower limit for NICs are assumed to qualify for credits towards the basic pension (see footnote 2 earlier). The Figure also assumes that henceforth the basic pension is increased in line with prices while the earnings limits for NICs, and Income Support for pensioners, are increased in line with earnings. Note therefore that the Figure makes the implicit assumption that the government could, if it chose, increase Income Support in line with earnings while not altering second tier provision in any way. This is not very plausible: as discussed in Section 1, the effect of means testing on saving incentives makes it practically impossible to operate such a policy without some form of countervailing intervention.

earnings, the level which it would have been in 1998/9 had Income Support been increased to £75 a week from April 1998 (rather than the additional increase announced in the 1998 Budget being delayed to April 1999). In common with the Green Paper, it is assumed that the value of the basic pension in relation to earnings will have halved by 2050, so that it falls from its current level of 15% of MAE to 7.5%. The gap between the basic pension and the minimum income standard in 2050 is therefore 10% MAE.



As the Figure shows, because SERPS is earnings-related it provides only rather modest benefits for people with low lifetime earnings, and hence is of little help in lifting such people above the government's minimum income standard. Indeed, as the Green Paper recognises (see page 81), any system which links benefits directly to earnings (and, by implication, to contributions) will inevitably be of little assistance to low lifetime earners. In essence, this is the reason why the government have rejected calls to extend the proportion of workers' salaries which they are forced to contribute to an earnings-related pension (the 'compulsion' strategy outlined in Agulnik and Le Grand, 1998). If the objective of pension policy is solely to secure a minimum income standard then compulsory saving is of very limited benefit, as the people one is most concerned about (low lifetime earners) gain least.

Similarly, restoring SERPS would also be of little benefit to the worst-off as, even under its original guise, SERPS was almost wholly earnings-related (there being no particular reason to expect the 'twenty best years' rule to help low lifetime earners more than high earners). In a revenue-neutral reform, raising the flat-rate basic pension would be more redistributive than improving the benefits provided by SERPS (Creedy, Disney and Whitehouse, 1993). This, in a sense, is precisely what the SSP does – it increases spending on flat-rate benefits, rather like an increase in the basic pension but with a fifty year time-lag.

3 The State Second Pension

Analysis of the SSP, and of second tier pensions more generally, must take into account the fact that provision is split between the public and private sectors. At present this split operates through a device known as 'contracting-out', whereby people in private pension schemes pay reduced National Insurance Contributions (NICs) or, equivalently, receive a rebate paid direct to their pension scheme. This contracted-out NIC rate - currently 4.6 percentage points less than the full rate – reflects the actuarial value of the SERPS rights which individuals would otherwise have enjoyed. At least in theory, this therefore means that all employees accumulate second tier pension entitlements of the same value as SERPS, but with some people receiving benefits directly from the state scheme and others receiving benefits via private schemes.[8]

This split between the public and private sectors will be retained under the SSP, but it will take a somewhat different form. Rather than the incentive to opt-out of state provision being neutral (i.e. actuarially-fair), there will be a built-in incentive for individuals to stay with the state scheme if their earnings are below £9,000 a year but to opt-out if their earnings are above this level.

Under the Green Paper's proposals SERPS will, in effect, become a flat-rate scheme providing pensions for people earning less than £9,000 a year (and for some non-earners such as carers). The value of the pension provided by the new scheme will be substantial – twice that which

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8 The equivalence between SERPS and the second pension entitlements earned by people in private pension schemes relies on the Government Actuary having accurately assessed likely investment returns, charges and annuity rates. If these assumptions turn out to be too optimistic then people in private schemes will, in retrospect, have been better-off remaining in SERPS. Conversely, should investment and annuity rates exceed assumed levels then people who chose to opt-out will end up with higher pension benefits than people who stayed in SERPS.

someone on £9,000 a year would currently get from SERPS.[9] Nevertheless, people earning more that £9,000 a year will have a strong incentive to opt-out as, above this level of earnings, the value of contracted-out rebates will exceed the actuarial value of the benefit provided by the state scheme.[10] This in turn reflects changes to the structure of rebates which the Green Paper proposes. In place of the simple proportionate structure of SERPS a three tier system will operate:

- on the first tranche of an individual's earnings, between the lower limit and £9,000, rebates will be double the current rate;
- on the next tranche (between £9,000 and £18,500) rebates will be provided at half their current rate;
- on the final tranche (between £18,500 and the upper limit) rebates will continue to be paid at the same rate as under SERPS.[11]

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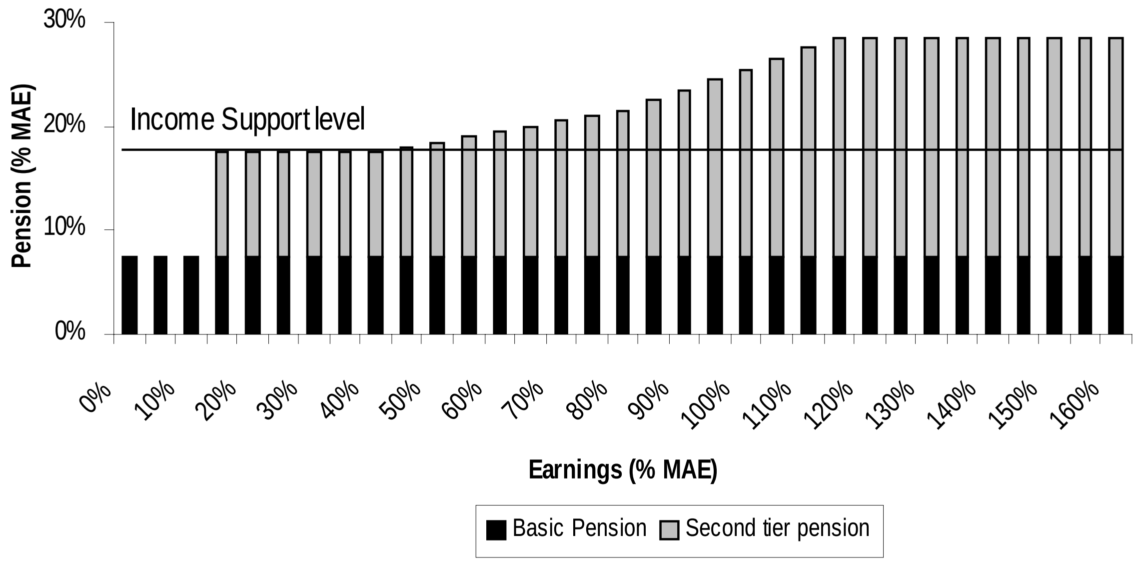
9 A little arithmetic shows that someone on £9,000 a year for the whole of their (49 year) working life would get a pension of £22 a week (in terms of today's earnings) from SERPS, assuming that the lower earnings limit is increased in line with earnings in the future, and ignoring the rise in the level of the lower earnings limit announced in the March 1999 Budget. The SSP will provide a pension for all its members (including those earning less than £9,000 and non-earners) at twice this level, i.e. £44 a week for someone who remains in the scheme throughout their working life. Uncoincidentally, £44 a week is fractionally more than 10% of MAE, the gap between the basic pension and Income Support in 2050.

10 Note, however, that even if people did act perfectly rationally in response to the incentives provided by the SSP, this prediction assumes that the level of rebates will adjust fully to the age of the recipient: as older people are closer to retirement, and hence benefit from less years of investment growth than younger people, they require higher rebates to be persuaded to opt-out. But whether the government will in fact provide fully age-related rebates is doubtful. To achieve full age-relation under SERPS the rebate paid to someone aged 55 should be equivalent to 15% of their earnings – a figure thought intolerably high by the last government who instead chose to cap age-related rebates at 9% (Government Actuary 1995, Table C). If history repeats itself the current government will similarly cap rebates for older workers. Therefore, as well as earnings affecting the decision as to whether to opt-out, age may also have to be taken into account.

11 Presumably, this retention of the earnings-replacement principle is simply to ensure that no one sees their pension benefits reduced relative to their current position under SERPS (ignoring the better benefits which some richer women would have been entitled to under Home Responsibilities Protection - see footnote 15). However, in fact the point at which people would start losing from the reduction in rebates on the tranche of earnings beyond £9,000 a year

The second tier pension benefits provided by the SSP and rebates are illustrated in Figure 2.[12] For the reasons explained above it is assumed that people earning more than £9,000 opt-out (and hence accumulate earnings-related pensions), and that people earning less than this amount opt-in. Like Figure 1 earlier, it is also assumed that earning levels remain constant throughout life (this assumption is relaxed later). Note that the 'bend points' in the scheme at £9,000 and £18,500 correspond, respectively, to 40 and 85% of male average earnings.

Figure 2: Future policy - Value of second pension and the basic pension in 2050, by lifetime earnings



As can be seen from the Figure, the flat-rate SSP fills the gap between the basic pension and the minimum income standard much more effectively than SERPS. Indeed, the Figure well illustrates the fact that the SSP has been designed to rather neatly plug the gap between the level of the basic pension and the minimum standard in 2050. However, the seeming elegance of this outcome is just that - a fortuitous feature of

is £20,000, not £18,500. Everyone will therefore enjoy higher benefits as a result of the Green Paper's proposals, albeit only very marginally so for people earning more than £18,500. This discrepancy within the scheme is recognised by the DSS, and is likely to be corrected in the government's final proposals, therefore, to simplify analysis, it is effectively assumed here that the benefits received by people on earnings above £18,500 are the same as they would get under SERPS.

12 See footnote 7 earlier for notes.

the date chosen to illustrate the scheme rather than an inherent property of its design. Peering a little further into the future we can already predict that, unless the lower contribution limit falls steadily in relation to earnings, the gap between the combined value of first and second tier pension benefits and the poverty line will re-emerge (see Rake, Falkingham and Evans).[13]

Moreover, irrespective of the time horizon chosen for analysis, the Figure gives a rather false impression of the true effects of the scheme. The assumption that individual earnings will remain constant throughout life is clearly unrealistic; in practice we all experience considerable changes in our labour market status and earnings over the course of our lives (see Hills and Gardiner, 1999; or Gregg, 1997). Allowing for this a rather less elegant pattern for the benefits provided by the SSP emerges, with almost all women, and a significant number of men, benefiting from the flat-rate element of the scheme at some point in their lives. This is because the SSP works through crediting pension rights on an annual basis - there is no 'claw-back' from people with high lifetime earnings.[14] Table 1 illustrates, also providing figures for SERPS for ease of comparison.

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13 It should, however, be borne in mind that the Figure refers to the 1st and 2nd tier pension entitlements which individuals will accumulate in their own right and, similarly, the level of Income Support for a single pensioner (aged 65-74) is shown. However, as the level of Income Support for couples is significantly less than twice that for single people, the combined 1st and 2nd tier pension entitlements of couples should lift them substantially above the minimum income standard even beyond 2050. Note also that, should the government's proposed shadow lower NIC limit prove durable, an element of 'dynamisation' will be built into the scheme, as the £9,000 figure will be increased in line with earnings while (presumably) the entry point for the SSP will be tied to prices.

14 The SSP is therefore rather different from the minimum pension guarantee systems outlined by Atkinson (1995), Hills (1997) and Falkingham and Johnson (1995) which, in effect, all act as a lifetime means test.

Table 1: Value of 2nd stage SSP and the basic pension in 2050, hypothetical individuals

Earnings/status	*Basic pension*	State scheme pension rights	Private pension rights	Total 1st and 2nd tier pension under SSP	Total pension under SERPS (without HRP[15])
£5,000 throughout life	£32	£44	-	**£76**	*£38.5*
£5,000 with ten years caring	£32	£44	-	**£76**	*£37*
£5,000 with ten years unemployed	£32	£35	-	**£67**	*£37*
£10,000 throughout life	£32	-	£46.5	**£78.5**	*£56*
£10,000 with ten years caring	£32	£9	£37	**£78**	*£51*
£10,000 with ten years unemployed	£32	-	£37	**£69**	*£51*
£15,000 throughout life	£32	-	£56	**£88**	*£77*
£15,000 with ten years caring	£32	£9	£45	**£86**	*£68*
£20,000 throughout life	£32	-	£64	**£96**	*£96*
£20,000 with ten years caring	£32	£9	£51	**£92**	£83

Note: The Table shows the weekly value of first and second tier pension benefits in terms of today's earnings. As earnings will have approximately doubled by 2050, the real value of benefits will be twice as large. Nevertheless, denominating pension entitlements in these terms is probably a more helpful approach than using 'real price' terms (see the notes to Chart 5, page 41 of the Green Paper).

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15 HRP = Home Responsibilities Protection. When originally designed SERPS operated on a 'best 20 years' formula which was, in theory, designed to help people with intermittent earnings histories. HRP was intended to give further assistance to carers to compensate for years out of the labour market. However, the introduction of HRP only becomes relevant in April 1999 when SERPS enters its 21st year and, as yet, no regulations have been laid to put the earlier legislation into operation. As such secondary legislation is required to implement HRP, and no action on this front has yet been taken, the benefits provided by SERPS in its current form are illustrated.

4 The Redistributive Effect of the SSP

The redistributive effect of the SSP can be calculated as the increase in second tier pension entitlements enjoyed by people on different earning levels (which, as noted earlier, is positive or zero for everyone) minus the loss of income resulting from the increased contributions needed to finance the scheme. This section looks at each part of this equation in turn, showing how the benefits of the scheme can usefully be expressed in present value terms, and calculating the change in NIC rates needed to finance additional provision. The overall redistributive effect of the scheme is then illustrated in Figure 4.

Distribution of benefits

As the previous section showed, the SSP works on annual basis (in the same way as SERPS also does). Anyone earning below £9,000 (but more than £3,300) in a particular year will receive a credit for the state scheme, whether or not their earnings (and hence pension entitlements) subsequently increase. Therefore, though they receive a pension promise rather than a cash payment, the system may be likened to the rebates which people earning more than £9,000 will receive. Ignoring the fact that people in the state scheme receive a pension promise rather than a cash payment, if future pension entitlements are discounted to their present value (PV) then the benefits of public and private provision may be compared directly. Table 2 illustrates, showing the PV of benefits (equivalently, the value of rebates) under SERPS and the SSP.

As can be seen from the Table, the transformation of SERPS into the SSP will greatly increase pension benefits for low and moderate earners. For instance, someone earning £5000 a year will be nearly £450 a year better-off as a result of the change, as the PV of their future pension benefits rises from £78 under SERPS to £525 under the SSP. This, in turn, reflects the fact that they would have only got a pension worth 1.5% of MAE from SERPS (assuming they had constant earnings throughout life), while they will get a pension of just over 10% MAE from the SSP. However, gains fall away as earnings rise, and people on more than £18,500 receive no additional pension benefits as a result of the government's proposals (again assuming their earnings do not fluctuate).

Table 2: Value of benefits under SERPS and the SSP

Earnings	Earnings between limits	PV of SERPS benefits[16]	PV of SSP benefits/ value of rebates	Change in benefits
£5000	£1700	£78	£525	£447
£10000	£6700	£308	£548	£240
£15000	£11700	£538	£663	£128
£20000	£16700	£768	£768	0
£25000	£21700	£998	£998	0
£30000	£21700	£998	£998	0

The PV of future pension benefits can helpfully be used to calculate the net cost of NICs for people at different earning levels. This is simply the gross cost of NICs minus the value of future pension benefits which arise as a result of contribution, the net figure so derived being a better representation of the true burden of National Insurance. Table 3 illustrates. As can be seen, under the SSP someone earning £5,000 a year (but more than the lower limit) will in effect receive more back from National Insurance than they pay in through contributions. This point is made even more clearly in Figure 3, which shows the burden of NICs as a proportion of all earnings (rather than just earnings between the limits, as in Table 3). It shows that for people earning below £8,500 a year NICs work in much the same way as a negative income tax, albeit with the benefit of the 'tax-credit' being delayed until retirement.

16 The PV of SERPS benefits is calculated using the Government Actuary's economic assumptions, and hence is equivalent to the rebate which would be payable under contracting-out. At present, SERPS rebates represent 4.6 percentage points of the total NIC rate (averaging across all ages). However, this is set to fall over time to around 3.5 percentage points, as the 'accelerated accrual' provisions within SERPS gradually die out. As the SSP contains no accelerated accrual provisions the comparisons in the Table should really be calculated with reference to this steady-state rebate rate. The results of the analysis would, though, be little different, and for ease of exposition the current reduction of 4.6 percentage points is used.

Table 3: Net cost of NICs under the SSP

Earnings	Earnings between limits	Gross NI contributions [17]	PV of SSP benefits/ Value of rebates	Net NIC payment	Net NIC payment as a % of earnings between the limits
£5000	£1700	£170	£525	-£355	-20.1%
£10000	£6700	£670	£548	£122	1.8%
£15000	£11700	£1170	£663	£632	4.3%
£20000	£16700	£1670	£768	£902	5.4%
£25000	£21700	£2170	£998	£1172	5.4%
£30000	£21700	£2170	£998	£1172	5.4%

Financing the proposals

The SSP will be 'paid for' out of the National Insurance Fund, in the same way as the basic pension, SERPS and other NI benefits are currently. As the SSP offers better pension benefits than SERPS for low and moderate earners, and equivalent pension benefits for high earners, it follows that NIC rates must rise if the Fund is to remain in balance (which, under current policy, it must).[18] However, it should be noted that under current policies the combined NIC rate is expected to fall by around 4.25 percentage points between now and 2050 (w.p.a. 11.2.99).[19]

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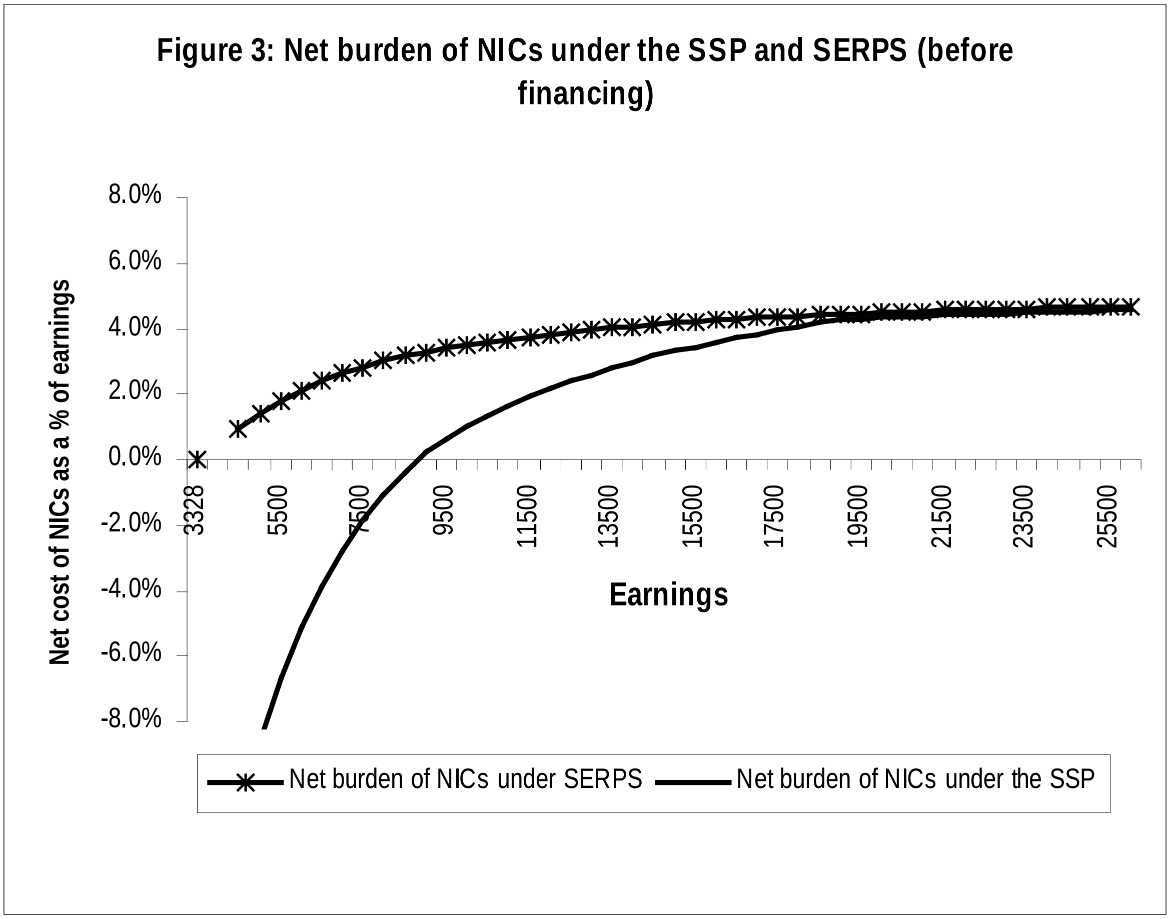
17 To avoid double-counting the gross cost of contributions is shown (i.e. the amount someone contracted-in to SERPS currently pays). The cost of the 2% 'entrance fee' for NICs, which was abolished in April 1999, is ignored, as are NIC payments made by employers.

18 In the normal course of events NIC rates are set so that they yield sufficient revenue to meet expected expenditure from the NI Fund. Administratively this operates through the Government Actuary estimating (on a five-year basis) the NIC rates needed to keep the Fund 'in balance' (see, for instance, Government Actuary 1995a). A zero Treasury grant is assumed and, at least in recent years, payments to the Fund from this source have been negligible.

19 It should also be borne in mind that the Government Actuary's projections assume that the NI contribution limits will be increased in line with prices rather than with earnings. This means that a worker on average earnings will experience an even more dramatic fall in the burden of NI contributions than is implied by the change in the rate of such contributions (see w.p.a. 15.2.99). As it is assumed elsewhere in this paper that the NIC limits will increase in line with earnings in the future, the analysis here should really be based on

Nevertheless, for analytical purposes whether NIC rates are set to fall or rise is irrelevant – the question is who wins and loses from the SSP relative to current policy.



The SSP will add to NIC rates (or rather, prevent NIC rates from falling) for two reasons:

1. The cost of rebates will grow, necessitating an increase in the NIC rate to maintain revenue to the Fund.
2. As the scheme matures public expenditure will rise relative to expected spending under SERPS.

The cost of rebates will grow both because the SSP produces higher pension benefits than SERPS for people earning less that £18,500, which will be reflected in employees on such earnings receiving bigger rebates, and because more people are likely to opt-out of state provision under the new scheme. In combination the effect will be to increase the

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the NIC rates which would apply under earnings indexation of the contribution base. However, for ease of exposition the following looks only at the change in NIC rates caused by the SSP relative to the 4.25 percentage point reduction expected under a price-linked contribution base.

total cost of rebates by £4.1 billion in 2050 (when the scheme will be fully phased-in).[20] Making up for this lost revenue will, in turn, require NIC rates to be 0.9 of a percentage point higher than would otherwise be the case.[21]

The long run increase in NICs as a result of the SSP will be even greater than this. The government estimate that, by 2050, expenditure on the new scheme will be £10.5 billion higher than it would have been under SERPS (w.p.a. 11.2.99). This will add a further 2.25 percentage points to the NIC rate (under the same assumptions as earlier). In the long term, therefore, the NIC rate will be a little under 3.25 percentage points higher under the SSP than it would have been under SERPS. In other words, rather than falling by 4.25 percentage points, the NIC rate will only be around one percentage point lower in 2050 than it is today.

However, this does not quite give the full story. Though the new scheme will increase the cost of NI benefits, it will also reduce spending on means tested benefits. The government estimate that the introduction of the SSP will lead to savings on Income Support of around £4.3 billion (w.p.a. 11.2.99).[22] Assuming that this saving is used solely to reduce income tax rates, a fall of around 0.6 of a percentage point might be expected as a result (assuming the higher, basic and lower rates are all reduced by the same amount). For ease of analysis this is included in

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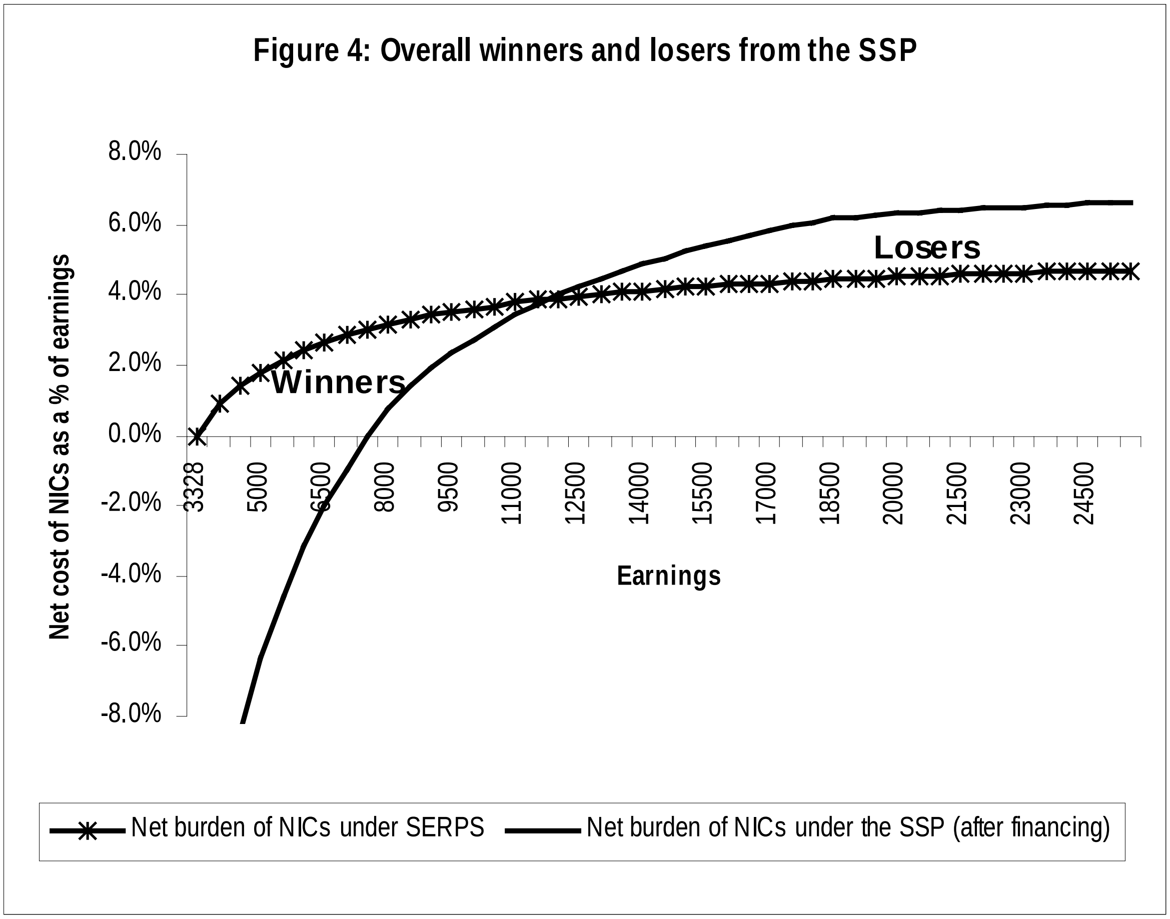
20 Government Actuary's estimate taken from a written parliamentary answer on 15.2.99. It is worth noting that the Government Actuary's very low estimate for the increased cost of NIC rebates in 2010 (a rise of only £0.9 billion compared to previous policy) suggests the new system of rebates will be introduced rather slowly. However, behavioural changes, as occurred when personal pensions were introduced, may cause a more rapid rise in the cost of rebates than the Government Actuary predicts.

21 Assuming that Class 2, Class 4 and employer contribution rates do not change, i.e. that employee NIC rates bear the full adjustment needed to keep the NI Fund 'in balance'. Note that the £4.1 billion estimate is in real price terms and hence, allowing for the increase in the tax base for NICs resulting from earnings growth, the necessary increase in the NIC rate is half what would be required today.

22 This estimate is relative to the level of expenditure expected under a policy of increasing the minimum income standard with earnings but retaining SERPS in its existing form. Note again that this figure is in real price terms, and hence in relation to today's tax base is half as large as indicated. Also note that there are good reasons for thinking that income tax rates may be higher in the future than they are today, as the ageing of the population is likely to have a very significant impact on NHS spending.

Figure 4 as an offset to the increase in the NIC rate, reducing the necessary rise to about 2.5 percentage points. The Figure therefore shows the overall distributional effect of the SSP, taking into account the value of benefits, the effect of financing these benefits through NICs, and the effect of lower income tax rates.



As the Figure shows, after taking into account the necessary increase in NIC rates the effect of the SSP is to redistribute resources from people earning over about £12,000 a year to people earning less than this amount (but more than £3,300). However, it is worth bearing in mind that the Figure only looks at people with earnings between the lower and upper limit, and therefore omits ‘very high’ earners. For such individuals NICs operate as a lump sum tax and, as can be seen from the Figure, the cost of this tax will be larger under the SSP (contributions having risen while benefits stay the same). But, precisely because NICs act as a lump-sum tax once the upper limit is exceeded, the burden of this increase (i.e. as a proportion of earnings) will be heaviest for people earning at the limit. As earnings increase above the limit the proportionate impact of higher NICs will fall. Moreover, at extremely high earnings the effect of the assumed decrease in income tax rates will outweigh the loss resulting from the increase in NICs.

It is also worth briefly commenting on the SSP's effect on the distribution of lifetime income. From one perspective the scheme is unambiguously positive: low earners benefit from considerably higher pensions than they would have got under SERPS but only pay a small fraction of the financing costs. However, this conclusion subtly alters if it is assumed that the minimum retirement income standard would in any case have risen in line with earnings. If the scheme is looked at in this way its effect is not to increase pensioners' incomes but to reduce the bill for means tested benefits, in which case it could be argued that the main gainers from the SSP are better-off people who now receive pension credits for periods outside the labour market (see Table 1 earlier). However, as discussed in Section 1, it is very unlikely that a policy of increasing Income Support with earnings but leaving other areas of pension policy untouched would have been either politically or economically feasible. The Green Paper's proposals must therefore be analysed as a package.

5 Conclusion

The analysis of the Green Paper presented above suggests there are three major problems, or potential problems, with its proposals. First, as readers may have gathered, the SSP is a complex scheme, difficult to understand and perhaps to implement. Second, while it does far more than SERPS to meet the government's objective of achieving a minimum retirement income standard without means testing, it does not guarantee that means tests for pensioners will be eradicated. Last, as the tax base used for financing benefits contains an upper limit, the redistributive effects of the scheme, while positive, are rather unusual, with low earners gaining at the expense of better paid workers, but with the burden of losses being highest for people earning at the upper limit for NICs.

In fact, all three of these flaws may be seen as arising out of the fact that the SSP will be a National Insurance benefit. Having two rather than one mechanism for collecting revenue from workers is, in itself, likely to add to the complexity of the tax system, not to mention the benefits system. Moreover, in order to justify its separation from the tax system National Insurance was explicitly designed to be exclusive – to offer benefits only to contributors rather than everyone. Similarly, the existence of the upper earnings limit helps to distinguish the NI system from general taxation, but at the same time means that NICs are regressive relative to income tax.

The upper limit to NICs is particularly problematic. At present its existence can be justified by the structure of SERPS, and if the government really believed in earnings-related pensions a case for its retention could be made. But, as shown by the Green Paper's analysis of the 'pensions problem', it is clear that New Labour do not believe it is the state's role to force people to have a pension income above the minimum standard. The earnings-related element of the SSP therefore arises partly out of a desire not to create any obvious 'losers' from the scheme, and partly out of the chosen mechanism for splitting provision between the public and private sectors. However, in terms of the objectives of the Green Paper, this earnings-related element of compulsory provision doesn't really make a great deal of sense. Similarly, it is questionable whether the upper limit makes sense in terms of who should bear the burden of additional pension spending.

The SSP is therefore best seen as a compromise between the government's goals for pension reform, and for social policy more generally, and its inheritance from past administrations, both Labour and Conservative. Figure 5 illustrates, showing how the government's plans fit into a 'decision tree' for pension policy. Three separate branches are shown, relating to decisions about the structure of first and second tier benefits (should they attempt only to ensure a minimum standard or should they also relate benefits to previous earnings / participation?), the tax base used for financing benefits (all income or earnings only and, if the latter, with or without a ceiling?), and whether or not the taxes used to finance benefits should be separated out from the tax system (i.e. 'hypothecated'), and if so whether benefits should be linked to contribution. Of course, in reality decision makers are unlikely to look at pension policy in this disaggregated way but, nevertheless, the diagram may usefully illustrate how the SSP differs from earlier policies.

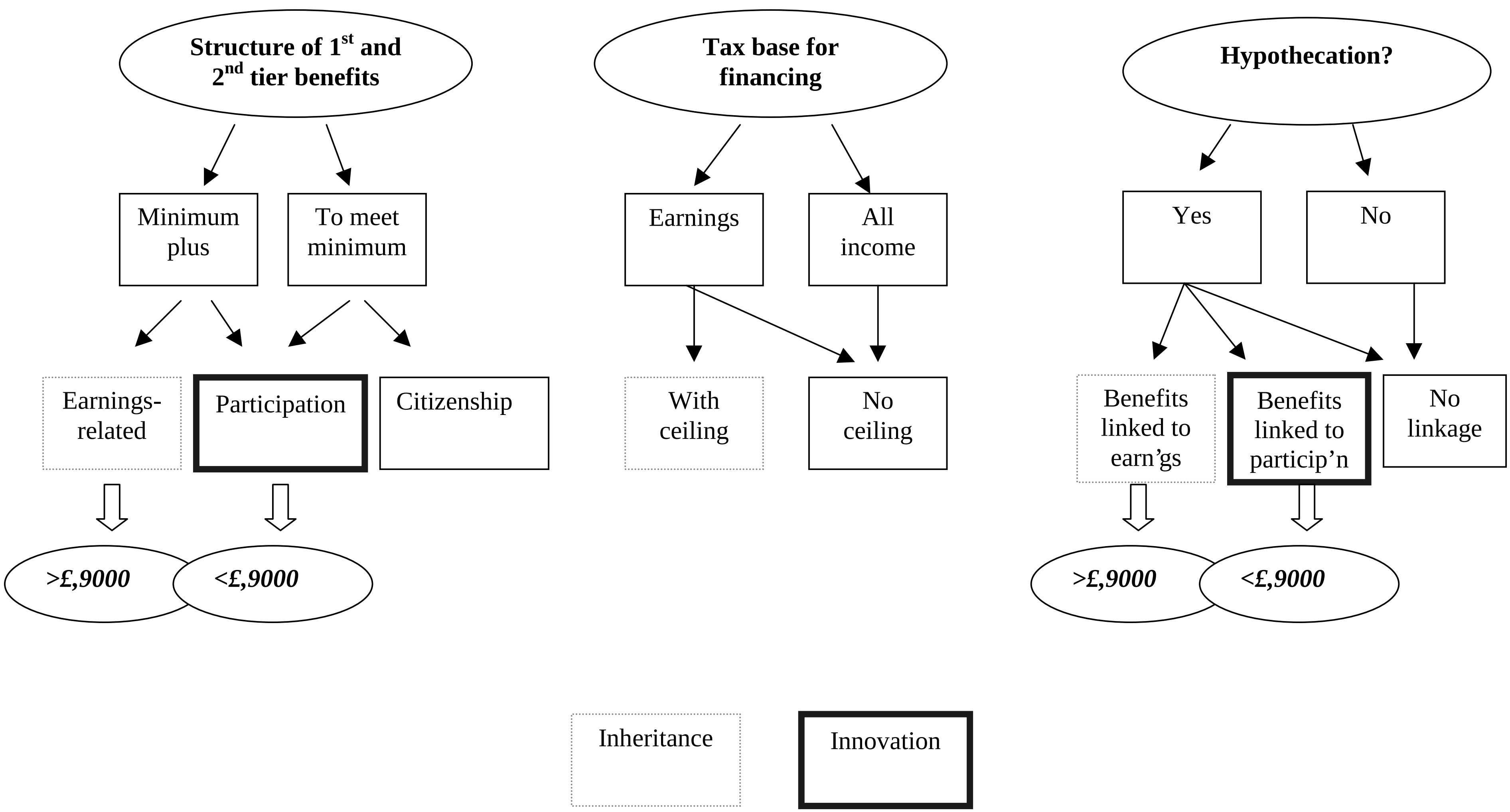
In terms of the structure of benefits (the left hand branch of the Figure), the SSP's major innovation is to link retirement income to past 'participation' rather than past earnings. However, an element of earnings-related provision remains, reflecting the government's inheritance from earlier policies. Similarly, as shown in the right hand branch of the Figure, the Green Paper strengthens the link between participation and benefit receipt, in effect providing a large bonus for people who cross the lower contribution threshold (of £3,300). Again, though, the inherited link between benefits and earnings has been retained in a weakened form. Note, therefore, that in both instances the citizenship principle has been ignored.

However, while the government have significantly altered the structure of second tier pensions, and thereby how contributions are linked to benefits, they have not attempted to change the way in which benefits are financed (the middle branch of the Figure). This, presumably, reflects the government's commitment not to raise tax or NIC rates. Therefore, though more radical reform of National Insurance might have been expected given the Green Paper's stated objectives for pension policy, it is apparent that the scope for reform has been limited by the legacy of previous pension policies and, perhaps more importantly, by the government's election promises.

How does this analysis relate to the Green Paper? Perhaps most importantly it shows that the National Insurance system needs to be looked at as whole; while the Green Paper's concentration on the benefits provided by the SSP reflects its departmental responsibilities, it is not the best example of 'holistic government'. On the one hand tunnel-vision about pensions can give the wrong answers: as illustrated by the March 1999 Budget, the assumptions in the Green Paper about the level of the NIC earnings limits and how they are uprated over time seem very unlikely to hold true. On the other hand, tunnel-vision can give a wrong (or, at least, incomplete) impression of the effects of a policy. For instance, the Green Paper appears to suggest that everyone is a winner from their proposals. Unfortunately, this is an arithmetical impossibility – improving benefits costs money, and this money has to come from somewhere. As this paper has shown, that 'somewhere' is people earning over around £12,000 a year, with the burden of the scheme falling most heavily on people earning at the upper limit for NICs.

Of course, people won't actually 'lose' in the sense of paying more NICs than is currently the case; rather, they will fail to gain through the NIC reductions which would otherwise have taken place. Even so, if the government are concerned to spread the burden of the Green Paper's proposals more fairly they need to adjust either the structure of benefits and rebates, or how these will be financed. In regard to the former the scheme could offer higher, or more widely available, benefits through the SSP (boosting the gain at the bottom so that the scheme is more redistributive overall), or higher rebates between £9,000 and £18,500 (raising the point at which 'losers' start). This might be paid for by capping rebates at the amount which someone of £18,500 will receive, so that the last component of the SSP's rather peculiar 40/10/20 accrual structure is effectively abolished. Conversely, the government could keep benefits constant but finance the scheme more fairly. One simple solution would be to reintroduce a Treasury grant to the National Insurance Fund, so that revenues from (income) tax absorb the cost of additional spending; this might bring the scheme more into line with Beveridge's original conception of the position of the National Insurance Fund in the government's accounts (see Titmuss, 1958). Alternatively the upper earnings limit could be raised, e.g. to the starting point for higher rate tax. In both cases the effect would be to bring in more revenue, thus allowing NIC rates to fall as predicted under previous policy or, preferably, paying for an increase in the lower earnings limit. However, whether the remaining principled arguments for National Insurance can withstand such changes is doubtful. Its death is probably inevitable, though not necessarily lamentable.

Figure 5: Decision tree for pension policy: the State Second Pension



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A public-private partnership in pensions: Getting the balance right

Nicholas Barr

1 Introduction

The New Insurance Contract in the December 1998 pensions Green Paper includes as a central objective,

> An assurance of a secure and decent income in retirement for all through the new minimum income guarantee ... Over the longer term our aim is that it should rise in line with earnings so that all pensioners can share in the rising prosperity of the nation ... (Department of Social Security, 1998, p.2, para.6).

In barest outline, the Green Paper proposed:

- Continuing the existing contributory basic state pension, indexed to price change.
- Reforming the Pay-As-You-Go (PAYG) state earnings-related pension (SERPS) (to be renamed the Second State Pension). The formula for people earning below £9000 is made more generous, and eligibility is increased by making credits (i.e. deemed contributions) for carers more widely available. This aspect of the reform is assessed in companion papers in this volume by Agulnik, and Falkingham and Rake, and Rake, Falkingham and Evans (1999).
- Introducing stakeholder pensions – simple, heavily regulated, individual funded accounts (i.e. a money purchase arrangement) intended primarily for people with earnings above £9000 who do not have the option of joining an occupational scheme. Membership of a stakeholder pension would be voluntary. This paper is largely concerned with assessing the resulting change in balance between PAYG and money purchase schemes.
- Continuing existing arrangements for occupational and personal pensions.

These arrangements, it is claimed (Summary, paras 40-44), are fair, are affordable, provide greater security, and build a new partnership. Some of the proposals represent unambiguous progress:

- Boosting the state pension for lower earners through the second state pension – though Falkingham and Rake (this volume) and Rake, Falkingham and Evans (1999) show that the detailed design of the proposed arrangements leaves significant gaps and perpetuates gender imbalances.[1]
- Extending credits to carers for the purposes of the second state pension.
- Surrounding action on such things as long-term care.

Other features require close scrutiny:

- The trend to continuing – if anything, to enhanced – reliance on income-testing for people whose pension entitlement leaves them below the minimum income guarantee, creating significant incentives against saving for people with low lifetime earnings.
- Claims that stakeholder pensions (a) offer greater security and (b) have macroeconomic advantages.

The next section examines in turn the latter two claims for stakeholder pensions. Its conclusions form the basis for the argument in the final section for a public-private balance in which the state pension arrangements avoid the need for an income test.

2 Assessing the stakeholder pension approach

2.1 Old age security

The Green Paper claims (Summary, para. 27) that stakeholder pensions will be secure, low cost and flexible.

Security in old age has at least two dimensions. The *level* of the pension (i.e. a person's living standard in old age) as established by the minimum income guarantee is discussed in this volume by Agulnik, and Falkingham and Rake, and by Rake, Falkingham and Evans (1999). A second aspect is the degree of *certainty* about the pension, i.e. pensioners need 'to know how much they should save to deliver the income they want in retirement' (Summary, para. 24).

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1 Gaps arise because the proposals incorporate only a small margin between the state pensions package (i.e. a full basic pension plus second state pension) and the income-tested minimum income guarantee. The resulting problems include what the authors call (a) *tightropes* – low earners may well fail to escape income testing, and so have little incentive to contribute or save, and (b) *tripwires* – common interruptions to earnings mean that many people will not receive the full package.

The idea of stakeholder pensions. At their simplest, stakeholder pensions work as follows. The individual puts money into her pension 'pot' week by week while working; by the time she retires, she will have accumulated a lump-sum; at retirement that lump sum is converted into an annuity (Department of Social Security, 1998, p.61).[2] The size of her pension will depend, first, on the size of the lump sum, determined by:

(a) the amount and timing of her contributions; and

(b) the performance of the pension fund, which in turn depends on the quality of management and the performance of financial markets.

The real value of the annuity will depend on the size of the lump sum, plus

(c) her age at retirement;

(d) the state of the annuities market; and

(e) inflation during her retired years.

The pension will not depend on gender, since annuities, as with current approved occupational arrangements, will be required to offer unisex benefits. The issue of indexation is taken up later.

Thus stakeholder pensions are individual, defined-contribution, funded schemes. Such money-purchase schemes, as is well known, face a number of risks, relating particularly to (b), (d) and (e). The rest of this section explores those risks as they apply to stakeholder pensions and discusses actions to ameliorate them.

Management risk. Pension funds require substantial regulation to protect consumers in areas too complex for consumers to protect themselves. There is no need to belabour the point, exemplified by mis-selling (UK Treasury Select Committee, 1998) and the Maxwell scandal (UK Pension Law Review Committee, 1993). Separately, management may be honest but incompetent.

The Green Paper proposals represent significant progress in addressing the management risk, not just for stakeholder pensions but for private sector pensions generally. The emphasis on regulation is welcome. What are needed are tightly drawn up regulatory procedures *and* the resources to implement them effectively. The latter task is more difficult than it looks: precisely because private pensions are such complex instruments, regulators need to be highly skilled – the sort of skills with a high price in the private sector.

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2 A fraction of the pension accumulation can be taken out as a lump sum (Department of Social Security, 1998, p.62).

The emphasis on improving information is also welcome, both through the availability of telephone inquiry lines and through 'an annual statement for all those in public and private schemes detailing their current predicted pension' (Summary, para.34). For this purpose it is essential that all statements are required to have a common format, and to be based on common definitions of rates of return, inflation, etc., just as credit card companies are required to use a common definition of the interest rate. Such transparency is essential to ensure that the claims of competitors are directly and precisely comparable.

Investment risk. Even if managed with complete probity and high competence, pension funds face the risk of differential pension portfolio performance (i.e. two people with identical earnings and contributions records may end up with very different pensions) and, more generally, are vulnerable to stock-market fluctuations, i.e. a stock-market downturn could adversely effect the lump sums, and hence the annuities, of an entire cohort.

Stakeholder pensions, properly implemented, could reduce the investment risk in comparison with previous personal pension arrangements. First, the average return to pension funds is boosted by keeping costs low, for example by collecting contributions through payroll deductions and by limiting advertising expenditure. Note, however, that the cost of running an individual pension account is broadly independent of the amount of contribution, making administrative costs proportionately higher for lower earners. Since charging each pensioner a fixed amount would largely eat away small pensions, the Green Paper proposes that administrative charges are levied in the form of *x*% of contributions. This is probably right, but it risks creating incentives for the better-off to switch to a personal pension. Should that happen, stakeholder pensions will be bought mainly by lower earners, necessitating a higher percentage contribution to cover administrative costs.

Another way in which stakeholder pensions could reduce the investment risk is by requiring funds to be run on fairly simple lines, e.g. as tracker funds, rather than actively managed, thus reducing or eliminating the lower tail of pension fund performers.

The good news is that these two aspects ensure that pension funds broadly parallel average financial market performance. The bad news is that that average is far more volatile than the contributions base on which the state pension is based. Stakeholder pensioners remain vulnerable to stock market developments, most particularly to a downturn at the time that they convert their lump-sum into an annuity (and, as discussed below, to fluctuations in the annuities market). At its starkest, consider individuals A and B with identical lifetime contributions profiles: if A retires when the stock market index stands at 5000, and B retires six months later when the stock market has fallen to 4000, B's stakeholder pension will be 20 per cent lower than A's. A 20 per cent fall is far from fanciful: it could be triggered by sharp stock-market falls in other countries, as in 1987, or by broader financial crises elsewhere, with no need to invoke more apocalyptic events (oil shock, use of ex-Soviet nuclear missiles by religious extremists, assassination of major world leader…).

Thus if people are obliged to convert on the day they retire, and if they are obliged to retire on their sixty-fifth birthday, the value of their stakeholder pension is to a significant extent a lottery. To reduce the resulting inequity, it is therefore essential, as the Green Paper proposes (p.62, para.79), to allow flexibility over the timing of conversion of a person's lump sum into an annuity.[3] In addition, thought should be given to designing methods which offer more powerful smoothing options.

The remaining – significant – investment risk is inherent in the logic of individual funded accounts in general, and stakeholder pensions in particular.

The annuities risk. The annuity a person can buy with her lump sum depends on (a) her expected duration of retirement, i.e. her remaining life expectancy at the time she retires, and (b) the interest rate the insurance company expects to earn over the lifetime of the annuity, in particular the rate of interest on long-term gilts. There is an element of uncertainty about the first variable. Much more important, however, the return – even on long-term gilts – varies, so that a person who retires during a recession, with low interest rates, may receive a significantly lower annuity than someone who retires during a period of higher interest rates.

A second, and separate, problem is that the annuities market is thin: with competing insurance companies, each company has only a small share of the market, and hence only a few people in each age group. Thus the opportunity of economies of scale is lost and, consequently, transactions costs are high. This reduces the value of an annuity, quite independent of interest rate fluctuations.

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3 Thus under stakeholder pensions, as with current arrangements, retirement can take place at any age between 50 and 75.

The inflation risk. Defined contribution schemes can generally cope with inflation during the build-up of pension rights, and with a given rate of *anticipated* inflation once the pension is in payment. But they do not cope well with unanticipated post-retirement inflation. The reason is straightforward: the real value of the annuity depends on the lump sum, life expectancy and the *real* rate of interest the insurance company can earn (i.e. the excess of the nominal interest rate over the rate of inflation). Two cases need discussion.

- Certainty: if inflation is 5 per cent per year with certainty, it is an easy matter to offer an annuity which rises by 5 per cent each year. Inflation is no problem.
- Uncertainty: inflation is a common shock and thus an uninsurable risk. A possible escape route where inflation is purely domestic is to hedge through an internationally diversified portfolio of pension assets. Another escape route, from the insurer's perspective, is to offer limited indexation. If the limit is 5 per cent then, so far as the insurer is concerned, the situation is similar to the certainty case, above – the risk of inflation beyond 5 per cent is transferred to the pensioner.

The conclusion is that once pensions are in payment, private, funded schemes can cope with limited inflation, i.e. can offer indexation up to some pre-specified level. This is what is known as limited price indexation, under which approved occupational and personal pensions in the UK are required to index pensions fully for annual inflation of up to 5 per cent and which, presumably, is the regime intended for stakeholder pensions. Beyond that limit, however, personal pensions face major problems. The point is much more than academic. The price index in Britain in January 1974 was 100; in September 1978, in the wake of the first oil shock, it was 200. With 5 per cent indexation, pensions would have increased from 100 to about 128, rather than to 200. Pensions in payment would have lost one-third of their value. Two points are noteworthy: the loss is permanent – in contrast with pensions during build up, there is no opportunity to make up any of the lost ground; and people in the future will generally be retired for longer than their forebears.

In the absence of publicly-organised indexation, stakeholder pensioners will thus be vulnerable to post-retirement inflation. There is a clear and continuing role for government to address this risk. There are several ways to do so.

(a) Mandating limited price indexation of pensions (say for inflation above 5 per cent), supported by government indexed bonds.

(b) Indemnifying pension funds for inflation above 5 per cent.
(c) Mandating full price indexation, supported by indexed bonds.

The present intention for stakeholder pensions is (a). However, a strong case can be made for full price indexation, both to give pensioners security and to ensure that stakeholder pensions have the same indexation provisions as the (fully price indexed) second state pension. One way to bring this about is through (c), at a minimum for stakeholder pensions, ideally also for approved occupational and personal pensions subject to an upper limit. This policy, however, might create distortions in the gilts market, for example if a very large fraction of the total demand for bonds was from pension funds buying indexed gilts. If that were a problem, an alternative policy package would be (a) plus (b).

Economic growth. This is not the end of the story, however. The Green Paper rightly argues that pensioners should share in rising prosperity. But individual funded pensions, including stakeholder pensions, do not allow a pensioner, once retired, to share in rising living standards. Annuities attract limited price indexation but not earnings indexation. Thus only the minimum income guarantee would be earnings indexed; the stakeholder pension, once in payment, would decline relative to average earnings, even if its real value was protected, thus attenuating shares in rising prosperity. As a result, the oldest pensioners will disproportionately be the poorest. Yet these are the very pensioners who are the most likely to require care, and hence to face higher costs.[4]

Two additional risks, it is sometimes claimed, afflict individual funded pensions less acutely than Pay-As-You-Go (PAYG) state pensions.

Demographic risk. Demographic shocks affect a PAYG system by shrinking the contributions base (or the rate of growth of the contributions base). Other things being equal the smaller the generation of workers the smaller the contributions base, correspondingly reducing the average pension which can be supported by a given contributions rate. With funding the mechanism is more subtle, but equally inescapable, operating through a mismatch between demand and supply in either the goods market or the assets market. The mechanism merits explanation.

4 As a stylised fact, retirement can be divided into period 1, in which the person can look after him/herself, and period 2, when he/she needs care from others. Period 2 is, of course, far more costly.

Suppose that a large generation of workers is followed by a smaller generation. Thus there is a large accumulation of pensions funds belonging to the older generation at a time when the workforce is declining. The high level of retirement spending out of its accumulated savings by the older generation will exceed the pension contributions of the smaller younger generation, reducing the rate of saving in the economy, and possibly leading to aggregate dissaving. Pensions then face pressures through either or both of two mechanisms.

- Price inflation: assume the price of pensioners' financial assets remains unchanged. In that case, net pensioner consumption is greater than saving by workers; and at full employment this causes demand inflation, thus reducing the purchasing power of pensioners' annuities.
- Deflation of pensioners' financial assets: if the desired sales of assets by the large pensioner generation exceeds desired asset purchases by the smaller succeeding workforce, asset prices will fall. In consequence, the lump sum received by the representative pensioner, and hence the resulting annuity, will decline.

In sum, the argument that funding insulates pensioners from demographic change should not be overstated. The policy implication is that demographic change is not *per se* a strong argument for shifting the balance of pension finance towards funding.

Political risk. A different argument is that social insurance is more vulnerable politically than private schemes, either through government failure (e.g. profligate promises which cannot subsequently be fulfilled) or though a change of policy (e.g. the change in the indexation provisions for the basic state pension in the late 1980s, or the removal of some of the tax advantages of private pension funds announced in the July 1997 budget).[5] The proposition that social insurance is more vulnerable than private schemes may or may not be true as an empirical matter in a particular instance, but it is important to be clear that effective government is essential for *any* pension arrangement.

Government failure harms both state and private schemes. The problem is most obvious with defined-benefit state PAYG schemes built on promises which are fiscally unsustainable. Results include inflationary pressures, reneging on past promises and, at its worst,

5 Prior to the change, contributions were paid out of pre-tax income and the income and capital gains of pensions funds were also tax free. In a change announced in the July 1997 Budget, the income, but not the capital gains, of pension funds are taxable.

political instability. Private pensions, however, are also vulnerable. At a macroeconomic level, fiscal imprudence leads to inflation which can decapitalise private funds. At a microeconomic level, problems arise if government lacks the capacity to regulate financial markets.

In contrast, effective government assists both state and private schemes. Government failure is not inherent. Governments throughout the OECD are putting into place cost containing measures in the face of demographic prospects (see Department of Social Security, 1993), recent reform in Sweden (Federation of Social Insurance Offices, 1998) and Canada being prime examples. Government capacity, similarly, assists private schemes by providing macroeconomic stability and effective regulation. The key message for policy design is that pensions depend on private sector capacity *and* government capacity.

A separate aspect of political risk is the argument that ownership rights over private funds may have greater legitimacy than claims to a state pension. Thus, it is argued, government might be less likely to interfere with pension funds than with the benefit formula of a PAYG pension. It is true that UK governments have made the national insurance pension less generous – by changing from earnings indexation to price indexation, by altering the formula under which the state earnings-related pension benefits are calculated, and so on. There are at least two responses. First, it was precisely that flexibility which allowed governments in a demographically more benign era to make pensions *more* generous. Second, private pension funds are not immune from changes in policy – the change in the tax treatment of pension funds in 1997 has already been mentioned.

The conclusion is that stakeholder pensioners are just as vulnerable as state pensioners to government *failure*; and the argument that they are less vulnerable to government *interference* (i.e. a change in the rules) is an empirical matter requiring proof rather than assertion.

2.2 Macroeconomic gains

The Prime Minister states in his Foreword to the Green Paper:

> These reforms mean that the total income of pensioners will rise in years to come, mainly fuelled by rising contributions. Public spending on pensions will rise too in real terms, but less sharply, and will fall as a proportion of national income. This will ensure that the pension system remains both fair and affordable (p.iv).

The implication is that stakeholder pensions, by reducing the publicly-funded component of pensions from 60% to 40%, have macroeconomic advantages ('affordable'). This view, which underpins the Green Paper strategy, needs testing.

The simple macroeconomics of pensions. There are two (and only two) ways a person can provide consumption for his old age. It is possible, first, to *store current production* by setting aside part of current output for future use. This is the only way Robinson Crusoe could guarantee future consumption, and is the method used by owner-occupiers to store housing services for old age. Beyond such limited cases, however, organising pensions in this way is a non-starter (for fuller discussion, see Barr, 1998, Ch.9).

The alternative is for individuals to exchange current production for a *claim on future production*. There are two broad ways in which a person might do this: by saving part of her wages each week she could build up a pile of *money* which she would exchange for goods produced by younger people after her retirement; or she could obtain a *promise* – from her children, or from government – that she would be given goods produced by others after her retirement. The two strategic methods of organising pensions broadly parallel these two sorts of claim on future production, funded schemes being based on accumulations of financial assets, and PAYG schemes, ultimately, being based on promises.

Under both PAYG and funding, therefore, pensioners' consumption comes out of current production. This truth holds whatever the financial mechanism by which pensions are organised. Thus *what matters is the future level of output*.

Pensions and output growth. Having established the centrality of output, the next questions are how it might be increased, and what role pensions might play. In principle, output can be increased by either or both:

- Increasing the productivity of each worker. This will involve increasing the quantity of capital, improving its quality, and/or improving the quality of labour.
- Increasing the number of workers from each age cohort and/or their hours of work. This will involve reducing unemployment, increasing labour force participation, particularly by married women, raising the age of retirement, and/or importing labour.

Thus, the menu of policies to increase output are:

(a) Increasing the quantity and quality of capital equipment, e.g. robots.

(b) Improving labour through more education and training.

(c) Increasing labour force participation, for example by reducing the tax wedge and by such policies as better child care facilities.
(d) Raising the age of retirement. The macroeconomic gain is that this decreases the number of pensioners *and* increases the number of workers. The social policy gain is that pensions are reduced not by reducing living standards in retirement, but by a shorter duration of retirement.
(e) Importing labour either directly (more relaxed immigration rules) or indirectly (exporting capital to countries with a young labour force).

From a macroeconomic perspective, therefore, there is a gain from moving towards funding only if that policy systematically leads to higher rates of growth. Such a move, however, has no direct bearing on policies (b) – (e).[6] Thus the argument boils down to whether funding contributes directly to growth (policy (a), above). In the face of a large and controversial literature (see Barr, 1992, 1998, Ch.9; Thompson, 1998), two observations are relevant. First, the magnitude of the effect is controversial; it is far from clear that a move to funding makes a *large* difference. Second, the debate about the economic impact of funding should not deflect our eye from the ball – namely that what matters is growth; and for that latter purpose, we should consider the *entire* menu of policies, not focus exclusively on pension funds.

Thus the macroeconomic gains of a shift towards funding should not be overstated. This opens up significant policy options.

3 Policy directions

The arguments in the previous section lead to two strategic conclusions:

- Stakeholder pensions, though potentially a major advance on previous personal pensions, are not completely secure – because by their nature they cannot be. Additional action, outlined in section 3.1, could reduce the degree of uncertainty, though not eliminate it.
- The macroeconomic advantages of stakeholder pensions should not be overstated. Specifically, the macroeconomic gain of shifting

6 There could be an indirect effect on (c) if funding, by reducing taxation, increased labour supply. Empirical evidence, however, suggests that the wage elasticity of labour supply, at least for primary workers, is inelastic to changes in tax rates in the range of tax rates typical in industrial economies.

the balance from a public:private ratio of 60:40 to one of 40:60 is less than the Green Paper implies. This opens up the possibility of a slightly different balance, discussed in section 3.2, between state and private pensions.

3.1 Enhancing the security of stakeholder pensions

Addressing management risk. The Green Paper proposals address management risk head on.

- Alongside prudential regulation, the laudable emphasis on improving information should be buttressed by mandating a common format and common definitions of key variables.
- Implementing regulation effectively will be a major challenge, and will require adequate resourcing because the necessary skills command a high price in the private sector.

Reducing investment risk. Investment risk is inherent with schemes like the stakeholder pension. Action to reduce that risk to the unavoidable minimum include:

- Keeping management costs low, thus increasing the net-of-administration return to pension savings.
- Running funds along simple lines, e.g. as tracker funds, thus reducing or eliminating the lower tail of pension performers.
- Allowing flexibility over the timing of converting a person's lump sum into an annuity, as discussed earlier, to allow at least some smoothing of stock-market fluctuations. Giving the individual a measure of choice over the date of conversion (and perhaps, as discussed below, also his or her date of retirement) is essential to minimise the effects of what would otherwise be a pensions lottery.

Improving the operation of annuities markets. Given the potential economies of scale in the provision of annuities, a strong case can be made for state action on annuities, including, perhaps, provision either of the annuity itself, or of 'annuity gilts' constructed to average across interest-rate fluctuations.[7] If the operation serves merely as a smoothing mechanism, there should be no long-run public expenditure implications.

Dealing with the inflation risk. Government can and should take action to reduce the inflation risk facing stakeholder (and other private) pensioners.

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7 I have stolen this idea from Phil Agulnik.

- The requirement that private pensions should offer at least limited price indexation (the current requirement is full indexation for inflation of up to 5 per cent) should continue, for stakeholder pensions and for occupational and personal pensions.
- The government should continue to issue indexed bonds.
- Government should indemnify stakeholder pensions and approved occupational and personal pensions against inflation above 5 per cent, up to some upper limit for a person's annual pension.

Sharing economic growth. Though it is intended that the minimum income guarantee will increase with earnings, an individual's stakeholder pension, by its very nature, cannot rise in line with post-retirement increases in average earnings. Thus the stakeholder pension will decline relative to average earnings over a person's retirement, leaving her poorest when she is oldest. One way forward is to pay a tax-funded age-related supplement – either to the state pension or the stakeholder pension – to allow pensioners to share in rising national prosperity after their retirement, and to ensure that the frail elderly have sufficient resources to pay for the additional care they need. This suggestion raises no new principle, since pensions already rise with age to a limited extent through higher tax reliefs for older people, through a small addition to the basic state pension to the over-80s, and through a minimum income guarantee which rises with age. These variables should be reviewed to allow elderly people more systematically to share in economic growth.

Links to long-term care. Given such links between pensions and care in old age, the reform of pensions and the – very welcome – recommendations of the Royal Commission on long-term care should be considered together.

3.2 Bolstering the minimum pension

The earlier argument that funding is not a critical instrument in addressing demographic risk has a major implication: it means that a fiscally prudent case can be made for a somewhat smaller shift in the balance between public and private pension spending, giving increased headroom to bolster the minimum pension in some or all of the following ways.

Making the second state pension more generous (a) to plug the gaps for people with low and/or intermittent earnings identified by Agulnik (this volume) and Rake, Falkingham and Evans (1999), and (b) to address the gender imbalances discussed by Falkingham and Rake (this volume). This could be done *inter alia* by extending eligibility, by increasing the value of the second state pension to give a ‘margin of error’ to cover some of the potential gaps, or by a mix of the two approaches.

Eliminating income testing for the great bulk of the elderly population, thus addressing one of the Green Paper’s strategic flaws – the disincentives to saving for low earners. There are a number of ways of doing so. The simplest method is to pay a higher basic state pension. A more targeted approach is to introduce a minimum pension guarantee based on criteria other than current income, for example some sort of lifetime income test of the sort described by Atkinson (1995) and Hills (1997).[8]

Affluence testing. An additional option, if fiscal constraints were regarded as binding, is to subject the basic state pension not to an income test (designed to restrict benefits to the poor), but to an affluence test, which has the more limited purpose of clawing back benefit from the rich. The Australian example (December 1998 figures) is illustrative. The first £35 or so of a married couple’s age pension is totally disregarded; thereafter pension is withdrawn at a rate of 25 per cent per person. Thus the state pension is not completely extinguished until a couple’s income from other sources exceeds about £275 per week. In short, all but the best off receive at least some state pension.[9]

Flexible retirement age. There are major advantages in allowing people to choose when to retire, such that someone who delays retirement receives an actuarially enhanced pension. To illustrate, consider someone with a life expectancy of 80 who delays retirement

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8 Under a minimum pension guarantee, anyone receiving any SERPS at all will receive a top up to bring their state pension to the income support level. This has the advantage (a) of ensuring old age security, (b) without an income test (piggy-backing on SERPS is, in effect, a lifetime income test), while (c) being more tightly targeted than increasing the basic pension, and (d) since not conditioned on private pension or other saving, has no adverse incentive effects.

9 In December 1998, the level of the age pension was A$298.10 per fortnight for each of husband and wife, i.e. a total pension of A$596.20, with a disregard of A$176 per fortnight of combined income from other sources. Thereafter pension is withdrawn at a rate of 25 per cent from each of husband and wife for each dollar of income from other sources. Benefit is extinguished when the combined income of the couple from other sources reaches A$1379.20 per fortnight (Commonwealth Department of Family and Community Services, 1998, Table 1).

from 65 to 68. Her pension 'pot' is thus payable over 12 years instead of 15, making it possible to pay a 25 per cent higher pension out of the same pot.[10] If she continues to make contributions between 65 and 68, the effect is stronger, since the pot becomes larger. Thus in social policy terms, a flexible retirement age enables someone who wants a higher pension to get one fairly quickly. In macroeconomic terms, this is possible at zero fiscal cost – a much more powerful instrument for addressing funding problems than adjustments to the balance between public and private funding.

An additional, more radical, option is to make the size of a person's pension at age 65 depend not only on his or her contribution record, but also on the size of his or her cohort. Other things being equal, therefore, someone from a larger cohort receives a somewhat smaller pension, thus containing aggregate pension spending. The person could then increase his or her pension at zero aggregate cost by delaying retirement. This is the route taken by recent reform in Sweden.[11]

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10 Ignoring interest, if a pot of 150 is paid out over 15 years, it gives a pension of 10; paid out over 12 years, it yields a pension of 12½.

11 See Sweden: Federation of Social Insurance Offices (1998) and/or http://www.pension.gov.se.

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‘Partnership in Pensions’: Delivering a secure retirement for women?

Jane Falkingham and Katherine Rake

In the foreword to the new Green Paper ‘A New Contract for Welfare: Partnership in Pensions’ the Prime Minister promises a radical reform of the whole pension system to ensure that “*everyone can look forward to a secure retirement*” (Department of Social Security, 1998a). In particular he highlights that the ‘partnership approach’ of the Green Paper will deliver “*dramatically better pension provision for … those unable to work because they are caring for children or a relative who is ill or disabled*”, the majority of whom are women.

The inadequacy of the current British pension system for women emerges starkly from every report on pension income. The high risk of poverty that female pensioners run has been well documented. Older female pensioners and women in single person households are particularly vulnerable to low incomes – nearly two-thirds (62%) of single female pensioners have income in the bottom two quintiles of the income distribution, with only 6% in the top fifth of the distribution (DSS, 1997a). These groups are consequently more reliant on Income Support and other means-tested benefits – 1.2 million women over 60 claim Income Support compared to 561,000 men (DSS, 1998b). Yet old age is a predominantly female experience. 60% of those aged over 65 are women and women make up three-quarters of those aged over 85. In light of the magnitude of the ‘pensions problem’ for women, the ability of the proposed reforms to deliver a fair deal to women should be a key criteria on which to judge the merits of the proposals. Will they deliver women, as Tony Blair promises, “*the security we all want, now and for the future*”?

1 The ‘pensions problem’ for women

The ‘pension problem’ for women stems from their different life course experiences in combination with a pension system that is not designed to meet women’s needs. Governments (the current one being no exception) have been quick to identify how behavioural differences between women and men, in labour market participation and in the division of caring labour, impact upon income in old age. They are, however, more reluctant to examine those institutional features that perpetuate the economic advantages and disadvantages experienced during the working life into inequality in old age. We argue here that women's 'pension problem' arises from a combination of behavioural differences *and* institutional features of the pension system:

1. ***Women spend fewer years in the labour market – all parts of the pension system reward long working lives.*** For the basic pension, a shorter working life jeopardises the ability of many women to meet the time requirements placed on entitlement – a full basic pension requires that contributions have been made for 9/10ths of the 'normal working life' of 49 years.[1] Receipt of Home Responsibility Protection (HRP) reduces the length of the 'normal working life' (i.e. with 5 years of HRP coverage the normal working life is taken to be 44 years), subject to a minimum of 20 years, but does not alter the 9/10ths requirement for full payment of the basic pension. Lack of contributory years means that currently 51% of women do not receive a basic pension in own right. For second tier pensions (including SERPS), shorter working lives simply mean less time to accumulate entitlements and a consequent lower income in old age.

2. ***Women earn less than men – all parts of the pension system either operate an earnings requirement and/or pay out earnings-related pensions***. An earnings requirement, in the form of the Lower Earnings Limit (LEL), operates for the basic pension and SERPS. When earnings fall below the LEL, as they do for at least 2 million women each year (McKnight *et al*., 1998), contributions are lost for that year reducing or jeopardising final entitlements.[2] Evidence points to the persistence of low pay – spells below LEL are likely to accumulate across the lifetime with serious consequences for income in later life. Pay outs of all second tier schemes (SERPS, occupational and private pensions) are related to earnings or to contributions made during the working life (which are, in turn,

1 From 2020 harmonisation of women and men's retirement age will mean that the basic pension will be based on a working life of 49 years for both.

2 The exception to this is where those below LEL are entitled to HRP, in which case credits will be given for that year.

related to earnings), so that low earnings in the working life translate into low income in old age.

3. ***Women have less access to occupational pension schemes – occupational pensions continue to offer the best value for money second tier provision.*** Although women's membership of occupational pension schemes has risen since 1945 the gender gap in occupational pension membership remains marked and since the early 1980s women's membership levels have stagnated. In 1994, 38% of full time female employees were members of an occupational scheme compared to 56% of male (ONS, 1996). Where women receive an occupational pension, average pay-outs are low. Data from the DSS Retirement Survey suggests that the median amount received from an occupational pension by women was £31 a week (January 1996 prices) compared to £71 received by men (Disney *et al.*, 1997). Small amounts of occupational pension may bring little or no financial gain. Rather a small private pension may merely disqualify the recipient from entitlement to means-tested benefits and with them all the other passported benefits – the so-called occupational pensions trap (Walker *et al.*, 1989). As a consequence of both lower membership of schemes and lower benefits when in payment, women rely more on the state, and on means-tested benefits, as a source of income in old age. This makes the level at which such benefits are payable especially important to women.

4. ***Women live longer than men – inadequate protection of survivors and inadequate inflation proofing of pensions affect the older elderly most***. Women's greater longevity means that they are more likely to experience bereavement in later life and the consequent change in household income. Furthermore, the impact of uprating benefits and pension income at a level below the rate of growth in earnings is greater the longer the period spent in retirement. Where pension income is indexed to prices, incomes will fall relative to the rest of the population - with the greatest relative loss of income experienced by the older elderly, the majority of whom are women.

2 The Green Paper and women

Given women's greater reliance on the state as a source of income in later life, the proposals in the Green Paper will affect women disproportionately and as such it is **essential** to examine their gender impact.

In outlining the problems of the current system, the Green Paper recognises the behavioural causes of women's lower incomes in old age, but not the institutional ones. The Green Paper states that "*Women tend to fare worse than men because of their different working patterns and greater longevity*" promising more research which will, in an unspecified way, "*inform future Government thinking*" (paragraph 15, p.14). Beyond this, bar the important section on carers which is discussed below, recognition of the difficulties that women face in gaining pension entitlement passes unnoticed. The proposals are typically gender-blind – for example, the statement "*Almost everyone of working age builds up rights to a basic state pension*" (paragraph 32, p.20) directly contradicts the figures cited earlier in the paper showing that just under half of women currently claim a basic pension in their own right. There is no disaggregation of recipients of means-tested benefits by gender, despite the marked gender imbalance shown above. The discussion of the occupational pension tier declares that "*Occupational pension schemes are one of the great welfare success stories of this century*" (paragraph 19, p.18), and fails to present any statistics on membership by gender. Such statistics would reveal the serious qualification that the statement needs – in terms of inclusiveness, and from the point of view of promoting equality of membership, occupational pension schemes cannot be counted a success. Is the government assuming that the gender imbalance of membership will wither away over time, or is it not considered a sufficiently important issue to attract comment and action?

Where a breakdown of membership by gender is made, it proves rather revealing. Talking about projected membership of the new Stakeholder Pensions (SHP) the Green Paper states: "*Those in today's workforce who are most likely to join stakeholder pension schemes are predominantly in full-time work…Roughly two-thirds are men and a third are women*" (paragraph 13, p.49). This shows that the government's expectation is that the gender imbalance of the occupational and private pension sector will be mirrored by SHP. This pensions vehicle, which will be privileged relative to the State Second Pension (SSP) in terms of payment in retirement, is to be populated in the majority by men, so that the ghettoisation of women in the poorer parts of the pension system goes unchanged and unchallenged.

Where the Green Paper is more comprehensive is in its references to carers, whose needs are explicitly recognised: "*There are millions of carers in the UK, most of whom are women…We believe there is a strong case for helping them*" (paragraph 22, p.42). Help comes in the form of credits to SSP. As part of the discussion of credits, an interesting, if rather under-specified, reference is made to the disabled who have had some labour market work which has, nevertheless, proved insufficient to build up entitlements. The Green Paper states that "*there is a strong case for introducing similar arrangements*" for these individuals, with a test of labour market attachment made "*at the point of award*" (paragraph 25, p.43). If we understand this proposal correctly, credits will operate both as compensation for those whose labour market histories have been interrupted through care of others, and those who have experienced interruption through disability. On first sight the proposals seem both generous and comprehensive and have the aim of ensuring that "*everyone with a lifetime of work behind them (or credits from caring) builds up rights to a pension which lifts them above the minimum income guarantee in retirement*" (paragraph 12, p.30). The government estimates that by 2050, four million will gain from this credit (the majority of whom will be women) and they will experience an increase in their pension income of £50 per week (paragraph 28, p.43). However, when we look at the proposals in more detail (below), the operation of these credits in reality may be less generous and comprehensive than the government would have us believe.

3 How far is the problem solved?

1. Women spend fewer years in the labour market – all parts of the pension system reward long working lives.

As with previous pension reforms, the Green Paper attempts to compensate women for their shorter working lives by offering credits, but we have major concerns about the effectiveness of the proposed credits.

Firstly, SSP credits are less generous than those offered by the present system. Currently, those registered as unemployed get National Insurance credits that count towards their basic pension (SSP offers no coverage to the unemployed), while Home Responsibility Protection also offers credits towards the basic pension. The most important aspect of current HRP is that which covers child care – currently over 99% of HRP years are claimed by women looking after dependant children (DSS, 1997b). HRP is available to those looking after children up to the child's 18th birthday if s/he is in higher education, up to 16 if not. By contrast, SSP credits offer coverage only until the child enters primary school and effectively cuts coverage by at least 11 years when compared to that available under HRP. According to our estimates this would affect a potential 6 million individuals (mainly women) at some stage in their lifetime. For other carers, the credits to SSP are as generous as HRP with those caring for someone who receives Attendance Allowance or Disability Living Allowance or who themselves receive Invalid Care Allowance all qualifying for credits, apparently without time limit. However, given the small number of individuals who claim credits in this way (under 10,000 per annum), this apparent generosity will have little impact.

Secondly, SSP credits will embody some of the problems of the previous system which mean that the credits will offer only limited rewards in reality. Although the Green Paper does not spell out how credits will work, if they operate in the same way as HRP does currently, the title 'credits' is misleading. In reality, credits do not provide a full year of contributions but rather deduct a year from the contributory requirement of a full working life. While this seems like a technical footnote it can have very real consequences, especially for those with extended periods of credits.

Thirdly, credits operate within SSP only. They are not transferable to other parts of the pension systems, and do nothing to enhance entitlements to Stakeholder, occupational or private pensions. If individuals accumulate entitlements across a number of parts of the pension system (for example, SSP combined with some SHP), then the value of the credits to SSP may be limited, and in extreme cases lost altogether. Assuming that SSP operates in the same way as the basic pension, a woman works and contributes to SSP for five years, followed by nine years of child care which are given credits. When she returns to the labour market, she decides to take out a Stakeholder pension. At retirement, the nine years' credit and five years' contributions are not sufficient to bring her over the minimum contributory threshold, so she receives nothing from her contributions or credits.[3]

3 If SSP operates in the same way as the basic pension, payments will be made on a sliding scale with full payment requiring 9/10ths of the working life, and no payments made if contributions fall below 25% of the contributory

Fourthly, even if a woman did gain full entitlement to SSP, there are real questions about the adequacy of this as a source of income. As Rake et al. (1999) show, even those single women with full SSP entitlement are very likely to fall into income-testing at, or early on in, retirement. Contrary to government claims, credits to SSP do not give carers an extra £50 of income a week when compared to the claims they could make to the minimum income guarantee regardless of years of earnings or credits.

2. Women earn less than men – all parts of the pension system either operate an earnings requirement and/or pay out earnings-related pensions.

The Green Paper does nothing to address the problem of the lack of coverage of those earning below the LEL, the majority of whom are women. No SSP coverage is offered to those women who take low paid employment which they can combine with their caring responsibilities for children over primary school age. What is more, the change signalled by the Green Paper in the overall pension mix has an important effect on women's outcomes. By continuing the shift away from a pension system which relies on pay-as-you-go towards individual funding, the government's ability to use the pension system to redistribute between high and low lifetime earners is further eroded.

3. Women have less access to occupational pension schemes – occupational pensions continue to offer the best value for money second tier provision.

Barbara Castle introduced SERPS in 1975 as an alternative second tier pension for those who were unable to contribute to occupational pensions. The original SERPS, because it was based on the best 20 years of earnings, promised to minimise the adverse effect of interruptions to women's working lives due to caring responsibilities on the amount of this pension. The combination of SERPS and the basic pension were redistributive to the low paid, providing a maximum replacement rate of 50 percent for a female full-time manual worker and lower rates for

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requirement. In the case of our example, she has 5 years of contributions. Her 'working life' is calculated as 40 years (i.e. 49 minus the 9 years of credit), and so to be entitled to any payment she needs to have contributed for at least 25% of 9/10ths of 40 years i.e. 25% of 36 years, which is 9 years. As she has not done this, the woman has no entitlement and in effect loses all her credits and contributions. In reality she would have been better off delaying taking out a SHP for a further 3 years.

higher earners (Groves, 1991). Changes in pension provision since then have reversed this advance; in particular the 1986 Social Security Act which changed the basis of calculating average earnings from the best 20 years to the whole working life – resurrecting the very institutional structures that work to the disadvantage of women. SSP has been presented as a replacement for, and an improvement on, SERPS. However, contrary to the government's claims, SSP will not provide an improved alternative second tier pension because in maturity it will pay out a flat-rate benefit which will barely lift individuals above the means tested minimum. In reality SHP has better claims to being a second tier pension, but like the occupational and private sectors will exclude many women. Once again, women will be left in a part of the system that will pay out the lowest benefits in retirement. The ability of higher paid workers to opt out of SSP means that SSP risks being a residualised system populated principally by low paid women. Any part of the welfare system in which the middle classes do not have a vested interest carries significant political risk – when cuts have to be made, such parts of the welfare system are vulnerable, and even more so if they are feminised, given women's lack of political voice.

4. *Women live longer than men – inadequate protection of survivors and inadequate inflation proofing of pensions affect the older elderly most.*

An effective pension system needs to provide protection from inflation throughout an individual's period of retirement. Women's greater longevity means that they are particularly vulnerable to the erosion of levels of income through inadequate indexation. The Green Paper proposals fail on a number of counts. First, SSP and the basic pension will be indexed to prices not earnings thus excluding older people from sharing fully in the benefits of economic growth, and forcing reliance on the means-tested minimum income guarantee which will be linked with growth in earnings (this issue is fully explored in Rake et al.). Second, SHP income will depend upon an annuity purchased at the point of retirement. Annuities rarely, if ever, provide full inflation proofing (see Barr, this volume). In the long run many women and men who retire on SHP will find their incomes dropping below that of the means-tested minimum income guarantee. This will send a signal to younger workers that there is little reward to thrift.

The Green Paper also makes no explicit reference to the treatment of SSP on bereavement. If no provisions are made for survivors within SSP, then, again, SSP will be less generous than SERPS. For low earning couples dependent on the basic pension and SSP, the lack of inheritable rights will mean a move to means-tested assistance on bereavement.

4 Conclusion

Taking the 'pensions problem' for women seriously, and using it as a criteria on which to judge the merits of the Green Paper has raised a number of serious difficulties that the proposals face in delivering a fair pension to women. These are:

- the potential ghettoisation of women in SSP (the part of the system that pays out the poorest benefits on retirement) leaving it vulnerable to cutback in later years;
- the *de facto* exclusion of women from the parts of the system (SHP and occupational pensions) that promise a higher income in old age;
- the inadequate protection of individuals throughout the period of retirement because of inadequate indexation of income;
- the lack of provision for survivors within SSP;
- the inadequacy of credits to SSP in compensating for the time that women take out of the labour market to perform caring duties;
- the continuing lack of coverage of low paid women workers.

An argument in the defence of the Green Paper that could be made is that women and men's labour market participation rate have converged in recent years and that the problems identified here will be less acute for future cohorts of retirees. Looking cross-sectionally, participation rates of women and men have indeed moved closer. However, much of this convergence is explained by a growth in women's part-time participation, and falling rates of participation amongst men. What the 'convergence thesis' also ignores is that over the lifetime participation rates for women and men remain markedly different because of women's efforts to combine reproductive and productive roles. Furthermore, the move to the flexible labour market for many is a move to an insecure labour market, with interrupted earnings histories becoming the norm.

The Green Paper has been a missed opportunity. The institutional features that contribute most to the perpetuation of economic disadvantage experienced during the working life into inequality in later life remain unchanged. Indeed, the shift away from collective provision and the emphasis on individual responsibility will reinforce this inequality, so that many women will continue to experience poverty in later life.

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Pension Tax Reliefs and the Green Paper

Phil Agulnik

A substantial proportion of state support for retirement incomes is provided through the tax system. Official estimates by the Inland Revenue put the cost of pension tax reliefs at £12.2 billion, equivalent to around 40% of the cost of the basic state pension. Moreover, as this paper shows, a large proportion of this benefit goes to the better-off. In particular, people who pay tax at the higher rate for all or part of their working lives but retire on an income which attracts basic rate tax gain significantly over their lifetime. At the same time, the current system offers only rather modest incentives for poorer people to save for retirement, with lower rate taxpayers qualifying for tax relief on pension contributions at half the rate of people earning over £30,000 (the start of the higher tax band). While probably not the main cause, the current system of tax reliefs therefore helps explain why private pension entitlements in the UK are so unevenly distributed. As such, the way tax support for pensions is operated reinforces other factors which are tending to widen pensioner income inequality.

This paper discusses the Green Paper's proposals for the tax treatment of Stakeholder pensions, focusing in particular on the proposed limit of £3,600 on voluntary contributions to such schemes, and on the suggestion that people will be able to contribute to Stakeholder schemes from unearned income. Both of these changes, it is argued, make more radical reform of pension tax reliefs significantly more likely. But before looking at the Green Paper's proposals it is worth setting out the effects of the current system.

The cost and distributional effect of the current system

The components of the Inland Revenue's estimate for the cost of pension tax reliefs in 1996/7 are set out below:[1]

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1 It should be noted that the Inland Revenue's costing ignores the fact that pension contributions made by employers also receive favourable treatment from the National Insurance (NI) system. While employee contributions are included in individuals' gross pay, and hence constitute part of the tax base used for calculating employee and employer NICs, pension contributions by

Tax relief on contributions	= £9.2bn
Tax relief on investment income of funds	= £7.5bn
Tax relief on lump sum payouts (unfunded schemes)	= £0.4bn
(Revenue from tax on pension payments	= £4.9bn)
Total	**= £12.2bn**

This paper looks exclusively at the £9.2bn cost of contribution relief. Tax relief on pension funds' investment income was severely cut back by the July 1997 Budget, which abolished Advanced Corporation Tax (ACT) credits. This change was expected to almost halve the cost of this form of relief, and further changes in this area in the near future seem unlikely. More importantly, however, there is a strong argument for ignoring this element of the Revenue's costing altogether. The fact that pension funds do not have to pay tax on their investment income does not necessarily mean that they are tax advantaged - other saving instruments also enjoy this tax status, and it is a moot point as to whether the treatment afforded to pension funds represents the exception or the rule. If the tax treatment of savings put into bank or building society accounts is seen as the norm then there is a genuine revenue loss resulting from failing to tax investment returns. But if the relevant comparison is with the tax treatment of Individual Savings Accounts (ISAs), where returns are free of tax, then the 'cost' of investment income relief is illusory - if money were not contributed to a pension it would be put into some other savings vehicle where investment income was not taxed, hence there would be no additional tax revenue.[2] Accordingly, the only potential source of loss from the provision of pension tax reliefs relates to the exemption of pension contributions from liability to income tax and the existence of the tax-free lump sum.

It is frequently argued that the cost of contribution relief is effectively zero - the fact that contributions to pension schemes are tax-free while payments are taxed means that revenue is not lost but merely deferred. This argument is incorrect. Even after taking into account the

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employers are not counted as a benefit-in-kind. Consequently neither employer nor employee NICs are payable on such pension contributions, causing revenue to the NI fund to be lower than would otherwise be the case.

2 See Dilnot and Johnson (1993) for a fuller exposition of this argument.

fact that revenue from tax on pension payments in the future (financed out of today's higher contributions) is likely to be around £1 billion greater than revenue from pensions currently in payment (£4.9bn in 1996/7), this still falls considerably short of the £9.2bn cost of contribution relief (see Agulnik and Le Grand, 1998). This situation arises for two reasons. First, individuals often pay tax at a lower rate in retirement than during their working lives, partly because of the higher age-related tax allowances which they become eligible to, and partly because income tends to go down in retirement. Second, the lump-sum part of a pension payment (limited to 25% of the pension fund in a personal pension, or one and a half times final salary in a defined benefit scheme) may be taken tax-free, hence further reducing the amount of tax collected on pension benefits.[3] Taken together, these factors mean that only a little over half the cost of contribution relief is returned to the Exchequer through tax on pensions in payment.

Distribution of contribution relief

As shown in Agulnik and Le Grand (1998), a large proportion of the total cost of contribution relief is accounted for by higher rate taxpayers. This results from two factors. First, the propensity of people to be in a private pension scheme increases with income, so that 90% of workers with earnings of £20,000 or more are in a private pension scheme compared to only 40% of workers with earnings of £7,000. This is illustrated in Figure 1, which shows membership of personal and occupational schemes as a proportion of the workforce. The figure also shows that there is a significant difference between personal and occupational schemes, with membership of occupational schemes rising steadily as earnings increase to £25,000 then declining thereafter, while membership of personal pensions rises steadily, but more slowly, with earnings.[4]

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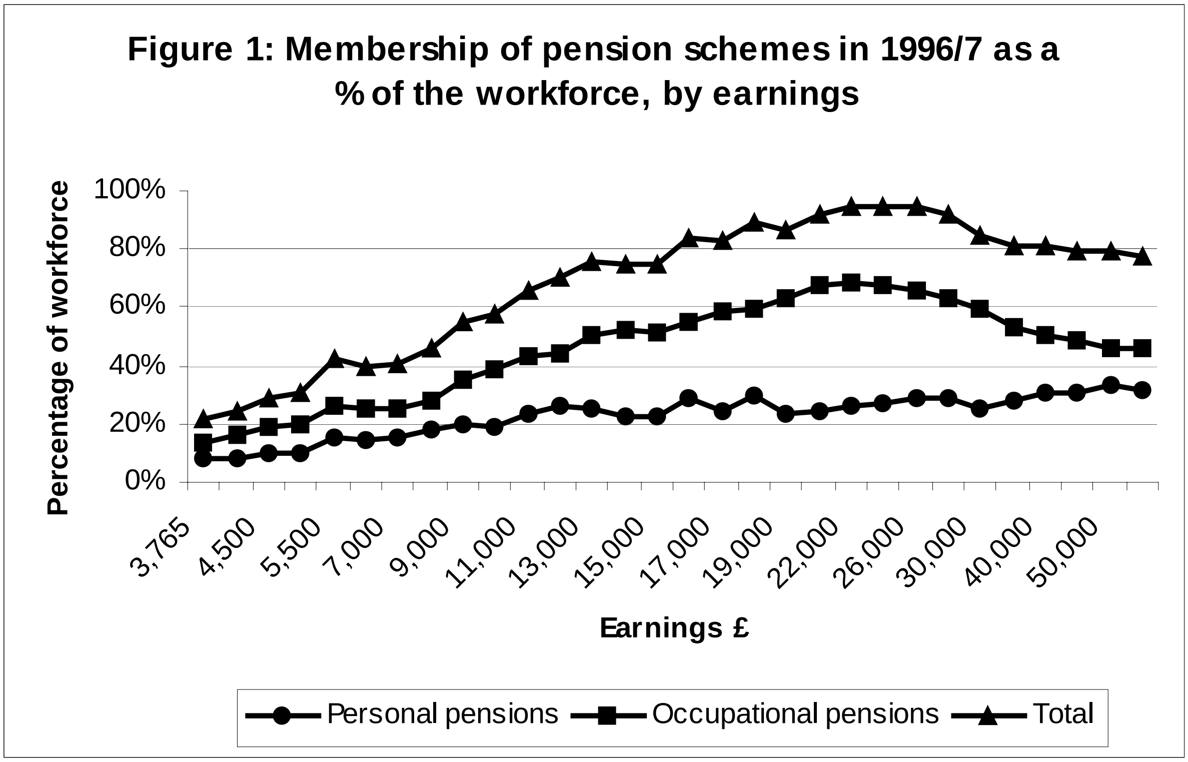
3 It follows that, while both ISAs and pensions allow individuals to accumulate interest free of tax, in general people who save in the form of a pension will pay less tax over their lifetime than those who save via an ISA. This advantage would only disappear if the average rate of relief on pension contributions (currently around 27%) was reduced to the average rate of tax on pension benefits (currently around 17%), or vice-versa.

4 Data from the New Earnings Survey, which looks only at the pension position of full-time employees in occupational or group personal pension arrangements, provides a rather different profile for scheme membership. In particular, it suggests that membership of occupational schemes peaks at a



The second reason for the regressivity of pension contribution relief relates to the fact that people can claim back tax at their marginal rate, so that higher rate taxpayers receive proportionately more tax relief than basic and lower rate payers (reflecting the higher marginal rate at which they pay tax). Figures 2 and 3 illustrate, showing the average level of contributions (and the amount of tax relief received on such contributions) by members of, respectively, personal and occupational pension schemes.[5] Note that the proportion of the total pension contribution accounted for by tax relief increases at £30,000, where higher rate tax becomes payable.

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slightly higher level than the Inland Revenue data indicate, and only tails off very marginally as earnings rise above £25,000.

5 Pension contributions made by employers on their employees behalf are ignored. Given the high level of such contributions, the Figure significantly understates the overall level of pension entitlements being built up by members of occupational schemes, and the cost of tax relief for such schemes. However, the distribution of contributions by employers may be different from that of employees, and available data do not allow such contributions to be incorporated into the analysis here.

Figure 2: Average pension contribution by members of personal schemes 1996/7, by earnings

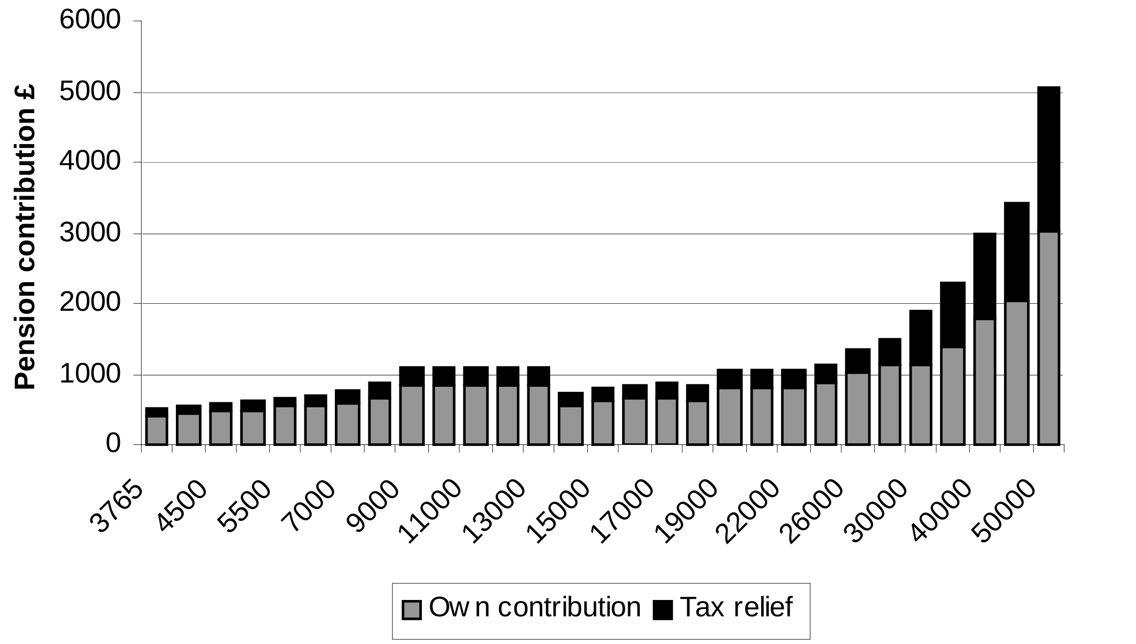
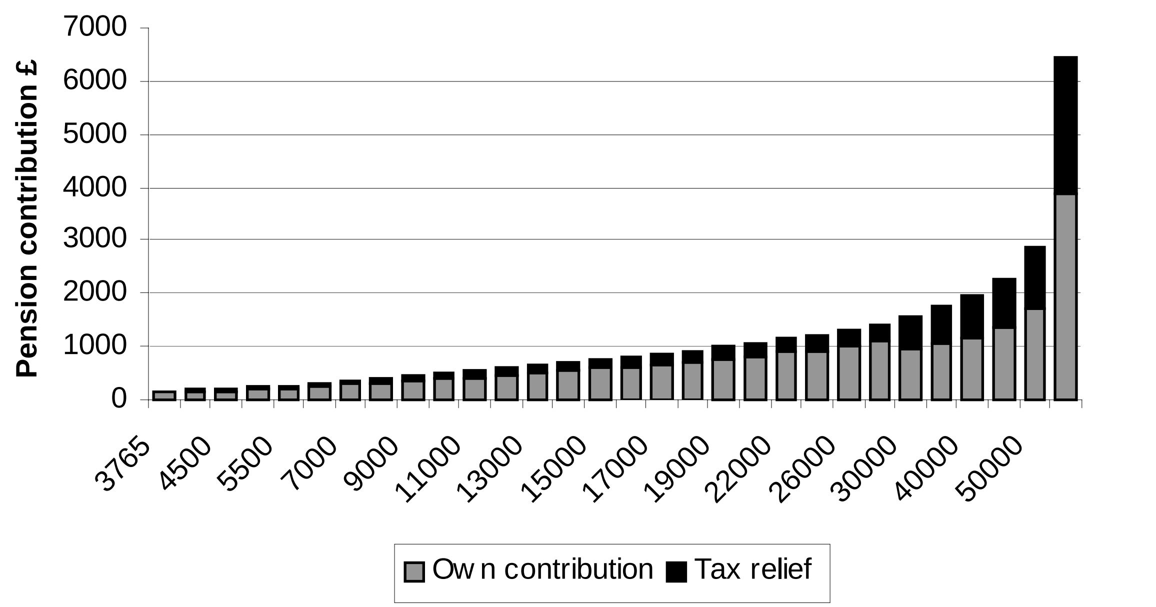
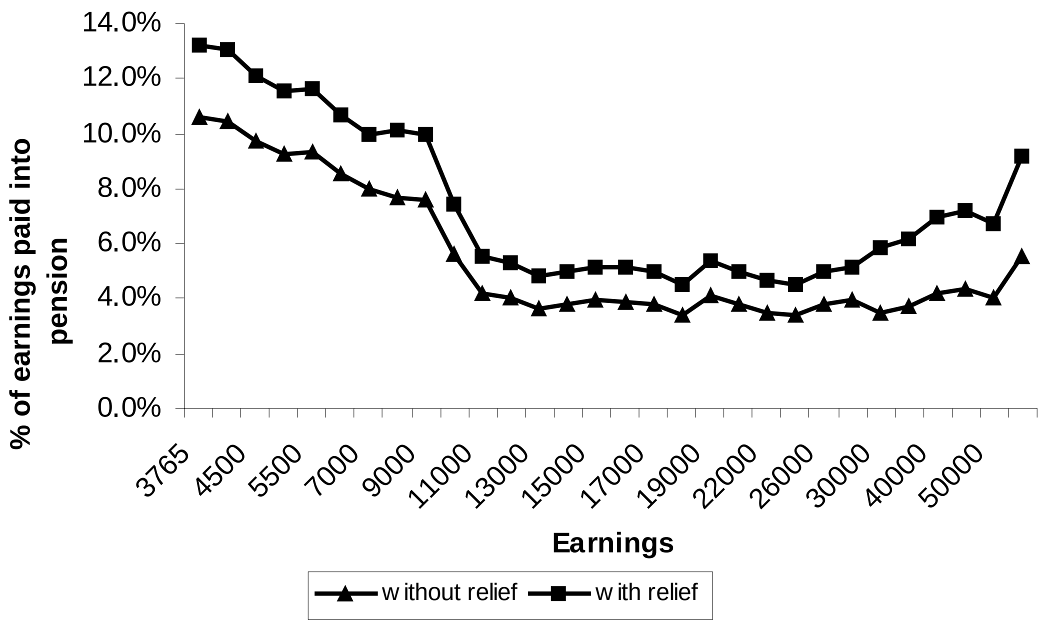


Figure 3: Average pension contribution by members of occupational schemes 1996/7, by earnings

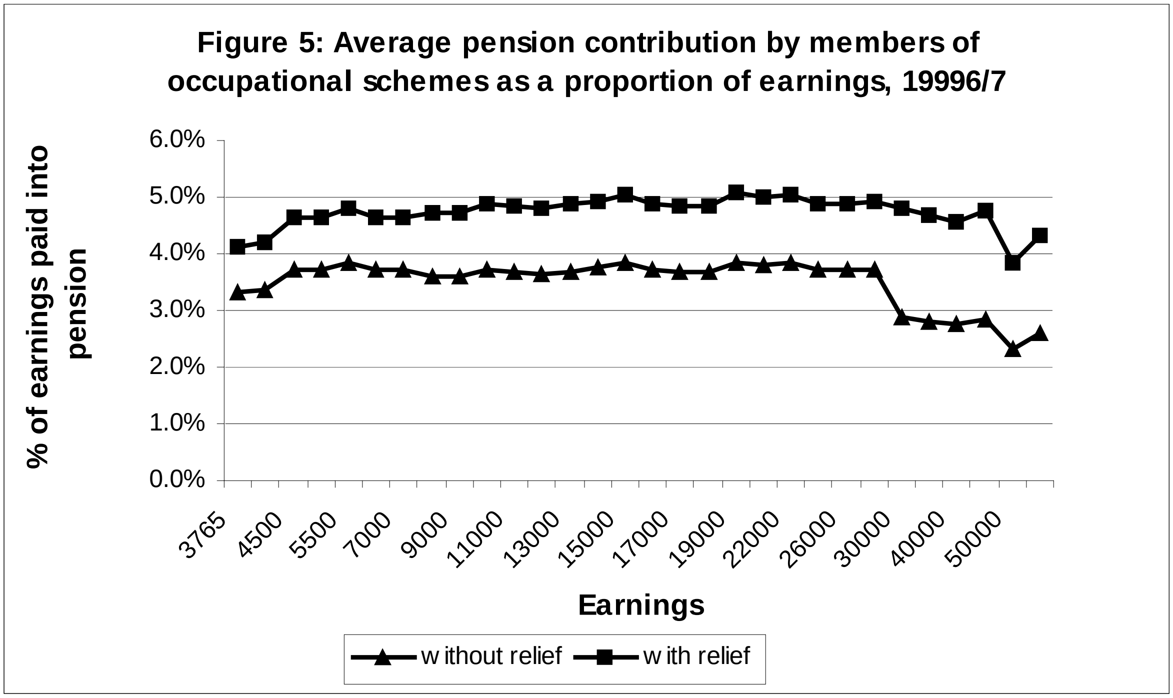


An additional explanation for the regressivity of contribution relief system might be that the low paid are reluctant to save for a pension. However, there is little evidence to support this proposition. Figures 4 and 5 show how much, on average, members of personal and occupational contribute as a proportion of their earnings. The latter Figure shows that contributions to occupational schemes are an almost constant proportion of earnings while, in contrast, contributions to personal pensions are inversely proportional to earnings, at least for people on less than £12,000 pa. The fact that low earners account for a small proportion of the overall cost of pension tax reliefs cannot therefore be seen as a reflection of insufficient prudence on their part. Indeed, the evidence presented here suggests that low earners who are making voluntary contributions to personal pension schemes are more willing than their richer peers to see a large proportionate drop in their income.[6]

Figure 4: Average pension contribution by members of personal schemes as proportion of earnings, 1996/7



6 The actions of personal pension providers may also affect the saving behaviour of low earners. In particular, personal pension providers may not be willing to accept rebate-only business from people on low earnings, as the value of contracted-out rebates will be insufficient to make a private pension economical once the effect of flat-rate charges has been taken into account. Providers may therefore insist that low earners make voluntary contributions to their pension account of at least, say, £10 a week. Even this level of payment will represent a large proportion of earnings for the low paid, hence producing the pattern for contributions illustrated in Figure 4.



Stakeholder pensions

The role of tax reliefs features little in the pensions Green Paper. Nevertheless, two aspects of it's proposals for Stakeholder pensions are worth commenting on. First, the Green Paper proposes that, in place of the current system where contributions cannot exceed a particular proportion of an individual's earnings, there should be a simple annual limit of £3,600 on voluntary contributions to Stakeholder schemes.[7] Second, the Green Paper states that people will be able to move savings between ISAs and Stakeholder schemes while still benefiting from tax relief. As the below sets out, both of these changes may have more far-reaching consequences than was perhaps envisaged.

Before looking at the effect of the government's proposed cap on contributions to Stakeholder schemes, it is worth setting out in detail how the current system for limiting pension contributions works. Everyone changing jobs or entering the labour market after 1989 is subject to an annual limit on the amount which they may contribute to a pension scheme tax-free. Employee contributions to occupational

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7 The Green Paper in fact proposes that contributions to Stakeholder schemes will "*be limited to a fixed sum of £3,600 a year, or 100% of the member's earnings, whichever is the lower*" (p.62). It is difficult to see why this second condition was added, and it is ignored in the following.

schemes may not exceed 15% of earnings while more generous limits, varying with age, apply to personal pensions (up to age 35 tax-free contributions are limited to 17.5% of salary, but this rises to 40% for the over 60s). In addition, an 'earnings cap' of £87,600 (for the 1998/9 tax year) is applied to both types of scheme: that is, the earnings figure to which the relevant contribution percentage is applied cannot exceed £87,600, thus setting an overall limit on the amount which can be contributed tax-free. Employer contributions are included within the limits applied to personal pensions, but there is no limit on employer contributions to occupational schemes (though the benefits which such schemes may produce are restricted).

As can be seen, the limit of £3,600 on contributions to Stakeholder schemes is considerably lower than the existing earnings ceiling, at least for higher earners. Indeed, it is likely that the majority of people earning more than £30,000 will find the proposed limit constricts their saving behaviour. However, as the Green Paper makes clear, the new type of scheme is intended to supplement existing pension vehicles and, in particular, it makes no mention of any changes to the current tax and regulatory regime surrounding personal pensions. People will therefore be free to choose the pension which best suits their needs, and hence we might expect most high earners to continue to use personal pension arrangements even after Stakeholder schemes are introduced. The rationale for, in effect, denying high earners access to the new type of scheme is somewhat unclear.

Perhaps more worryingly, however, the existence of higher contribution limits on personal and occupational schemes would create rather strange incentives to switch provision at particular points in the lifecycle. For instance, someone earning £25,000 who decides to increase their voluntary pension contributions from 10 to 15% of earnings would find that, in order to build up the desired level of pension entitlements, they had to switch out of a Stakeholder scheme into a personal pension. Similarly, someone receiving employer pension payments of 10% of salary would find that a pay increase from £35,000 to £40,000 would force them to supplement their Stakeholder pension with a personal pension. It is difficult to see any arguments in favour of such arbitrary incentives to move from one type of scheme to another.

Notwithstanding the equity argument for applying the same contribution cap to all types of pension arrangement, the practical difficulties in implementing one rule for Stakeholder pensions and another for personal and occupational schemes therefore makes some change from the position taken in the Green Paper more or less inevitable. One possibility would, of course, be to retain the existing tax relief rules for Stakeholder as well as personal and occupational schemes. However, the current rules are rather complex and involve checking contributions against earnings, thus adding to administration costs. Given that Stakeholder pensions are intended to reduce unnecessary costs, thus improving value-for-money for contributors, this would be a move in the wrong direction.

A more attractive alternative would therefore be to abandon the current system entirely and apply the £3,600 limit, with no relation to earnings, to all types of pension scheme. Assuming low earners do not increase their contributions, this would save around £500 million a year, which might then be used to provide a higher level of relief on all pension contributions. I calculate that the additional revenue resulting from the imposition of a cap of £3,600 on all voluntary pension contributions, plus partially restricting relief for higher rate taxpayers, would allow a uniform rate of relief of 33% to be imposed.[8] If the tax-free lump sum were also retained this rate of relief would be sufficient to ensure that pensions remained more tax advantaged than ISAs even for people expecting to pay higher rate tax in retirement.[9]

The introduction of a uniform rate of relief on pension contributions is particularly relevant given the Green Paper's aim to allow people "*to transfer money from ISAs into Stakeholder pension schemes both when they are in and out of work, with tax relief*" (p63). This objective will only be possible if there is a single rate of relief on all pension contributions as, if there are different rates of relief for different taxpayers, it would be necessary to trace back the origin of money paid into an ISA to see what rate of relief should be applied to the money being transferred into a pension. This is an administrative impossibility. Hence not only does the Green Paper make it possible to finance a

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8 Equivalently, tax relief could be abolished and a system of matching grants introduced in its place, with each £ of pension contribution attracting 50p of matching grant from the Exchequer. The arguments in favour of substituting matching grants for tax reliefs are set out in detail in Agulnik and Le Grand (1998).

9 Assuming that the tax-free lump sum accounts for 25% of an individual's pension, the effect of this additional tax exemption is to reduce higher rate payers' effective rate of tax on pension benefits to 30% (40%*.75). If pension contributions receive relief at a rate of 33% there would therefore remain some advantage, albeit reduced, in saving via a pension rather than via an ISA.

reasonably high uniform rate of relief (using savings from the imposition of a £3,600 limit on all pension contributions), it also suggests a link between ISAs and Stakeholder schemes which will be impossible to operate while relief remains linked to individuals' marginal tax rates.

Conclusion

The Green Paper may herald rather larger changes in pension tax reliefs than, at first sight, it appears to suggest. The imposition of a £3,600 limit on tax-free contributions to Stakeholder pensions but not on contributions to other types of pension is anomalous and, in all probability, unworkable. One solution to this would be to simply apply the existing tax rules to Stakeholder schemes. However, as this paper has demonstrated, the current system predominantly benefits the better-off, hence such a change would be regressive. Relaxing the rules surrounding Stakeholder pensions would therefore be a mistake – imposing the £3,600 cap on all pension contributions and using this money to increase the rate of relief provided on all contributions (or an initial tranche of contributions) would be preferable. Indeed, reversing tax relief rates – so that the initial tranche of contributions receives relief at a higher rate than subsequent contributions – might fit in well with the government's strategy of 'redistribution by stealth'.

However, an even more progressive option would be to reduce the cost of tax reliefs dramatically and use the additional revenue to directly increase the incomes of the poorest. This was the solution to the 'pensions problem' suggested by Richard Titmuss (1958). He suggested that fiscal welfare (as he termed tax reliefs) should be cut back, thus allowing a much larger Exchequer grant to be paid to the National Insurance Fund, and hence allowing the level of universal flat-rate pension benefits to rise (from which the poor would gain most proportionately). This option remains open to the government. Large amounts of additional revenue (though not as much as the gross figure of £12bn) could be brought in by restricting tax relief on pension contributions to the basic rate, phasing-out the tax-free lump sum, treating pension contributions as a benefit-in-kind for the purposes of calculating NICs, and abolishing tax relief on contacted-out rebates (so that they receive the same tax treatment as contributions to SERPS or the proposed State Second Pension). Using this money partly to pay off the national debt and partly to finance increases in the basic pension would be a sustainable alternative to the Green Paper's strategy.

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