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

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Editorial Note and Acknowledgements

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Abstract

This paper analyses the proposals contained in the Government Green Paper, *A New Contract for Welfare: Partnership in Pensions* for low paid workers and the potential of the new rules to guarantee a decent income in old age. It discusses the general principles inherent in the design of the British pension system and analyses the balance of these principles is represented in the Green paper. The paper then examines how the Government's proposals protect individuals from a means-tested old age. The paper identifies a number of design faults that could extend means-testing to a large number of low paid workers. The paper then models lifetime incomes for a range of hypothetical, low-income individuals and their partners under the Green Paper's proposals.

This paper finds that the Green Paper's proposals add up to reinventing a new two-stage basic pension. However, two key features of such a basic pension package are missing – an 'adequate' level of payment and comprehensive entitlement. Because of these missing principles we argue that the Green Paper's proposals incorporate *tightropes* and *tripwires* for the low paid. The tightrope is an income from the basic pension and the secondary pension which is so near the means-tested minimum that little is gained in retirement from a lifetime of work and contribution. Tripwires exist because common life events that disrupt basic and secondary pension entitlement are not covered by the Green Paper's proposals. These tripwires include periods of unemployment, sickness or training, extended periods of caring, time below the low earnings limit and bereavement.

The paper expresses concerns about incentive problems the sustainability of the proposals, the robustness of the assumptions about family formation and labour market participation and the sensitivity of the low paid to fluctuations in the annuity markets. The authors make several suggestions about changes to the proposals that could meet their concerns.

I. Introduction

This paper analyses the proposals contained in the Government Green Paper, *A New Contract for Welfare: Partnership in Pensions* (DSS 1998a). Our focus is on the provisions for low paid workers and the potential of the new rules to guarantee a decent income in old age. Our argument proceeds as follows. First, we outline the general principles inherent in the design of the British pension system. Second, we see how the balance of these principles is represented in the new 'Partnership for Pensions'. We here ask: "How effectively do the Government's proposals protect individuals from a means-tested old age?" In this section we identify a number of design faults written into the Green Paper's proposals, each of which will have the effect of extending means-testing to a large number of low paid workers. Thirdly, we set out a model of lifetime incomes through which we can explore how a range of hypothetical, low-income individuals and their partners would experience the new regime. In addition, we investigate how sensitive the outcomes of these hypothetical individuals are to changing assumptions about the lifetime profile of earnings and the annuity rate. If the proposals prove to be highly sensitive to these assumptions, then the robustness of the scheme must be brought into question.

II. Four Elements of Pension Provision

Present pension policy is comprised of four basic elements.

- First is the contributory *basic pension*. This is paid on a flat rate basis to everyone who has fulfilled the contributory requirements when they reach pensionable age (currently 60 for a woman and 65 for a man, but these are harmonising to 65 in the future).
- The second element of pension incomes is a means-tested minimum now called the *minimum income guarantee* (MIG). This is, in effect, a new name for Income Support. Indeed, the use of the word "guarantee" is misleading because it is not guaranteed – it requires people to take-it up. Presently about 18% to 24% of all people entitled to Income Support do not take it up (DSS 1998b, Table H4.01). The figures may in fact be higher for the older population who are particularly reluctant to claim despite large-scale DSS efforts. This "guarantee" is provided by the state social

security system through a benefit called Income Support and associated Housing Benefits and Council Tax Benefits.

- The third element of pension provision is a *state-run secondary pension*. Currently this is provided by SERPS which is designed to supplement the basic pension for low earners who are unable to benefit from private and occupational pension schemes. Under the proposals, this element will be the State Second Pension (SSP).
- The fourth element is *private provision*. This can take the form of pension schemes run by employers and/or banks and insurance companies but also includes income from personal savings and investments.

The inter-relationship of these four elements is crucial to a balanced pension policy that meets needs and maintains incentives to work and save. It is the Green Paper's underlying view of these relationships that concerns us first. What are the relative levels proposed of minimum income guarantee, basic pension and SSP? Do the new proposals provide income from a basic pension and a secondary pension that is sufficiently above the means-tested minimum?

III. A means-tested old age?

In examining the provisions made for low paid workers and how far they protect them from means-testing we look at two issues. We first examine the current relationship between the basic pension and means-tested benefits and then explore how the proposed State Second Pension will alter or reinforce that relationship.

a. The basic pension and means-tested benefits

The Green Paper's proposals both support the continuance of a basic, flat-rate pension and continue the tradition of devaluing this basic pension relative to means-tested benefits. The rates of basic pension and MIG are given in Table 1:

Table 1: Weekly rate of basic pension and Minimum Income Guarantee (April 1999)

Weekly rate for:	Single	Couple
Basic pension	66.95	106.90
MIG	75.00	116.60
Basic pension as % of MIG	89.3%	91.7%

As the table shows, the basic pension now only satisfies *89%* of government defined basic needs for single pensioners and *92%* for couples. While the Government's generosity in increasing the level of MIG for pensioners has an obvious up side – better support for pensioners – it has a down side as it further undermines the ability of the basic pension to provide a non-means tested platform for retirement.

The situation of the basic pension relative to means-tested benefits is actually worse when we also consider means-tested assistance for council tax and/or rent, not directly included in MIG. Housing benefits cover 100% of rent and council tax on top of MIG – in 1988 an average of £8.87 was given towards rent and £42.46 towards council tax.[1] This means that, on average, the basic pension only covers 79% of the needs of a single pensioner who owns their own home, and only 53% of the needs of their tenant neighbour.

These rates apply the moment the pensioner retires. However, as pensioners grow older MIG rises and the relative value of the basic pension falls. MIG rises to £77.30 for a 75 year old single person and to £119.85 for a couple, and for an 80 year old to £82.25 for a single person and £125.30 for a couple (April 1999 rates).

Figure 1 plots the value of the basic pension against MIG (frozen at April 1999 prices for a single person) and shows the shortfall between the basic pension, the basic rate of MIG and that claimed by the average owner-occupier and average tenant. The "shortfall" between basic pension and MIG is a political decision about benefit rates and targeting (if the basic pension was higher the shortfall would be lower but the costs would increase because everyone receives the basic pension). Faced with this shortfall between the basic pension and MIG, the performance of SSP is key if lower earners are to be brought above the MIG. We now examine whether SSP will be successful in protecting such lower earners from a means-tested old age.

b. The State Second Pension and means-tested benefits.

To avoid getting confused by transitional rules, let us jump to 2050, the first year of a whole working cohort retiring under the proposed reformed system. Because it is difficult to anticipate what actual prices will be in the future, it is better to think of pension levels in terms of relative income levels. The government hopes that MIG will rise in line

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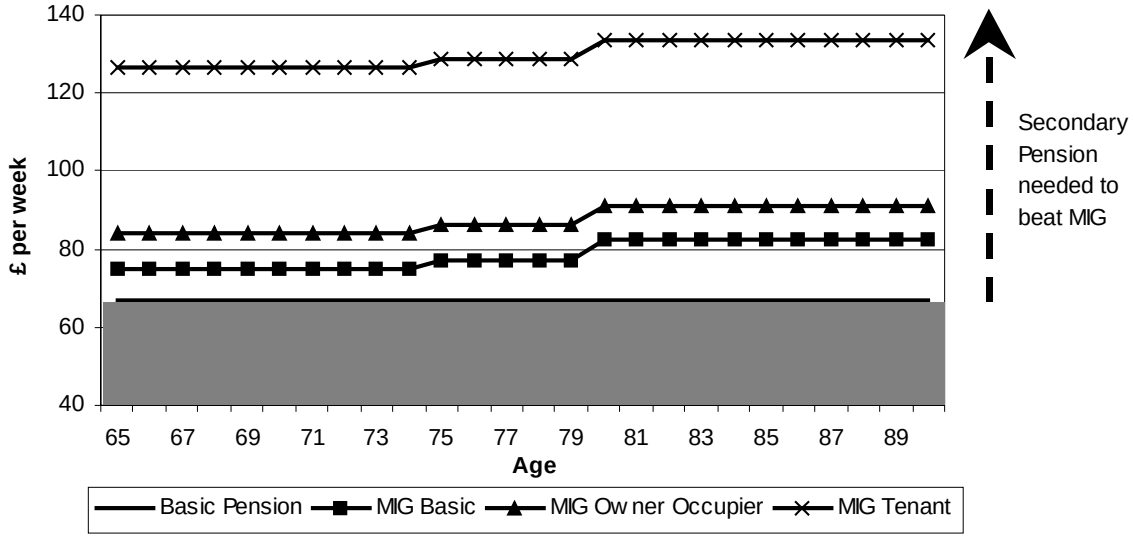
1 The average rent of housing benefit recipients aged over 60, and the average council tax for council tax recipients over 60 (from DSS (1998b), Tables A3.06 and A4.04 respectively).

with incomes generally and be set at around 17.5% of average male earnings. The Green Paper makes clear that it will continue the price-indexation of the basic pension. This means that its value will wither away until it is only worth 7.5% of average earnings in 2050. The government's projections suggest that SSP will be worth around 10.4% of average earnings in 2050.

Figure 1: Basic Pension and the Minimum Income Guarantee (MIG)



All held constant at April 1999 rates. For a single person with average housing costs.

For low earners (those earning up to £9,000 p.a. in April 1999 prices), the Green Paper estimates that SSP, in combination with the basic pension, will give an income equivalent to £76 a week against the basic MIG of £75.[2] The first point to raise is that this £76 income is only £1 above the *basic* level of MIG. Those retiring on full SSP and the basic pension are walking on a narrow tightrope above the means-tested minimum. Further, as we know from Figure 1, there is an important issue of housing costs. Unless there is a revolution in local government and housing finance by the year 2050, pensioners will still need help towards Council Tax and Rent liabilities. Remember low-earners have

2 We follow the Green Paper's example in presenting the projected value of the matured system relative to current earnings. The Green Paper estimates the percentage of earnings that SSP and the basic pension will offer under a fully matured system in 2050, and then presents this as a percentage of *current* (1998) average earnings. In 2050, the absolute rates of SSP and the basic pension will be much higher with their exact rates depending on earnings growth and price inflation.

limited access to owner-occupation, and are most likely to be tenants; for such individuals the tightrope will be too narrow and they will fall into means-testing at the point of retirement.

Despite its apparent generosity, at its optimal value SSP combined with the basic pension does little to lift pensioners out of means testing. Those reliant on SSP/basic pension alone will have an income of £1 above MIG, leading to a net income after paying rent and council tax of only 20p above MIG. In our opinion this means that in practice SSP will be nothing more than a targeted flat-rate top-up to an inadequate contributory basic pension.

So far we have argued that SSP will in practice be an additional contributory minimum pension that is set at rates that ensure a large degree of means-testing for all who retire in 2050. Still, the basic pension and SSP combined give an income £1 above MIG and one could argue that this is some sort of protection against means-testing. However, this £1 tolerance proves to be ephemeral as it will not stop the pensioners of 2050 sliding inexorably towards a means tested retirement during the period of their retirement.

Under the Green Paper's proposals SSP performs optimally for the first year(s) of retirement only. Why? First, indexing MIG to earnings while the basic pension and SSP are indexed to prices means that the £1 is whittled away in real value by the difference between price and earnings inflation. As recent answers to Parliamentary Questions show the Government itself admits that once the scheme is matured those retiring on full SSP and the basic pension would fall below the level of MIG within 5 years of retirement.[3] This adds a new level of complexity to that shown previously in Figure 1. Inflation will mean that the shortfall between the basic pension and MIG will actually *increase* during an individual's retirement, while the value of SSP relative to MIG will fall over time. Second, even if the effect of differential indexation was not built into the Green Paper's proposals, MIG is staggered upwards according to age (Figure 1) and hence anyone who escapes the effect of relative loss of value of the basic pension/SSP will, in any case, be means-tested when they are 75.

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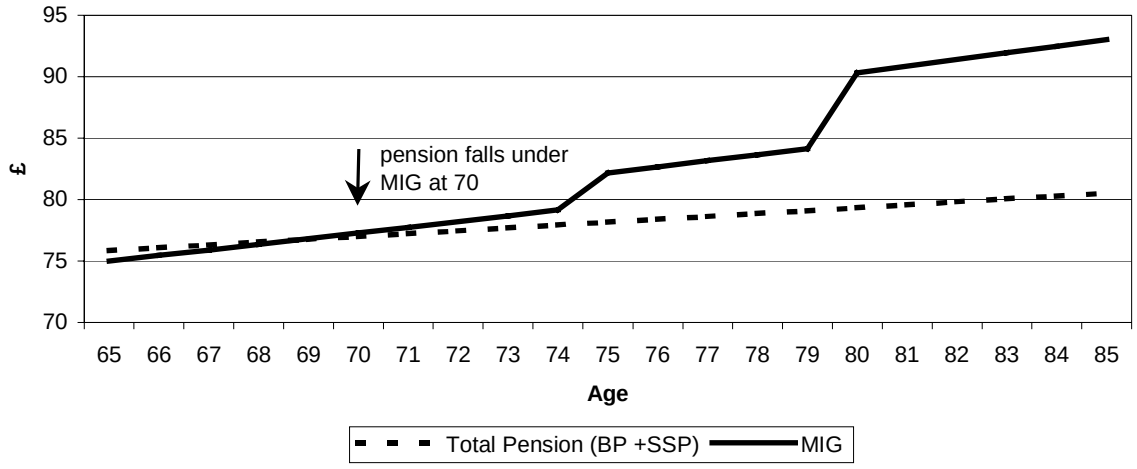
3 The government's calculation appears to be based on a very conservative estimate of earnings growth. We estimate that the government's figures have set earnings growth at a level only 10% above the rate of inflation (i.e. if price inflation is 3% then earnings is 3.3%).

To illustrate this we take the case of a single person who has earned under £9,000 each year of their working life and who is in the first cohort of pensioners retiring in 2050 under the Green Paper's proposals. Figure 2[4] shows the changing relative levels of the combined income from basic pension (price indexed) and SSP (also price indexed) versus the MIG (indexed to earnings) using the Government's assumptions that the rates will cross at the age of 70. To make the graph simpler we have ignored the impact of housing costs – already shown in Figure 1 above.

Figure 2: Single Pensioner Retiring in 2050
Pension Income and Minimum Income Guarantee



Rates of inflation set to meet Government's estimates.

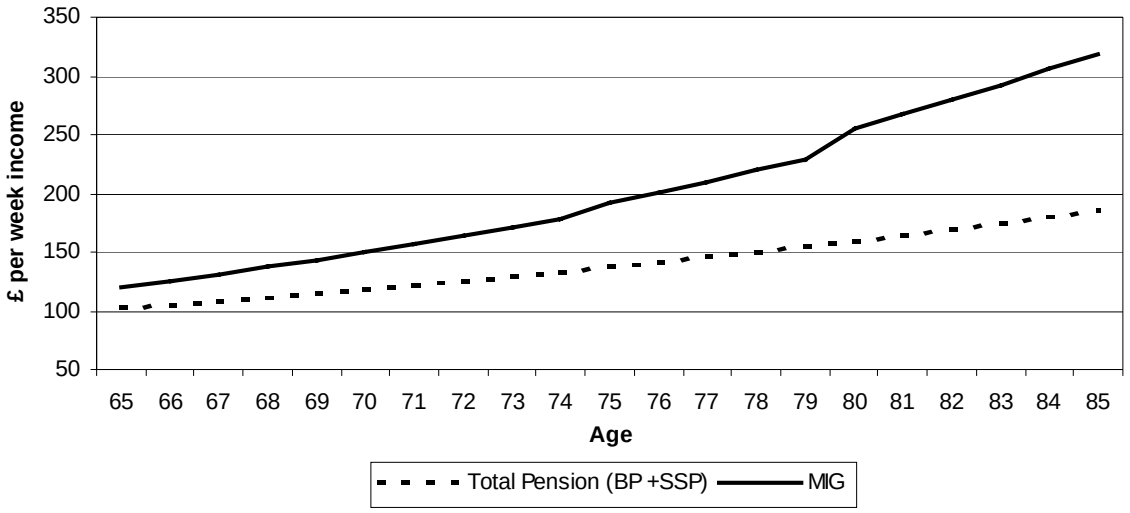
It is clear that there is an in-built problem in the Green Paper's proposals – even if SSP delivers an income above MIG at retirement, indexation to prices and an age-related increase in MIG mean that SSP will not be sufficient to maintain basic pension and SSP income above MIG through retirement.

The problem of differential up-rating of the pension components also leads to a cohort problem. The cohorts of pensioners to retire after 2050 will be faced by a basic pension that has fallen even further relative to earnings and hence to MIG. The rate of real increase in earnings (the amount by which earnings inflation is greater than price inflation) will have a very significant impact. Figure 3 shows a single pensioner retiring in 2060. Using current inflation rates of 3% for prices and 4.5%

4 Calculations for Figures 2 to 5 are based on 1998 benefit levels that are frozen and taken forward to 2050 (see previous footnote 2). After 2050, we adjust these levels for projected inflation and earnings growth.

for earnings, the basic pension will have fallen to 6.5% and SSP to 9% of average earnings in 2060, while MIG remains at 17.5%. As a result, the combined income from SSP and the basic pension will *already* be under MIG at 65. Thus, on our assumptions, by 2060 SSP will not make up the shortfall between the basic pension and MIG. For those whose retirement income comes from the basic pension and SSP alone, SSP will, in effect, be redundant as a second pension by the year 2060.

Figure 3: Single Pensioner Retiring in 2060
Pension Income and Minimum Income Guarantee



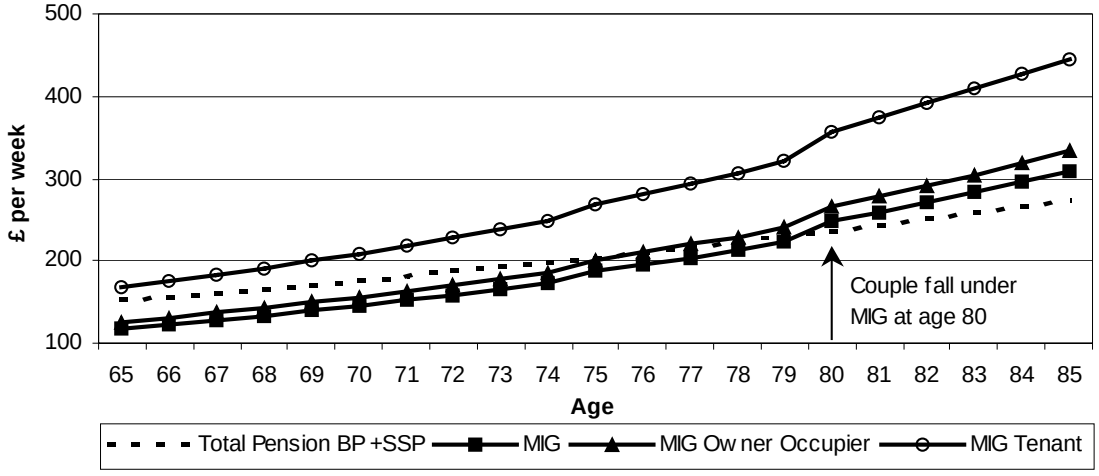
Based on Green Paper's 2050 projections. SSP 9%, Basic Pension 6.5% and MIG 17.5% of 2060 average earnings. Price inflation 3%, wage inflation 4.5%.

One obvious response to our calculations and examples is that we have focused on single pensioners only. Of course, many couples will have earnings that will build up joint entitlements to pensions. If each has entitlement to SSP then their combined incomes from basic pension and SSP will provide for them more adequately than we have so far described. Figure 4 shows the position of a couple retiring at 65 with equal entitlements to the basic pension and SSP. Even with differential price indexation, the problem of being on the borderline of basic MIG is only solved until the couple reaches the age of 80. Further as Figure 4 also shows the problem of housing costs remains – tenants will face a means-tested retirement from age 65 and owner occupiers from age 75.

However, pensioner couples face another problem, that of bereavement and survivorship. What happens if one of the couple dies during the period of retirement? Despite the full coverage of provision for the bereaved in the discussion on stakeholder and private pensions, the Green Paper remains silent on how SSP entitlements will be

transferred to the survivor. If it is really the Government's intention to leave SSP out of such provisions, then for couples who rely on SSP and the basic pension, bereavement will be a tripwire which propels the survivor into reliance on MIG, as illustrated in Figure 5. Figure 5 shows the situation where the couple experience the death of one partner at the age of 76. Their joint pension entitlement before bereavement is the same as that shown in Figure 4. They are safely above MIG. However, on bereavement if there are no survivorship rights to the deceased's SSP then the survivor's income will immediately fall below MIG. This would have the unfortunate effect of combining the loss of a lifelong partner with a dramatic fall in income and benefit status. The survivor will have to apply for means-tested help with council tax and rent, as well as MIG, at a time when they may feel least able to cope with the complex paperwork claiming means-tested benefits involves. If however, the government chooses to make SSP inheritable it is faced with a choice about rates. In our example, a 50% inheritance rate will protect the survivor from the means-tested trap but only for five years (see Figure 5). A 75% rate would extend this protection from means-testing for another five years, while a 100% rate would extend protection beyond the survivor's 85th birthday.

Figure 4: Couple Pensioner Retiring in 2050
Pension Income and Minimum Income Guarantee
(including housing costs)

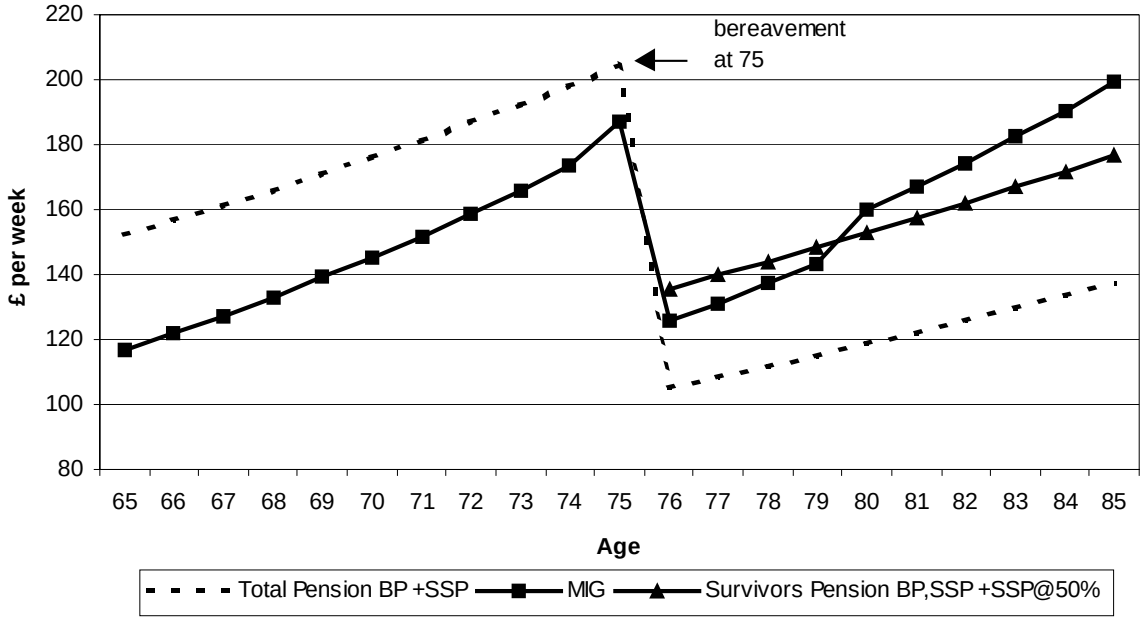


SSP 10.4%, single MIG 17.5% average earnings - weighted for couples. Basic pension 7.5% of average earnings. Price inflation 3%, wage inflation 4.5%.

In sum, all pensioners who rely on SSP and the basic pension to provide a decent income in old age will be walking on a narrow tightrope above means-tested benefits. For single pensioners, the age-

related uprating of MIG and inflation will mean that SSP alone will not protect them from claiming MIG through retirement. For single pensioners retiring after 2060, the basic pension and SSP will fall below the level of MIG even at the point of retirement. Unless SSP entitlements are made transferable between couples, bereavement will operate as a tripwire – pushing survivors into reliance on MIG. The arguments illustrate the centrality of means-tested provision to the working of the proposed pension system. The level of income promised by SSP, in combination with the basic pension, is so close to MIG that many will not benefit in retirement from their lifetime's contributions. For these poorest workers, incentives to save are compromised.

Figure 5: Couple Pensioners and Survivorship
Pension Income and Minimum Income Guarantee, 2050 cohort



SSP 10.4%, single MIG 17.5% average earnings - weighted for couples. Basic pension 7.5% of average earnings. Price inflation 3%, wage inflation 4.5%.

IV. Modelling Lifetime Incomes Using Hypothetical Individuals

Our discussion has so far focused on the details of the design of aggregate pension outcomes. What underlies such outcomes are the working lives of individual men and women. We now turn our attention to such lives and explore how different profiles of earnings and work

histories will be affected by the structural problems we have identified so far. Problems that commonly lead to low pension entitlements are: interrupted working lives, part-time working, low earnings and/or a combination of any of these three.

In order to examine how well the proposed pension system deals with such problems, our approach here is to compare pension entitlements for different individuals using a simulation model, **P**ensions and **Hy**pothetical **L**ifetime **I**ncome **S**imulation model, or PHYLIS. In an update of a previous version, PHYLIS has been programmed with the new Green Paper pension proposals, and allows us to look at the accumulation of pension contributions and entitlements across a range of individuals and couples with different lifetime earnings profiles and work histories. Readers are pointed to previous papers that have employed PHYLIS for a more detailed explanation of her programming (Evans and Falkingham 1997, Johnson and Rake 1998).

Given that the Green Paper remains silent on several key design issues, we have had to make a number of assumptions about the detailed operation of the reformed system. The key rules written into PHYLIS about the reformed scheme are:

1. Following the Green Paper, benefits are paid at the following weekly rates: full basic pension of 7.5% of average male wages (the equivalent of £32 per week in current prices); full SSP of 10.2% of average male wages (£44 per week); MIG at age 65 of 17.5% of average male wages for a single individual (£75 per week and £117 for a couple). We follow the Green Paper's example by expressing benefit rates as a percentage of current average earnings.
2. We assume that SSP entitlement is calculated in the same way as entitlement to the basic pension is currently calculated. Full entitlement follows if contributions have been made for 9/10ths of the working life, with payment reduced proportionately for shorter contribution periods. If the contribution period is less than 25% of that required for full entitlement, no payment is made at all.[5]
3. As with the current basic pension, we assume that SSP credits for care reduce the number of contributory years needed (e.g. 5 years

5 The assumption that entitlement is lost if contribution period is less than 25% of the required period affects Case 6 only. For that case we also look at an alternative assumption - that some payment is made regardless of the years of contributions. This alternative assumption more closely mirrors the rules which currently apply to SERPS.

of credits reduces the contributory requirement for full SSP from 44 to 39 years).

4. Contributions to the Stakeholder Pension (SHP) are set at the rate of NIC rebates for those opted out of SSP. Following the outline given in the Green Paper, on the tranche of earnings above the lower earnings limit but below £9000 we assume a flat-rate contribution of £524 (equivalent to a 9.2% rebate), for the tranche of earnings between £9000 and £18500 the rate of contribution is 2.3% while for earnings above £18500 the rate is 4.6%. After management costs, the real rate of return is assumed to be 1.75% and the default annuity rate is set at 7% (we show the effect of changing the annuity rate in Figure 7).
5. Our age-specific lifetime earning simulations lead us to model hypothetical cases where incomes across the working life are both above and below the £9,000 ceiling for SSP. This means that we had to assume rules about entry and exit from SSP and SHP for a single individual. We thought that any one-way exits from SSP for low income workers would be inherently unjust if their earnings later fell to a level that was better covered by SSP. We have therefore allowed free flows between schemes, even though this is a promise that the Government may not actually be making.

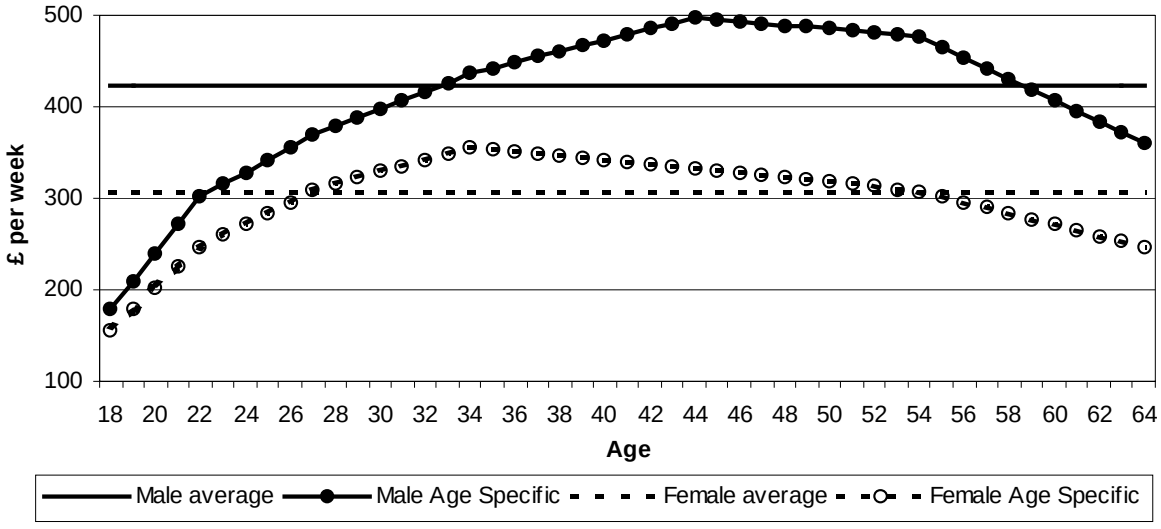
We begin our simulations using simple whole working lifetimes – continuous low paid from the age of 18 through to pensionable age at 65. For this paper couples are modelled as composed of two individuals of the same age, who retire at the same age on a joint pension entitlement. We then put interruptions into working lives – due to unemployment and childcare and see how these affect the Green Paper's proposed outcomes.

This type of simulation modelling does not, of course, produce representations of real social security outcomes. Instead it illustrates how the Green Paper's proposals would treat individuals in the absence of other policy changes and economic and demographic effects. Indeed, PHYLIS is constructed on the steady state assumption that the pension system remains constant throughout the working life. This enables us to focus on the design of the Green Paper's proposals, although in reality alternative systems may be introduced before the proposed scheme fully matures.

The hypothetical cases we choose are not representative but illustrative of the experience of low earners. The Green Paper takes the case of a £9,000 earner as a central illustration of the functioning of their proposed reforms. We follow this example. The calculations of pension

outcomes in the Green Paper appear to be based on the assumption that average life-time earnings of £9000 p.a. mean that an individual earns £9000 in each year that they are in the labour market. As we know, actual earnings profiles are not flat, as the Green Paper calculations suggest, but have gender-based age-specific profiles. In the following calculations we compare how outcomes change when the understanding of average is shifted from that of the Green Paper, to the more realistic assumption that individuals earn an average of £9,000 over the lifetime with periods above and below that lifetime average. We derive our age-specific profiles from a contemporary cross-section of British full-time male and female earnings from the 1998 *New Earnings Survey* (ONS 1998, Table F13). These age-specific earnings profiles are shown in Figure 6, which demonstrates not only that women experience lower earnings but also experience less of an age effect. Of course, this is not an accurate representation of any actual individual's lifetime earnings profile as an individual's earnings profile will be affected by period as well as age effects (no one lives their whole lifetime in 1998). The use of a cross-sectional earnings profile is, however, consistent with our 'steady-state' assumption that the policy world remains unchanged throughout the working life. Further, by including cases where there are periods spent at different earnings levels, we can evaluate the potential impact of the proposals on those whose earnings are for a period above £9,000 and

Figure 6: Age Specific Earnings Profiles and Average Full-time Earnings, 1998



Source: New Earnings Survey 1998.
Male average £423, female average £307.

who respond to government incentives and switch into the Stakeholder Pension for a period of their working lives.

V. Results

Hypothetical Case 1 - Frank

Our first hypothetical case is male and we call him Frank. To start with a simple case and to show the basic workings of SSP, Frank works continuously from the age of 18 until he retires at 65 in 2050. He never meets a lifetime partner, and retires a single man. Frank earns 40% of average male full-time earnings. On a flat earnings profile, he earns just under the £9,000 annual limit for SSP proposed by the Green Paper all his working life (£169 a week, £8,798 per annum). On the age related earnings profile, his earnings go above £9,000 for 24 years out of a total of 47 years.

Table 2 shows that assuming a flat earnings profile, the reward from state pensions for a lifetime of hard work is to have a basic pension worth £32 and SSP worth £44. These together leave him with an income of £76 a week. This is £1 gross above the MIG. If he is a tenant, Frank will still need to claim benefits to pay his council tax and rent and this reduces his net income above MIG after housing costs to the princely sum of 20p a week. Soon after retirement (depending on inflation) Frank would be eligible for MIG itself.

Using an age related earnings profile, Table 2 shows that Frank would do slightly better overall than the Green Paper suggests. His total income of £79.36 is £4.36 above MIG hence he would still need help with his council tax and rent if he was a tenant.

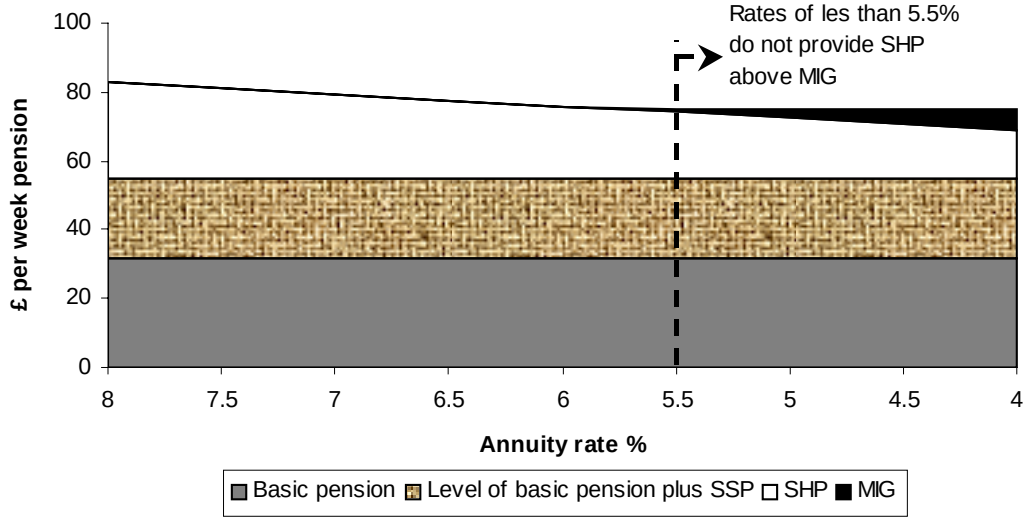
Table 2: Pension for Frank Case 1

	Flat earnings profile	Age related earnings profile
Basic pension	£32.00	£32.00
SSP	£44.00	£23.00
SHP	--	£24.36
MIG	--	--
Total	£76.00	£79.36

Note: Frank works 18-65, no gaps.
Source: Author's calculations using PHYLIS

On the face of it, Frank's loss of SSP is more than compensated for by his income from SHP. However, this is based on an assumed annuity rate of 7%. Given that annuity rates track the changes in interest rates, and that we expect interest rates in general to fall (especially if we join the Euro), this may be an over-optimistic assumption. In Figure 7, we plot Frank's SHP income according to a range of annuity rates between 8 and 4%. As the Figure shows, annuity rates in 2050 of less than 5.5% will not lift Frank above MIG. This raises several concerns. First, for low income individuals, the Green Paper's conclusions about the performance of SHP in bringing people above MIG is highly sensitive to its assumptions about annuity rates. Rates of 5.5% and less provide no guarantee against a means-tested old age. What is more, even annuity rates of 7% will not protect tenants from reliance on means-tested benefits. Second, the low level of protection afforded by SHP for incomes at the margin of £9000 leads to real problems of choice and incentives. If individuals had perfect foresight and knew in advance that annuity rates at retirement would not deliver a sufficient income, they would do better to remain within SSP. However, as we know, individuals cannot hope for perfect foresight and it is a shame, therefore, that the Government is not offering guaranteed SHP coverage that is, at a minimum, equal to SSP. Despite tighter regulation of SHP provision, there is an in-built potential to over-sell to low income individuals for whom membership would only be of marginal value.

Figure 7: Annuity Rates and MIG The effects on a single low earner pensioner



Pensions calculated using age specific earning profile. See Table 2 for basic assumption at 7%.

Hypothetical Case 2 - Frank suffers Unemployment

Using our second hypothetical case, we explore the impact of breaks in employment on SSP. Case 2 allows us to examine the issue of how the Green Paper proposes to cover gaps in the working life. Under the proposals, periods of unemployment as well as sickness, and home responsibility will continue to receive credits towards final basic pension entitlement. The proposed SSP, however, credits only some periods of home responsibility,[6] and offers no coverage for spells of unemployment, sickness or time spent in education or training. These could be potentially serious omissions for low paid workers. To illustrate the potential impact of this, our second hypothetical case is Frank with exactly the same earnings and exactly the same life story except that this time he has two periods of unemployment. He is first unemployed for two years between the ages of 25 and 27. Then later in life, aged 57 following an ideological disagreement with his employer he is made redundant and does not work again. Table 3 shows the effect that these gaps to his working life have on his pension entitlement.

Assuming a flat earnings profile, Frank continues to receive £32 basic pension but his SSP entitlement is now only £36, leaving him eligible to claim £7 MIG a week. Similarly, under the age-related profile, Frank is eligible to claim MIG and, as argued above, will be even more dependent on MIG if annuity rates are less favourable than the assumed 7%. Under either assumption, the effect of these spells of unemployment is to leave Frank reliant on MIG. Partial crediting of SSP, unlike the rules for the basic pension, makes unemployment a tripwire for low earners which propels them into a means tested old age.

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6 SSP credits will be given to those caring for a child under 5, and for those caring for someone in receipt of Disability Living Allowance and Attendance Allowance or who themselves are in receipt of Invalid Care Allowance. The proposed system of credits to SSP is, therefore, less generous than that currently operating for the basic pension as under Home Responsibility Protection, those caring for a child up to its 16th or 18th birthday are given credits (see Falkingham and Rake, 1999).

Table 3: Pensions for Frank 2

	Flat earnings profile	Age related earnings profile
Basic pension	£32.00	£32.00
SSP	£36.00	£13.00
SHP	--	£23.56
MIG	£7.00	£6.44
Total	£75.00	£75.00

Note: As Frank 1 but with unemployment between ages of 25-27, and 57-65.
Source: Author's calculations using PHYLIS.

Hypothetical Case 3 - Frank and Harriet

Our third hypothetical case is Frank 1 with the same life time earnings profile but this time he does find a life partner. We call her Harriet. Marrying early they have children and Harriet leaves work to look after the children between the ages of 22 and 35. Before having children Harriet works full-time, earning 45%of average female full-time earnings (£138 a week or £7196 per annum). When she returns to work at 37, she works part-time at 50% pro-rata (£69 a week or £3598 per annum). On the age related earnings profile, her earnings do not go above £9000, but fall below the lower earnings limit during her last 6 years of employment.

Table 4: Pensions for Frank and Harriet

	Flat earnings profile		Age related earnings profile	
	Frank	Harriet	Frank	Harriet
Basic pension	£32.00	£32.00	£32.00	£28.90
SSP	£44.00	£44.00	£23.00	£36.24
SHP	--	--	£24.36	--
Individual total	£76.00	£76.00	£77.36	£65.14
MIG	--		--	
Household total	**£152.00**		**£144.50**	

Note: Frank works continuously aged 18-65 with no gaps. Harriet works 18-22 full time, cares for their children from 23-34 and returns to work part-time from 35-65.
Source: Author's calculations using PHYLIS.

Assuming a flat earnings profile, Frank and Harriet each receive the full rate basic pension of £32 and full SSP of £44. This gives them a

joint income of £152 which means that they will probably only need means-tested help if they are tenants. Using an age related earnings profile, Frank has a slightly higher pension income (as in Case 1) – but this is more than offset by Harriet's loss in income of £10.86. For both the basic pension and SSP this loss in income is a result of her years spent below LEL. The loss of SSP is, however, larger in both absolute and relative terms. Under SSP Harriet has already lost some entitlement by spending more years caring for her children than she had SSP credits for (we make the generous assumption she has her second child when the first goes to primary school and so receives a full 10 years' credits); this loss of entitlement is compounded by the years spent below LEL resulting in a 18% reduction in her SSP income.

Hypothetical Case 4 - Frank and Harriet with unemployment for Frank

Our fourth hypothetical case brings forward Frank's experience of unemployment from Case 2 (he has two periods of joblessness, between the ages of 25 and 27 and from 57 until 65). Harriet has the same earnings history as in Case 3 (she works full time 18-22, looks after their children 23-34 and returns work part time at 35 until 65). Table 5 shows that they both receive £32 basic pension but their SSP differs. Harriet continues to receive SSP at the maximum rate, because of the credits she receives to cover most of her years of child care. However, Frank's SSP is reduced because of 10 years unemployment. This gives them a total of £144 per week which, while above the MIG, will mean they need means-tested help with their rent if they are tenants. Using the age related profile, Frank does marginally better but this does not offset the loss experienced by Harriet because of her years below the LEL.

Table 5: Pensions for Frank (unemployed) and Harriet

	Flat earnings profile		Age related earnings profile	
	Frank	Harriet	Frank	Harriet
Basic pension	£32.00	£32.00	£32.00	£28.90
SSP	£36.00	£44.00	£13.00	£36.24
SHP	--	--	£23.56	--
Individual total	£68.00	£76.00	£68.56	£65.14
MIG	--		--	
Household total	**£144.00**		**£133.70**	

Note: Frank works continuously aged 18-65 with unemployment between ages of 25-27, and 57-65. Harriet works 18-22 full time, cares for their children from 23-34 and returns to work part-time from 35-65.
Source: Author's calculations using PHYLIS

Hypothetical Case 5: Frank (unemployed) and Harriet (unemployed)

Our 5th case is the same as case 4 except that Harriet now stops work and becomes unemployed when Frank becomes unemployed aged 57. This is perhaps encouraged by the heavy use of means testing during unemployment that provides little incentive for Harriet to keep working. Table 6 shows the pensions that result.

Assuming flat rate earnings they both receive a basic pension of £32 and both receive a reduced level of SSP. Harriet, however, receives less SSP as she has no credits for either her years of unemployment or the two years of child care she undertakes without credits. This gives them a total of £133.65 and they are over the MIG, but will require means tested help with rent if they are tenants. Under an age related earnings profile a very interesting thing happens to Harriet – here she loses some SSP but has full entitlement to the basic pension because of credits for her years of unemployment. This leaves her with a higher individual income than in Case 4, where she is working part-time up to the point of retirement with some years under the LEL. As we can see, Harriet would be better off in retirement if she is registered unemployed at the end of her working life, than if she continues to earn with earnings below the LEL.

Table 6: Pensions for Frank (unemployed) and Harriet (unemployed)

	Flat earnings profile		Age related earnings profile	
	Frank	Harriet	Frank	Harriet
Basic pension	£32.00	£32.00	£32.00	£32.00
SSP	£36.00	£33.65	£13.00	£33.65
SHP	--	--	£23.56	--
Individual total	£68.00	£65.65	£68.56	£65.65
MIG	--		--	
Household total	**£133.65**		**£134.20**	

Note: Frank works continuously aged 18-65 with unemployment between ages of 25-27, and 57-65. Harriet works 18-22 full time, cares for their children from 23-34 and returns to work part-time from 35-57. She is unemployed from 57 to 65.
Source: Author's calculations using PHYLIS

Hypothetical Case 6: Frank (unemployed) and Harriet (very low earnings)

To illustrate further the impact of the LEL on Harriet's entitlements, our last hypothetical case is identical to Case 5 except that Harriet *continues to work* but earns a lower amount than in the previous cases. Her earnings are reduced to 35% of average female full-time earnings (£108 per week), with her part-time earnings set at 50% of that amount (£54 per week) as before. Thus, between the ages of 35 and 65 under both flat rate and age related earnings she falls below the lower earnings limit. Table 7 shows the pensions that result. Under both scenarios, Harriet's entitlements amount to £19 dependant's addition under the basic pension. Her earnings below the LEL count for nothing towards her pension and her period of earnings before she had children are insufficient to give her entitlement to any SSP, even when combined with credits for child care.[7] They receive MIG and are means-tested from the date they retire. The proposed pension rules thus severely affect incentives to work at the margins of the lower earnings limit. McKnight et al (1998) have already shown that 3 million workers currently earn

7 This assumes that SSP pays out nothing if contributory years fall below 25% of the contributory requirement. On the alternative assumption that SSP works like SERPS and pays out something regardless of total years in the system, Harriet would get an additional £3.88 from SSP, raising her total individual income to £22.88. This would still leave the couple below the level of MIG, and they would claim £25.56 top-up.

below this level, and that they are primarily in poor households, real life Frank and Harriets.

Table 6: Pensions for Frank (unemployed) and Harriet (very low earnings)

	Flat earnings profile		Age related earnings profile	
	Frank	Harriet	Frank	Harriet
Basic pension	£32.00	£19.00	£32.00	£19.00
SSP	£36.00	--	£13.00	--
SHP	--	--	£23.56	--
Individual total	£68.00	£19.00	£68.56	£19.00
MIG	£30.00		£29.44	
Household total	**£117.00**		**£117.00**	

Note: Frank works continuously aged 18-65 with unemployment between ages of 25-27, and 57-65. Harriet works 18-22 full time, cares their children from 23-34 and returns to work part-time from 35-57.
Source: Author's calculations using PHYLIS

These six hypothetical cases show that the Green Paper's proposals only work to provide a minimum pension significantly above MIG for low income *couples*, and only where their working histories are complete. The treatment of gaps provides very strange patterns of potential coverage for low earners whose periods of unemployment, sickness and education are excluded from the proposed second state pension coverage. On the other hand, some cover is provided for time spent undertaking unpaid caring. The differences in crediting periods of unpaid caring and unemployment may lead to unusual inequalities of income within poor working households at retirement – women with shorter earnings histories or with lower life-time earnings can have higher pensions than their spouse where their partners have experienced periods of unemployment.

The limits placed on the caring credits (paid only until the child reaches school age) has a negative impact on women's incomes where caring periods are extended and/or caring for school age children is combined with some years of earnings under the LEL. As the age related profile for Harriet in Case 4 demonstrated, uncredited caring plus a few years below the lower earnings limit has a particularly pernicious impact on SSP entitlements. Indeed, if some years of uncredited caring are taken, pension income will be higher if this is followed by

unemployment rather than by years below the lower earnings limit – at least ensuring entitlement to some basic pension.

The hypothetical individuals have illustrated that the trip wires to pension coverage are not only uncovered gaps in lifetime labour market history, but also periods of working below the contributory threshold. This leads to fairly perverse lifetime incentives to work and save, especially where linked to periods of unemployment.

VI Discussion – tightropes and tripwires?

We would argue that to ensure a decent, non means-tested income in old age for all any pension system must incorporate two key features – an 'adequate' level of payment and comprehensive entitlement. Thus, the basic state and secondary pension must provide an income that is sufficiently far above the means-tested minimum to ensure that a lifetime of contributions is rewarded in retirement. Second, entitlement rules to the basic state and secondary pension system must be flexible enough to reflect real lifetime profiles of paid work, care, unemployment and sickness so as not to propel large numbers of individuals into a means-tested old age. If either of these features are absent, a pension system risks incorporating *tightropes* and *tripwires*.

The Green Paper's proposals run a very real risk of establishing a tightrope for low earners. As it stands, the Green Paper proposes an income from the basic pension and the secondary pension which is so near the means-tested minimum that little is gained in retirement from a lifetime of work and contribution. The narrowness of the gap between the basic pension combined with SSP and MIG means that low earners have no clear incentives to save. Furthermore, the gap between the basic pension/SSP and MIG will narrow over time, meaning that incentive problems will intensify for cohorts retiring after 2050. The tightrope is less evident for couples, but is still a problem as the couple ages. Those low earners who find themselves in couples are relatively protected against claiming MIG, but not against claims on other means-tested support for housing costs. In any case, to rely on 'coupledom' as a protection against low incomes in old age is a high risk strategy for a government to adopt when faced with increasing divorce rates.

As the outcomes of the hypothetical individuals and couples demonstrate, the proposals also incorporate a number of *tripwires* - common life events which disrupt basic and secondary pension entitlement to the extent that individuals are forced into a means-tested

old age. These tripwires include periods of unemployment, sickness or training, extended periods of caring, time below the low earnings limit and, if insufficient or no provision is made for sharing SSP entitlements, bereavement. This means that the incentive problems extend beyond saving – by not covering periods in education and training, those low paid workers who choose to up-skill during their working lives will pay a pension penalty in later life. This raises questions about who will really be able to benefit from life-long learning.

From our analysis, it is questionable whether SSP really is a secondary pension – in reality, it operates as a top-up to basic pension for low earners. The minimum income guarantee is currently worth 17.5% of average male earnings; in maturity, the basic pension plus SSP will perform at or below this level, meaning that governments of the future will again face a pressing need for reform. Thus, the *sustainability* of the proposed system is brought into question. This question of sustainability will be brought into even sharper relief for cohorts retiring after 2050 as the combination of SSP and the basic pension will not be enough to lift individuals above MIG at the point of retirement.

Finally, the proposals are highly sensitive to underlying assumptions concerning the working life and annuity rates raising questions about the *robustness* of the proposals. As we show, simply changing the profile of average lifetime earnings from flat to age related can change individual's pension outcomes considerably. Further, if in 2050 individuals are more heavily reliant on deriving their pension income from an annuity purchased with funds from their SHP, the value of that income will be very sensitive to fluctuations in the annuity markets.

Further, the proposals do little to cut through the enormous *complexity* of the British pension system (and may indeed add to its complexity), making it very difficult for individuals to make an optimal pension choice. Individuals in the system will have difficulty in calculating the benefits of different pension schemes, especially if they experience spells out of the labour market. As the hypothetical cases demonstrate, the Stakeholder Pension may not be the most appropriate vehicle for low earners whose ability to generate sufficient income to keep them above a means-tested minimum may be compromised by such things as falling annuity rates. Given the emphasis on individual provision and planning, this seems be an unfortunate feature.

VII. Conclusions

We have concentrated our analysis on the Green Paper's proposal to provide pensions for poor earners. Our main task has been to assess how effectively the Green Paper's proposals avoided two problems in pension system design:

- The *tightrope* of providing a basic pension and secondary pension that is so near the means-tested minimum that little is gained from a lifetime of work and contribution.
- *Tripwires* where common life events can disrupt basic and secondary pension entitlement to the extent that individuals are forced into a means-tested old age.

We find that:

1. The proposals build in a tightrope for poor workers. SSP combined with the basic pension provides an income that is only £1 above MIG in 2050.
2. The differential up-rating of different retirement benefits undermines the adequacy of SSP. This means that the first cohort retiring in 2050 will fall below MIG within five years or so. Subsequent cohorts of pensioners, retiring five to ten years after 2050, will receive a basic pension plus SSP that is *below MIG at the point of retirement*.
3. Low income couples are reliant on joint pension entitlements to be above MIG. Unless SSP is inheritable, the effect of a partner's death may be to plunge the survivor onto dependence on MIG.
4. The entitlement criteria for SSP are set too narrowly to provide coverage for a range of lifetime experiences resulting in a series of tripwires. Periods of unemployment or extended unpaid child care result in reduced entitlement to both SSP and SHP, which are insufficient to lift people out of a means-tested retirement.

In general we regret the apparent move to extend means-tested coverage for old age. However, the following improvements to the Green Paper's proposals would go some way towards meeting the concerns raised above:

- A greater distance needs to be put between contributory pensions (the basic pension plus SSP) and the MIG. This could be done either by raising the level of the basic pension or increasing the generosity of SSP.
- This distance should be maintained by up-rating SSP, basic pension and MIG by earnings.

- Coverage of SSP should be more comprehensive. This can be done by a combination of extending credits and/or reducing the number of qualifying years needed for full entitlement. In either case, consistency across the basic pension and SSP in terms of the periods credited would be very welcome.
- SSP rights need to be inheritable – at least 50% of the deceased partners rights should pass on to the survivor.

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