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SHOULD WE LET PEOPLE OPT OUT OF THE BASIC STATE PENSION?

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Should we let people opt out of the basic state pension?

The UK pension system has been subject to almost continuous structural reform since the Social Security Act of 1975 introduced, from 1978, the State Earnings-Related Pension Scheme (SERPS). From 1980 until 1997, successive governments reduced the future generosity – and cost – of the state pension system. Since 1997, the government has increased the generosity of state commitments to the current generation of pensioners, the most significant change being the substantial increases in means-tested benefits for low-income pensioners.[1]

For future generations of pensioners, the Labour government has followed the general thrust of reform seen over the previous 20 years by expecting individuals to take more responsibility for their own pension savings through increased use of private pensions.[2] While the current generation of pensioners receive 40% of their income from private sources, the policy of the current Labour government is to aim for this to increase to 60% by 2050.[3] It is hoped that this can be achieved by continuing to target additional state resources at those on low incomes through the minimum income guarantee, the pension credit and the state second pension, while continuing to price-index the basic state pension. Middle and higher earners are increasingly being encouraged to make their own private pension provision, for example through the introduction of stakeholder pensions.

1. The Conservative Party's proposals for the basic state pension

The Conservatives have proposed that this shift from state to private provision should go further. The Conservative Party manifesto states that

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[1] Income support for pensioners, since renamed the minimum income guarantee, has been increased by up to 25% in real terms between April 1997 and April 2001. The current government is also proposing a new pension credit from April 2003, which will increase the amount of means-tested support to pensioners further still. For more details, see Election Briefing Note 9.

[2] For a detailed analysis of the reforms, see R. Disney, C. Emmerson and S. Tanner, *Partnership in Pensions: An Assessment*, Commentary No. 79, IFS, London, 1999, the executive summary of which is available at www.ifs.org.uk/pensions/partnership.shtml.

[3] Department of Social Security, *A New Contract in Welfare: Partnership in Pensions*, Cm. 4719, DSS, London, 1998 (www.dss.gov.uk/publications/dss/1998/pengp/index.htm). It is, as yet, unclear whether this aim has been changed due to the planned introduction of the pension credit in April 2003, which represents a further increase in means-tested state support for pensioners.

> 'The best way to achieve higher pensions in the future is by more genuine funding of pensions. We wish to enable young people to build up a funded alternative to the basic pension in the future'.

If implemented, this policy would allow younger individuals to choose between retaining their entitlement to the basic state pension or forgoing entitlement in return for lower National Insurance contributions. This is very similar to the way in which individuals who earn above the lower earnings limit are currently able to opt out of SERPS entitlement in return for the payment of a National Insurance (NI) rebate into their own private pension by the Department of Social Security.

2. What are the cost implications of this proposal?

It is clear that, in both the short and the medium run, this policy would have a net cost to the government, since National Insurance contributions would decline but pension expenditure would be unaffected until some time in the future. The cost would depend on the generosity of the rebate, which would have to be generous enough to ensure some choose to opt out of the basic state pension. A person currently aged 20 who expected to receive the basic state pension for 15 years in retirement might be expected to require a National Insurance rebate of around £10 a week for them to choose to forgo their pension entitlement.[4] Older individuals would require a higher level of rebate, since they have fewer years until retirement to build a fund sufficient to replace their forgone basic state pension entitlement.

If the Conservatives chose to set a relatively generous level of rebate, it is possible that large numbers of individuals would choose to opt out of the basic state pension. For example, when individuals were first allowed to opt out of SERPS into a personal pension in 1988, the rebates offered were very generous compared with the amount of SERPS that these people were forgoing, particularly for younger people. This led to a higher-than-expected number of people taking out personal pensions at greater cost than had been anticipated by the government at the time.[5] The cost of reduced National Insurance contributions, after netting off the reduced entitlements to SERPS, was £5.9bn for the period from 1988 to 1993.[6]

Whether or not the Conservative policy implies a long-run net cost to the government depends on the expectations that young people have about how generous the basic state pension will be when they reach retirement. This is

[4] This example assumes that the person knows with certainty that the basic state pension will be indexed in line with prices and that they are able to receive a real return of 3% a year on their NI rebate. Future pension entitlements are also discounted by 3% a year.

[5] For more details, see R. Disney and E. Whitehouse, *The Personal Pensions Stampede*, IFS, London, 1992.

[6] For more details, see A. Budd and N. Campbell, 'The roles of public and private sectors in the UK pension system', in M. Feldstein (ed.), *Privatizing Social Security*, National Bureau of Economic Research, Chicago University Press, Chicago, 1998.

because of the voluntary nature of the contracting-out arrangements – only those individuals who believe that the NI rebate is worth more to them than their future pension entitlement would choose to opt out.[7] If young people believe that the state will be at least as generous as implied by current government policy, then the Conservative policy would have a long-run net cost to the government. There is evidence, though, that young people believe that the state will be less generous than is implied by current government policy.[8] If this does turn out to be the case, then it is possible that the Conservative policy would not have a long-run net cost to the public finances, since it might be possible to encourage people to opt out of their entitlement for a relatively low level of NI rebate.[9]

3. Other issues

There are several arguments for and against the Conservatives' proposal. We now address some of these in turn.

Reduced future government expenditure

The Tories' proposal would lead to lower expenditure once individuals who have opted out of the basic state pension reach retirement age. As discussed above, the voluntary nature of the reform makes it unclear whether the reform would lead to a long-run net cost or net benefit to the public finances.

Increased individual choice

The Conservatives' proposal might be justified as allowing individuals greater freedom from the state, since they would be able to choose how they want to invest their NI rebate. This, in fact, was one of the arguments put forward for the introduction of personal pensions – the 1985 Social Security Green Paper stated that 'The Government wish to encourage the freedom and individual choice which personal pensions allow'.[10] The Conservative proposal would allow individuals to choose how they want to invest the NI rebate that replaces

[7] A more detailed explanation of this in the context of individuals opting out of SERPS is contained in R. Disney, C. Emmerson and M. Wakefield, 'Pension reform and saving in Britain', *Oxford Review of Economic Policy*, vol. 17, no. 1, forthcoming 2001.

[8] See S. Tanner, *The Role of Information in Savings Decisions*, Briefing Note no. 7, IFS, London, 2000 (www.ifs.org.uk/publications/briefnotes.shtml).

[9] In fact, the main difference between the current Conservatives' proposal and the 'basic pension plus' proposal that they put forward prior to the May 1997 election is that, under basic pension plus, contracting-out among new entrants to the labour market would be mandatory. This has the advantage that it is possible to guarantee that, in the long run, the reform will not have a net cost to the government to implement, and it is the route that has been taken by many other countries. For a discussion of the reforms made elsewhere, see R. Disney, R. Palacios and E. Whitehouse, 'Individual choice of pension arrangement as a pension reform strategy', IFS, Working Paper no. W99/18, 1999, (www.ifs.org.uk/workingpapers/wp9918.pdf).

[10] Department of Social Security, *Reform of Social Security: Programme for Change*, Cmnd 9518, HMSO, London, 1985.

their entitlement to the basic state pension, in the same way that individuals can already choose how to invest the rebate that compensates those who have 'opted out' of SERPS.

Whether this increase in individual choice is seen as desirable depends, in part, on attitudes towards the increased levels of risk taken on by individuals who opt out. In addition, there is the potential problem of individuals whose investments fail to deliver sufficient levels of return falling back onto state support in the form of means-tested benefits in their retirement. It is the near universality of the basic state pension that, at least partially, mitigates these problems. There are also arguments in favour of universal social insurance, since, if individuals are allowed to opt out of the basic state pension, many people may expect that they would never receive a National Insurance benefit at any point in their lives – which could potentially reduce support for the basic state pension in future.

Increased levels of certainty over future pensions

Another argument made in favour of greater levels of funding is that state pension entitlements are uncertain, since future governments may reduce the generosity of state schemes. For example, as a result of the reforms made to SERPS in the Social Security Acts of 1986 and 1995, forecast expenditure in 2030 is just 30% of what it would have been under the original SERPS arrangements. But funds held in private pensions can also be affected by the decisions made by future governments. For example, the July 1997 Budget decision to abolish the payment of dividend tax credits on private pension funds increased the tax liability of dividends received by pension funds by over £5bn a year.

Higher return from increased holding of equities

The return on equities has, at least historically, been higher than both the return on government bonds and that which is likely in a pay-as-you-go pension such as the basic state pension. This means that individuals who choose to invest in portfolios containing a high equity element would expect to end up with a higher retirement income. It is important to note that at least part of the reason why equities have had higher returns in the past is that they are considered relatively risky investments. Hence part of any additional return that individuals received would simply reflect a more risky investment portfolio. There is also some evidence that the rate of return on equities has been higher than it should have been, even given the higher risk involved.[11] It is by no means certain whether this can be expected to persist into the future – and if it did, it would suggest that the financial markets operate on a far from efficient way. If we could be sure that these higher expected equity returns were going to materialise, then the government could itself finance any of its future public spending plans by increasing government debt and investing in equities. There need to be very strong justifications for governments to invest in the markets on behalf of society. This is very similar to arguments regarding

[11] See R. Mehra and E. C. Prescott, 'The equity premium: a puzzle', *Journal of Monetary Economics*, vol. 15, pp. 145–62, 1985.

the Conservatives' proposals to reduce public expenditure by setting up endowment funds for universities, which is discussed in Section 10 of Election Briefing Note 7.

Increased levels of national savings

It has also been argued that higher levels of funding would lead to higher levels of saving and hence investment. This is not necessarily the case, since it is not clear whether the proposed reform would make individuals save more or less – for example, an individual who already has a personal pension would unambiguously save less as a result of this reform. This is because they can only be expected to opt out of the basic state pension if doing so provides them with an increase in their expected retirement income, which would reduce the amount that they need to save for their retirement. The addition to their pension fund from the NI rebate should not be counted as additional saving, since it comes directly from a reduction in government saving.[12] International capital flows reduce the likelihood that increased saving would lead to increased levels of domestic investment.

4. Conclusion

Moving towards greater levels of funding does not avoid the problems caused by an ageing population. The incomes of pensioners in the future will have to come from future income, regardless of whether this is financed through a combination of pay-as-you-go and funded pensions savings or through entirely private pension savings. The rate of return offered by a pay-as-you-go pension scheme will fall when the population is ageing, since the contributions charged on the smaller working population have to rise to pay for the pensions of the larger retired population. But there is also uncertainty over the returns that equities and annuities will offer in the future. For example, it is possible that these will be affected by greater amounts of world-wide private pension saving and an ageing world population. Given that individuals should hold balanced portfolios, it seems sensible that a portion of future state pension provision should be funded on a pay-as-you-go basis.

[12] Again, a more detailed explanation of this in the context of individuals opting out of SERPS is contained in R. Disney, C. Emmerson and M. Wakefield, 'Pension reform and saving in Britain', *Oxford Review of Economic Policy*, vol. 17, no. 1, forthcoming 2001.