An initial response to the 2nd Pensions Commission report

by Carl Emmerson, Zoë Oldfield, Gemma Tetlow and Matthew Wakefield

Responding to today’s publication of the Pensions Commission’s 2nd report Matthew Wakefield, a senior research economist at the IFS, said: “The analysis contained in the Pensions Commission report is a welcome addition to the debate. The proposed reforms to state support for pensioners will require particularly careful consideration as the Commissions own calculations rightly underline the fact that if we want to maintain or increase the generosity of state support for pensioners without means-testing, politicians will inevitably face the painful task of raising funds, increasing the state pension age, or both”

Do we need further pension reforms?
The Pensions Commission’s first report pointed out that increases in longevity will require individuals to: spend less while working, retire later or have less to spend during their retirement. Under existing policies, the required adjustment is increased further because the generosity of state support for pensioners is set to decline significantly relative to the living standards of those in work. Key objectives are to continue to protect the most vulnerable, while helping everyone to choose and make their adjustment efficiently as possible. Any potential reforms should be judged against these criteria.

Are the principles behind the proposed reforms to state support for pensioners sensible?
The main principle behind the proposed reforms to state support is to ensure that the incomes of the poorest pensioners keep pace with average earnings, without requiring an extension of means-testing through the pensioner population that might undermine attempts to boost private retirement provision. Reduced reliance on means-tested payments to pensioners would provide some with an increased reward from saving more for their retirement. Increasing the generosity of state pensions would reduce some people’s need to save privately, and any increase in taxation required to finance it also would reduce some people’s ability to save. The overall impact on private saving is theoretically ambiguous for many individuals.

There would be other effects of the reform. For example, fewer people would need to apply for mean-tested support and therefore fewer would fail to take up the targeted support to which they were entitled. The system of state support would be simpler, albeit at the expense of being less focussed on poorer pensioners.

The report also proposes that the State Pension Age should be increased to reflect increases in life expectancy. But in terms of increasing the length of working life it is retirement ages rather than the state pension age which matters, and most people are out of work before they reach the State Pension Age. Increasing the State Pension Age could lead to an increase in retirement ages either by sending a signal (for example if it led to an increase in normal pension ages in public and private defined benefit pension schemes) or if some individuals remained in paid work simply because they could not afford to retire before being eligible for the State Pension.

An increase in the State Pension Age would also strengthen the Government’s finances.
How much would the reforms to state support for pensioners cost?
The Government currently spends 6.2% of national income on transfer payments to pensioners. The Department for Work and Pensions forecasts that in 2050 the cost of the current system (assuming that the Basic State Pension is indexed in line with prices and that the Pension Credit Guarantee is indexed in line with earnings) would rise to 6.6% of national income. This assumes that the private incomes of pensioners (including the State Second Pension) will grow in line with average earnings. But the Pensions Commission believes that private incomes will grow less quickly (as a direct result of increasing disincentives to save resulting from the spread of mean-tested benefits implied by the Government’s current indexation strategy). Lower growth in private incomes would increase entitlements to the Pension Credit, which the Pensions Commission believes would push up the cost of an unreformed system to 7.6% of national income in 2050.

The Pensions Commission believes that its proposed system would cost 7.5% of national income in 2050 if the State Pension Age were increased to 69, but 8.0% of national income in 2050 if the State Pension Age were increased to 67. Its central case is for a State Pension Age of 68 and state spending of 7.8% of national income in 2050. This is just 0.2% of national income higher than they think the current system would cost, but 1.2% of national income higher than the DWP thinks it would.

Should we choose to implement the Pensions Commission’s reforms then the cost of the current system in 2050 is irrelevant. What matters is what the reformed system would cost and how that compares to the present cost of the current system. If the Pensions Commission figures are correct, then their central proposal (with a State Pension Age of 68 in 2050) would require a 1.6% of national income increase in taxation to finance it. This is almost £20 billion in today’s terms which by 2050 is equivalent to £290 pounds per person per year. While this might not be considered a particularly large increase in the tax burden over the next 45 years (it is, for example, smaller than the increase seen since Labour was elected 8 years ago) it would be a significant increase in spending focussed on a still relatively small part of the population.

Would immediate tax increases be required to finance this?
The Pensions Commission analysis argues that tax increases would not be required until 2020 since it does not anticipate pension spending increasing until then. However if we are now sure that future tax increases are required then it might be more appropriate to increase them sooner rather than later so that the change is less abrupt. Smoothing tax rates in this manner might be more efficient.

Who would gain and who would lose from the reforms to state support?
Who would gain and lose is complicated by the fact that tax increases would be required to finance the proposals and the Pensions Commission report does not indicate which tax instruments should be used. In principle however it is clear that the Pension Commission envisages a system in 2050 in which the amount that pensioners receive from the state is less contingent on their other income than is currently the case. This means that it would provide relatively lower support for poorer pensioners than if the same amount of public spending were targeted in the way implied by the current system. This is because the level of the Pension Credit Guarantee would be unchanged by the proposed reforms, but total support for pensioners would be increased. However, the reformed system would also be closer to flat rate – i.e. those who have higher earnings in a particular year would not accrue greater state pension rights than those with lower earnings during that year. The overall impact on the progressivity of the reforms is therefore unclear – not least as the means with which they would be financed are yet to be determined.
Who would lose from increasing the state pension age (SPA)?
The rationale for increasing the State Pension Age is that individuals are living longer and that the report believes that each generation should face “the same proportion of adult life contributing to and receiving a state pension”. However if some of the additional years of life are unhealthy then the proportion of healthy life spent in receipt of the state pension could fall over time.

Currently only around one-third of men are in work when they reach the state pension age, and this illustrates why it is not clear how many more individuals would work beyond age 65 if the SPA were increased after 2020. The individuals who would be most likely to continue working might well be those who are financially less well off, and thus unable to afford to retire until they can claim state pensions. While continuing to work might increase the incomes of such individuals, they may consider themselves worse off if they would prefer not to have to work.

Individuals who could be made financially worse off by the measure would be those who were unable to take state pensions, but also unable to find work. The Pensions Commission has proposed that these people could be helped by allowing them to claim Pension Credit Guarantee from age 65. The Pension Credit is more generous than the means-tested benefits that are available to (healthy) younger individuals. Future governments might not be prepared to decouple the age at which state pensions and the pension credit can be claimed, and would instead choose to increase the qualification age for the pension credit – if so those aged 65, 66 and 67 on low incomes would lose.

Another set of losers from increasing the SPA would be individuals with low life-expectancy, who tend disproportionately to be lower income individuals: even if the increase in the SPA were used to pay for increasing state pensions, these individuals would expect to receive the more generous payments only for relatively few years.

In its 2002 pensions Green Paper the Government recognised the potential distributional impact of increasing the SPA, and ruled out a universal increase in the SPA.

Who would gain from a universal BSP for those aged 75 and over?
The Pensions Commission has suggested making the BSP universal for those aged 75 and over, with immediate effect. This would help those individuals with incomplete BSP entitlement who would not have all their extra income tapered away through means tested benefits. These are often married women with low own incomes but whose partner has a higher income.

What are the principles behind the proposed National Pension Saving Scheme?
The Pensions Commission has proposed a new pension scheme which all employees would be automatically be members of, unless their employer automatically enrolls them into a private pension that would be expected to provide an at least equally generous retirement income. Individuals would be able to choose actively to opt out of this scheme. Individuals and their employers would then have the option to increase their contributions (subject to an annual cap).

The “presumption” involved in these arrangements aims to utilise inertia (whereby people follow the default option) to increase the number of people saving in pensions. Evidence from the United States suggests that it would boost coverage, and the fact that employers would have to contribute would make choosing not to join less attractive.
What would be the effect of the NPSS on employers and employees?

Many employers do not currently offer their employees a pension contribution as generous as the required contribution proposed. For these employers, if at least some of their employees choose to stay in the NPSS, their labour costs will rise, assuming that there is no offsetting fall in wages. For employers who do currently offer all their employees an equally generous pension, this policy will not affect their labour costs if membership of this scheme does not change. However, if inertia results in more employees belonging to the pension scheme (when the default position is to be opted into the scheme), even these employers could see a rise in their labour costs. In the medium term, employers might be able to offset the additional labour cost introduced by this scheme for example by offering lower wage increases or a less generous pension scheme (although not less generous that the minimum set by the NPSS).

As Lord Turner acknowledged in this mornings press conference, there is a danger that employers (faced with having to make a 3% contribution for every employee who opts to stay in the NPSS) could encourage employees to opt out, perhaps offering alternative, less costly inducements to do so. Alternatively employers may seek to employ more individuals who have an incentive not to currently save in a pension. This could include those with high debts or those with currently relatively high consumption needs.

If presumption did induce more employees to contribute to a private pension then the new members could include two types of people. First, those for whom saving in a private pension is an appropriate decision – this group of people would gain. Second, those for whom saving in a private pension is not an appropriate decision, for example if they have pressing consumption needs – this group of people would lose. In addition the US evidence also suggests that though more people would save in pensions as a result of auto enrolment the existence of a default contribution level means that some would save less than they would otherwise have done.

The contributions to the NPSS will be centrally collected, which will reduce the administrative costs of collecting pension contributions below that of typical individual private pensions. This would leave some employees better off.

ENDS

Notes to editors: